



Failed Bank Review

Louisa Community Bank | Louisa, Kentucky

April 2020

FBR-20-001



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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Assistant Inspector General for Program Audits and Evaluations

Subject | **Failed Bank Review Memorandum** | Louisa Community Bank |
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Background

On October 25, 2019, the Kentucky Department of Financial Institutions (KDFI) closed Louisa Community Bank (the Bank), and the Federal Deposit Insurance Corporation (FDIC) was appointed receiver. The Bank was a locally owned, state-chartered nonmember bank located in Louisa, Kentucky. The institution was established and became insured on August 7, 2006. The Bank had no holding company. According to the FDIC's Division of Finance, the estimated loss to the Deposit Insurance Fund (DIF) was \$4.5 million or 17 percent of the Bank's \$27.4 million in total assets. According to KDFI documentation, the Bank had "permitted capital to become impaired to a level which d[id] not permit the Bank to operate in a safe and sound manner" and, therefore, the KDFI took possession of and closed the Bank.

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

Causes of Failure

Based on the review of key FDIC documents, the Bank's failure resulted from an "ineffective and dysfunctional" Board of Directors (Board) and executive management that led to poor risk management practices, operational deficiencies, weak internal controls, and inaccurate accounting and reporting that adversely impacted every facet of the Bank.² The Board and executive management also failed to maintain adequate and qualified staffing in key management positions, and were unable to address the

¹ When the DIF incurs a loss under \$50 million, the Federal Deposit Insurance 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. 12 U.S.C. § 1831o(k).

² In conducting this review we assessed key documents related to the Bank'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.

many financial, managerial, operational, and regulatory issues that examiners started to identify in 2014. The Bank became unprofitable in 2015, followed by material operational losses and elevated credit losses that eroded capital levels and stressed liquidity.

FDIC Supervision

Between 2007 and 2012, the Bank was subject to six annual examinations, five onsite visitations, and quarterly reviews of the bank's progress reports and financial information. During that period, the Bank received a "3" composite rating at each of the annual examinations except in two instances—the initial full-scope examination dated July 9, 2007 and the examination dated October 29, 2012.³ The Bank was also subject to a Memorandum of Understanding (MOU) starting in 2008. In 2012, the FDIC upgraded the Bank's composite rating from "3" to a "2" because of management's efforts in addressing prior examination criticisms. The FDIC also terminated the MOU. However, in 2014, examiners found that the Bank's overall condition had declined.

In 2014, while financial metrics were stable, examiners downgraded both the Management component rating and composite rating from a "2" to a "4" due to deficient internal controls and inadequate risk management practices. Examiners also reported that since the 2012 examination, the Bank's President/Chief Executive Officer and Operations Officer had left the Bank and were not adequately replaced. The FDIC's supervisory strategy included (i) issuing a Consent Order, which became effective December 11, 2014; (ii) performing annual examinations; (iii) conducting on-site visitations every 6 months; and (iv) undertaking quarterly reviews of the Bank's progress reports and financial information.

Between 2015 and 2019, the Board and management did not demonstrate the ability or willingness to correct problems. Consequently, examiners progressively downgraded the component ratings of Capital, Management, Liquidity, and Sensitivity to market risk. In 2015 and 2016, credit administration and underwriting practices deteriorated significantly and problem assets began to rise. The FDIC issued revised Consent Orders on January 29, 2016, August 18, 2016, and May 3, 2017, to address examination findings. The Bank's financial condition continued to worsen in 2017 and 2018. Examiners downgraded the Bank's composite rating from a "4" to a "5" in 2017.

In 2019, capital depletion accelerated from continued operating and loan losses at the Bank. The FDIC notified the Bank that it was *Undercapitalized* based upon the Bank's filing of its March 31, 2019 Consolidated Reports of Condition and Income.⁴ The Bank became *Significantly Undercapitalized* on April 30, 2019 and *Critically Undercapitalized* on July 31, 2019.

³ 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.

⁴ The FDIC's rules and regulations specify five capital levels for banks ranging from *Well Capitalized* to *Critically Undercapitalized* (12 C.F.R. §324.403).

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.