



1997 – 2002 – Financial Institution Failures

This study of financial institution company failures over the last five years should prove valuable to any practitioner that has clients in these areas. These statistics and the commentary that attaches to them may provide some insight into risk areas not previously considered. It goes without saying that we learn most from our failures and much can be learned from the failures of the companies in these industries.

Failures and the Practitioner

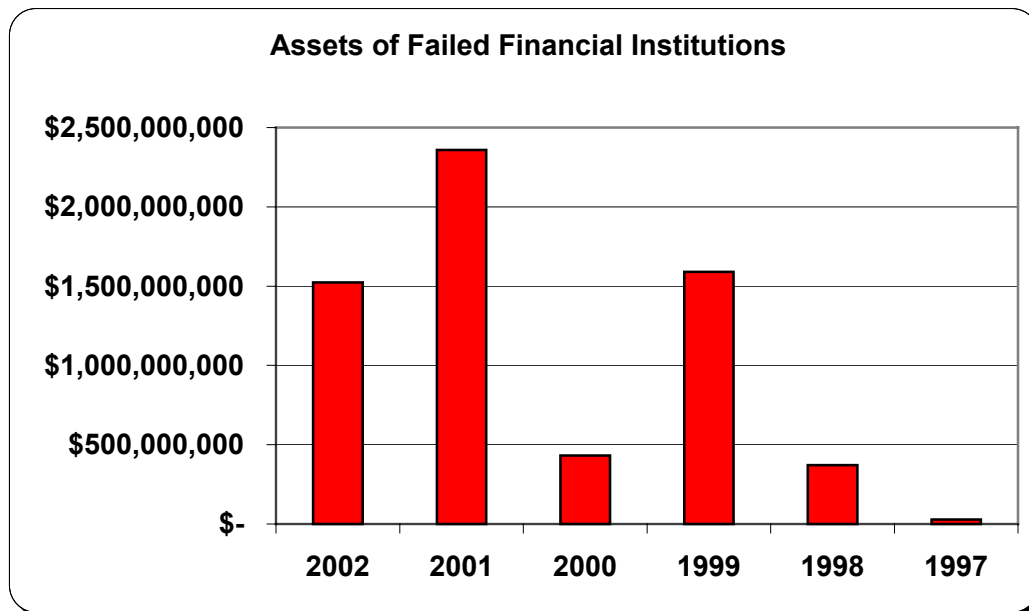
It is well known that when a company fails, goes bankrupt or is taken over by a regulator, one of the duties of the trustee or receiver is to determine whether there is a third party that is culpable for the company's demise. We at AccountingMalpractice.com monitor company failures for several reasons, three of which are:

1. To keep the practitioner abreast of trends in a particular industry,
2. To identify any malpractice suits that have arisen and,
3. Identify the root causes of the claimed malpractice.

Failures of Financial Institutions

Financial institution failures can represent some of the riskiest exposure areas for practitioners. While a repeat of the mid to late 80s and early nineties has not taken place, one needs to be very cautious. The value of commercial real estate investments and collateral is currently on the decline. The spread between loan and deposit rates is narrowing after many years of record differentials. Many large companies are failing and consumer credit is starting to show signs of increasing failure rates. Taken together, these factors and trends should cause a practitioner to remain on alert.

Graph 5



Lessons from the Largest Failure

The majority of assets of institutions that failed in 2002 so far related to the closing of Hamilton Bank NA (\$1.4 billion). According to a press release, “WASHINGTON -- Hamilton Bank, N.A., Miami, Florida, was closed today by the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation (FDIC) was appointed receiver

Information about the Hamilton Failure

According to the Comptroller of the Currency (“OCC”) the bank's board and management were not responsive to OCC efforts to address the bank's problems, beginning in 1998 when the OCC issued a safety and soundness notice to the bank. Because they were not addressed, the problems at Hamilton deepened and the bank entered into a Consent Cease and Desist Order with the OCC in 2000. The bank did not comply with provisions of the order and, in fact, willfully violated the order by failing to make its books and records available to the OCC. The bank also concealed material information from OCC examiners.

The OCC acted after finding that the bank, which had assets of \$1.3 billion at the time of its closing, was undercapitalized and suffered from deteriorating asset quality, poor earnings, a high level of non-performing loans and sharply declining capital levels. The bank's most recent examination showed that:

- Hamilton's condition had continued to deteriorate from the already unsatisfactory condition found in prior exams;

- The bank's management failed to make significant progress in addressing underlying problems and its board of directors failed to hold management accountable;
- The bank's capital was quickly being depleted because of loan and operating losses, and no plausible source of new capital was apparent;
- Asset quality was poor, primarily because of poor initial underwriting, poor borrower supervision, and poor identification of problem loans.
- Classified loans at the last examination increased to 151 percent of capital;
- The bank's reserve for loan losses and the method for calculating that reserve, was chronically inadequate;
- The bank concealed information from OCC examiners concerning some major assets and failed to make bank employees aware of information necessary to evaluate credits;
- The administration of liquidity was inadequate;
- Hamilton failed to comply with applicable enforcement actions; and Earnings, which had been poor in the past, declined precipitously in recent months;
- Losses from the first six months of 2001 amounted to 3.5 percent of the bank's assets;
- The OCC found that the multitude of problems at Hamilton had demonstrated six grounds under the Federal Deposit Insurance Act for appointing a receiver. The OCC found that Hamilton had:
 - Experienced a substantial dissipation of assets and earnings due to unsafe or unsound practices;
 - Been in an unsafe or unsound condition to transact business;
 - Engaged in unsafe or unsound practices and experienced conditions that were likely to cause substantial dissipation of assets or earnings, weaken the bank's condition and otherwise seriously prejudice the interests of the bank's depositors and the deposit insurance funds;
 - Concealed, or refused to submit for inspection, books and records;
 - Willfully violated a cease-and-desist order; and

- Failed to file an acceptable capital restoration plan within required timeframes, as required for an undercapitalized bank.”

Other Bank Failures

The majority of losses represented by the total assets for failed banks in 2001 arose from the failure of Superior Bank, FSB (total assets \$2.3 billion). According to the “STATEMENT OF JOHN REICH DIRECTOR FEDERAL DEPOSIT INSURANCE CORPORATION on THE FAILURE OF SUPERIOR BANK, FSB before the COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS U.S. SENATE, September 11, 2001

The primary reason for Superior's failure was the decision of its board and management to book high levels of retained interests related to the securitization of sub-prime assets. The retained interests were deeply subordinated, at a first loss position, to more senior claims on the more than \$4 billion in sub-prime loans that Superior sold to investors. Over the course of several years, Superior's retained interests represented an increasing multiple of its Tier 1 capital...Since 1998, failures of institutions with risk characteristics similar to those of Superior have cost the FDIC insurance funds more than \$1 billion. The failure of Superior again highlights the inherent volatility of retained interests... ***Finally, the failure of Superior highlights the role of the institution's accountants when their opinions are at odds with the regulators. Going forward, this is a serious public policy issue that must be addressed.***” According to another press release the SEC is investigating Superior’s accounting practices.

The above quote is indicative of how the FDIC perceives the role of auditors in financial institutions.

The majority of the other banks that failed during 1997 – 2002 were small. It is inevitable that a certain number of small institutions will fail substantially because they are subject to higher risks than larger banks, simply by the fact that they are small and cannot diversify their circumstances. Based on the information contained in the above graph a concise trend cannot be determined. The information provided on the two institutions above we believe is very useful to the practitioner.

Malpractice Cases

Other than several outstanding class actions suits, we are not currently tracking any accounting malpractice cases in this industry. For those that are interested, our malpractice case database on www.AccountingMalpractice.com does contain information related to at least thirty such cases. In addition, our database of court documents contains hundreds of cases against financial institutions covering a myriad of issues including mergers and acquisitions, director and officer claims and other competitive issues.