Failed Bank Review

Farmers and Merchants State Bank of Argonia | Argonia, Kansas

February 2018 **FBR-18-002**

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Federal Deposit Insurance Corporation
Office of Inspector General
Office of Program Audits and Evaluations

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Memorandum To: Doreen R. Eberley
Director, Division of Risk Management Supervision

From: /Signed/
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Subject **Failed Bank Review Memorandum** | Farmers and Merchants State Bank of Argonia | Argonia, Kansas | FBR-18-002

Background

On October 13, 2017, the Kansas Office of the State Bank Commissioner (KOSBC) closed Farmers and Merchants State Bank of Argonia (FMSB) and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver. According to the FDIC's Division of Finance and KOSBC documentation, the estimated loss to the Deposit Insurance Fund (DIF) was $2.6 million, and the grounds for appointing the FDIC as receiver were that the bank could not sufficiently recapitalize, liquidate its indebtedness, or resume business to the satisfaction of depositors and creditors.

FMSB was a $34.9 million, state-chartered, nonmember institution that operated from two offices comprised of the main bank in Argonia, Kansas, and a branch office in Wichita, Kansas. FMSB was established in 1901 and had been FDIC-insured since 1957. The bank served a rural community and emphasized local agricultural and commercial lending. FMSB was owned by a one-bank holding company.

This Memorandum examines whether the subject bank failure warrants an in-depth review.[1]

Causes of Failure

FMSB's failure stemmed from the Board of Directors' (Board) inadequate oversight of management's operations coupled with poor lending and loan administration practices. These practices resulted in the bank's critically deficient asset quality, poor earnings, and insufficient capital. In particular, the Chairman and President promoted over-lending to a large relationship, which violated the state legal lending limit and contributed to the bank's losses. Examiners deemed the bank to be critically deficient

[1] When the DIF incurs a loss under $50 million, Section 38(k) of the Federal Deposit Insurance Act (FDI Act) requires the Inspector General of the appropriate federal banking agency to determine the grounds upon which the state or federal banking agency appointed the FDIC as receiver and whether any unusual circumstances exist that might warrant an in-depth review of the loss. To conduct this review, we assessed key documents related to FMSB's failure, including the Division of Risk Management Supervision's (RMS) *Supervisory History* and the Division of Resolutions and Receiverships' *Failing Bank Case*. This review does not constitute an audit conducted in accordance with Generally Accepted Government Auditing Standards.

(rating of “5”) primarily because of a deterioration in this relationship.[2] A decline in agricultural commodity prices also contributed to the bank’s decline.

FDIC Supervision

Between 2012 and 2017, the FDIC and state regulators conducted five examinations and four visitations of FMSB. Examiners downgraded FMSB’s composite examination rating to “3” at the March 2016 examination and further downgraded its composite rating to “5” at the February 2017 examination. Examiners attributed the rapid decline in the bank’s condition to management’s lack of action to address previously identified weaknesses in the bank’s lending function, coupled with a decline in agricultural commodity prices. A visitation in July 2017 downgraded FMSB’s capital, liquidity, and sensitivity to market risk component ratings from “4” to “5,” resulting in a “5” for each of the component ratings and the composite rating. The FDIC notified FMSB that it was *Significantly Undercapitalized* in August 2017, and then *Critically Undercapitalized* in September 2017.[3]

The FDIC and state regulator imposed a Memorandum of Understanding (MOU) in June 2016, to address several examiner concerns, including FMSB’s management and staffing, capital levels, adversely classified assets, loans to problem borrowers, and credit concentrations. Examiners replaced the MOU with a Consent Order in July 2017, which reiterated the MOU’s concerns. In August 2017, the FDIC notified FMSB that it was noncompliant with the Consent Order because it did not submit a formal, proposed capital restoration plan.

The lack of proper oversight and inaction by the Board to address prior examination criticisms prompted RMS’ Kansas City Regional Office to consider civil monetary penalties (CMP) against the bank for violating the Consent Order and a removal action against the bank’s President.[4]

Conclusion

We determined that proceeding with an in-depth review of the loss is not warranted because we did not identify unusual circumstances in connection with the bank’s failure.

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[2] Financial institution regulators evaluate a bank’s performance in six components represented by the CAMELS acronym: **C**apital adequacy, **A**sset quality, **M**anagement practices, **E**arnings performance, **L**iquidity position, and **S**ensitivity to market risk. Examiners assign each CAMELS component and an overall, composite score, a rating of “1” (strong) through “5” (critically deficient), with “1” having the least regulatory concern and “5” having the greatest concern.

[3] Part 324 of the FDIC’s rules and regulations specifies five capital levels for banks ranging from *Well Capitalized* to *Critically Undercapitalized* (Title 12, Code of Federal Regulations, section 324).

[4] Section 8(i) of the FDI Act grants the FDIC authority to impose CMPs against institutions. CMPs may be assessed for violations of final and temporary orders, written agreements with the FDIC, and laws and regulations; unsafe and unsound practices; and breaches of fiduciary duty. CMPs are imposed to punish the wrongdoer and create a disincentive for such conduct by others who hold positions of trust at institutions. Section 8(e) of the FDI Act grants the FDIC authority to remove officials from the banking industry and prohibit them from participating in any affairs of any insured depository institution for life.