Office of Inspector General

Failed Bank Review

Ericson State Bank | Ericson, Nebraska

August 2020 **FBR-20-002**

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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** | Ericson State Bank | Ericson, Nebraska | FBR-20-002

Background

On February 14, 2020, the Nebraska Department of Banking and Finance (NDBF) closed Ericson State Bank (the Bank), and the Federal Deposit Insurance Corporation (FDIC) was appointed receiver. The Bank was a state-chartered nonmember Bank located in Ericson, Nebraska. Wheeler County Bancshares, Inc., a one-bank holding company, owned 1,999 shares or 99.95 percent of the institution's outstanding common stock. According to the FDIC's Division of Finance, the estimated loss to the Deposit Insurance Fund was $14.1 million or 14 percent of the Bank's $100.9 million in total assets. According to NDBF documentation, the NDBF took possession and closed the Bank because the Bank was insolvent, operated in an unsafe and unauthorized manner, and lacked prospects for a capital injection.

This Memorandum examines whether the subject bank failure warrants an In-Depth Review.[1]

Causes of Failure

Based on our review of relevant FDIC documents, the failure can be attributed to a critically deficient Board of Directors (Board) and poor Management oversight.[2] The Bank President exercised unrestrained dominance over the Bank's operations, including the lending function. Specifically, 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. § 1831*o*(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*, the Division of Resolutions and Receiverships' *Failing Bank Case*, and examination reports issued from 2015 to 2019. This review does not constitute an audit conducted in accordance with Generally Accepted Government Auditing Standards.

Bank President serviced loans associated with entities owned by his son (related-entity lending); extended funds to these related entities without seeking Board-required Loan Committee approval; and did not obtain proper documentation to support the credits. The related-entity lending commenced in 2014, growing from $251,000 to $7.2 million by the time of the FDIC examination in 2019. The Bank President also knowingly advanced funds beyond the Nebraska Legal Lending Limit.[3] These activities resulted in losses that eroded the Bank's capital.

The erosion of capital ultimately impacted the Bank's liquidity position, because Management's funding strategy relied on brokered, listing service, and high-rate deposits. Financial institutions that are deemed to be less than *Well Capitalized*[4] are subject to certain restrictions, including the use of brokered deposits under Section 29 of the FDI Act and Part 337.6 of the FDIC Rules and Regulations. Consequently, as the Bank's capital position eroded, the Bank's liquidity position became critically deficient, which directly impacted the viability of the Bank.

FDIC Supervision

After the Bank began related-entity lending in 2014, examiners rated the Bank as a composite "2" from 2015 through 2017.[5] The FDIC conducted an examination in 2016, and the NDBF conducted examinations in 2015 and 2017. The FDIC's 2016 examination report included concerns about the related-entity loans and risk management practices, but the examiners concluded that the Bank was taking corrective actions to address these concerns. However, in 2019, examiners found that Management had not been responsive to previous regulatory recommendations. Significantly, examiners found that the Bank President failed to correct deficiencies associated with the related-entity lending. Further, subsequent to the 2016 FDIC examination, the Bank President extended substantial under-secured funds to those related entities.

Given its findings at the 2019 examination, examiners concluded that Board and Management performance were "critically deficient" and downgraded the Management component rating from a "2" to a "5". Examiners downgraded the Bank's composite rating from a "2" to a "4". The examination report stated that the Board of Directors had failed in its duty to provide adequate supervision of the Bank's affairs and allowed the Bank President to operate the Bank's lending and funds management functions without regard for prudent banking policies and practices, laws, and regulations. Further, the report noted that Management's poor loan underwriting and administration practices significantly contributed to the Bank's high-risk profile and resulted in a severely underfunded Allowance for Loan and Lease

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[3] According to the Nebraska Banking Act, "no bank shall directly or indirectly loan to any single corporation, limited liability company, firm, or individual, including in such loans all loans made to the several members or shareholders of such corporation, limited liability company, or firm, for the use and benefit of such corporation, limited liability company, firm, or individual, more than twenty-five percent of the paid-up capital, surplus, and capital notes and debentures or fifteen percent of the unimpaired capital and unimpaired surplus of such bank, whichever is greater." Neb. Rev. Stat. § 8-141 (2017).

[4] FDIC regulation specifies five capital levels for banks ranging from *Well Capitalized* to *Critically Undercapitalized*. 12 C.F.R. Part 324 (2018).

[5] 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 sufficiency, **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 supervisory concern and "5" having the greatest concern.

Losses (ALLL).[6] Additionally, liberal use of payment extensions, often without the collection of interest, understated past-due and nonaccrual loans and overstated earnings. Examiners noted that prudent care must be exercised when extending credit, as these extensions have a dollar-for-dollar impact on available liquidity reserves and exacerbate the liquidity challenges facing the institution.

The Bank became *Adequately Capitalized* as a result of the 2019 examination findings. Consequently, the Bank's ability to accept or renew brokered and high-rate deposits it relied on for funding became restricted. To address the issues identified in the examination, the FDIC issued a Consent Order that became effective September 30, 2019. On January 6, 2020, the FDIC visited the Bank to ascertain Management's progress in complying with the Consent Order and addressing asset quality and liquidity deficiencies outlined in the FDIC examination of April 2019. Examiners identified approximately $5 million in additional losses since the prior examination, of which $3 million was attributable to the related-entities relationship.

On January 15, 2020, the FDIC advised the Board that based on the preliminary results of the ongoing visitation, the Bank would need to expense a significant provision to account for loan losses and to fund the ALLL. Because of the Bank's depleted capital position, the FDIC determined that it was *Significantly Undercapitalized*. FDIC officials notified the Bank that it was in imminent danger of failing and required attention to enhance its capitalization and liquidity positions. On February 14, 2020, the NDBF closed the Bank, and the FDIC was appointed receiver.

Conclusion

We determined that unusual circumstances existed related to the escalation of the Bank President's actions in extending funds to related entities owned by his son without proper documentation and support and knowingly advancing funds beyond the Nebraska Legal Lending Limit. According to the FDIC, this related-entity lending did not pose substantial risk to the Bank until after the FDIC's 2016 examination. During the next FDIC examination, in 2019, the FDIC identified the risk, and examiners concluded that Board and Management performance were "critically deficient" and downgraded the Bank's composite rating from a "2" to a "4". Given the FDIC identified the risk and took action to address it in 2019, the unusual circumstances do not warrant an In-Depth Review of the loss.

[6] The purpose of the ALLL is to reflect estimated credit losses within a bank's portfolio of loans and leases.