Failed Bank Review

The First State Bank | Barboursville, West Virginia

November 2020 **FBR-21-001**

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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

/Signed/

From: Terry L. Gibson
Assistant Inspector General for Program Audits and Evaluations

Subject **Failed Bank Review Memorandum** | The First State Bank | Barboursville, West Virginia | FBR-21-001

Background

On April 3, 2020, the West Virginia Division of Financial Institutions (WVDFI) closed the First State Bank (FSB) and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver. FSB was a locally owned, state-chartered nonmember bank located in Barboursville, West Virginia, that the FDIC first insured on May 14, 1934. FSB was wholly owned by First Bancshares, Inc., a single bank holding company. The bank President and Chief Executive Officer's (CEO) family controlled 82 percent of Bancshares' common stock and Bancshares' Employee Stock Ownership Plan (ESOP) owned the remaining 18 percent of common stock.

According to the FDIC's Division of Finance, the estimated loss to the Deposit Insurance Fund was $47 million or 30 percent of the bank's $156 million in total assets. The WVDFI took possession and closed FSB, because it had experienced longstanding capital and asset quality issues, was substantially impaired (as of March 11, 2020),[1] and had become insolvent.[2]

This Memorandum examines whether the subject bank failure warrants an In-Depth Review.[3]

[1] The WVDFI Commissioner deemed FSB's equity capital level substantially impaired on March 11, 2020.
[2] According to W. VA Code §31A-7-2(e), (f), a financial institution is insolvent when it is unable to pay its debts to its depositors and other creditors in the ordinary and usual course of business or when it is in a state of balance sheet insolvency (the assets of the financial institution are less than its liabilities, exclusive of capital). W. VA Code §31A-7-4(a) mandates that the Commissioner appoint a receiver whenever the Commissioner ascertains that a financial institution is insolvent.
[3] 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 identified by the state or federal banking agency for appointing the FDIC as receiver and whether any unusual circumstances exist that might warrant an in-depth review of the loss. Section 38(k)(5) of the Federal Deposit Insurance Act (FDI Act), 12 U.S.C. § 1831*o*(k)(5).

Causes of Failure

Based on our review, we believe that the failure occurred because of a critically deficient Board of Directors (Board) and poor management oversight. Management was unable to correct deficiencies noted in prior FDIC and WVDFI examinations, resolve problem assets, address the terms of an FDIC Consent Order in a timely manner, and obtain sufficient capital to operate the bank as a going concern.[4] The bank's President and CEO was a dominant policy-making official primarily responsible for strategic planning, regulatory responses, and raising capital. He exerted considerable influence over family members who comprised a large portion of the bank's executive staff. Prior to FSB's closing, the FDIC was considering various actions against management, including a Prompt Corrective Action (PCA)[5] dismissal against the bank President and CEO.

The bank's high level of problem assets and management's inability to resolve them ultimately eroded earnings and depleted the bank's capital.[6] Financial institutions deemed less than *Well Capitalized* 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 earnings position eroded, its capital position became critically deficient, directly impacting the viability of the bank. By December 31, 2019, FSB's capital levels became too low to allow for continued operations.

FDIC Supervision

According to the FDIC's Supervisory History, FSB's primary lending focus was residential rental properties and subdivision development. At the beginning of the economic recession in 2008, FSB began to expand its commercial lending program, but did so without proper underwriting, expertise, and oversight. Accordingly, examiners downgraded the Asset Quality component to a "3" rating[7] during the examination in September 2008.

FSB received Composite 2 ratings from 1994 until 2012. On November 26, 2012, the State examination downgraded the bank to a Composite "3" rating. At that time, examiners deemed Board and management oversight less than satisfactory. The Board and management failed to adequately identify, manage, monitor and control risk within the bank, and failed to address previously identified concerns regarding credit underwriting and administration practices. During this same examination, the WVDFI also uncovered a potential loan fraud scheme perpetrated by a former Vice President and

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[4] 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.

[5] Section 38 of the Federal Deposit Insurance Act provides the FDIC with the authority to resolve the problems of insured depository institutions at the least possible long-term loss to the Deposit Insurance Fund. The Act authorizes the FDIC to take actions based on five capital levels for banks ranging from ***Well Capitalized*** to ***Critically Undercapitalized.*** 12 U.S.C. 1831*o*.

[6] As of March 31, 2019, FSB's Adversely Classified Items (ACI) coverage ratio was 641 percent. The ACI coverage ratio is a calculation of Adversely Classified Items divided by Capital plus the Allowance for Loan and Lease Losses (ALLL). The ACI coverage ratio is a measure of the credit risk and ability of capital to protect against that risk. A higher ratio indicates exposure to poor quality assets and less ability for the bank's capital to absorb any losses associated with those assets.

[7] Financial institution regulators evaluate a bank's performance in six components represented by the CAMELS acronym: **C**apital adequacy, **A**sset quality, **M**anagement capabilities, **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.

Commercial Loan Officer. This former Vice President and Commercial Loan Officer was indicted in September 2013 on six counts of bank fraud and the misapplication of bank funds.[8] While the fraud scheme contributed to FSB's financial deterioration, deficient Board oversight and weak risk management were the primary factors.

Between 2013 and 2015, examiners found that the overall condition of the bank continued to worsen. By January 2015, the FDIC and WVDFI considered FSB to be deficient, thus downgrading its composite rating from a "3" to a "4." The examiners noted that poor management oversight remained prevalent, losses from the fraud scheme continued to surface, and credit underwriting weaknesses were persistent. To address the issues identified in the examination, the FDIC and WVDFI issued a Consent Order that became effective on November 10, 2015. The Consent Order required among other things that FSB's Board increase its participation in the affairs of the bank and the bank maintain a leverage ratio[9] of no less than 8 percent and a total capital ratio[10] of no less than 12 percent. The Consent Order also restricted FSB from accepting or renewing brokered deposits and prohibited payments and dividends to its holding company.

In 2016, the examiners found that the institution continued to deteriorate and represented a significant regulatory concern. Capital and earnings were critically deficient and FSB's sensitivity to market risk remained elevated due to its overall financial condition. As a result, examiners downgraded the composite rating of FSB from a "4" to a "5".

In 2017, examiners determined FSB was noncompliant with the Consent Order and downgraded the Management component from a "4" to a "5" due to the bank's inability to generate additional capital and bring material improvements to the overall condition of FSB. In 2018, examiners identified that FSB remained substantially noncompliant with the Consent Order, noting that its inability to address the provisions of the Consent Order had resulted in the continuing deterioration of FSB's already critical financial condition and threatened the viability of the bank. FSB's capital category for PCA purposes fell to *Undercapitalized* in September 2018, requiring the bank to establish a Capital Restoration Plan and submit it to the FDIC for approval.[11]

In May 2019, the FDIC conducted a joint visit with the WVDFI, concluding that FSB remained critically deficient and was a serious supervisory concern. Examiners determined that operating losses continued to erode already deficient capital levels, resulting in a *Significantly Undercapitalized* designation. In September 2019, the FDIC and WVDFI conducted a joint examination, which reflected that the overall condition continued to be critically deficient. Based on the examination findings, the examiners considered the institution to be *Critically Undercapitalized* for PCA purposes. Additionally,

[8] The former Vice President and Commercial Loan Officer ultimately plead guilty. He was sentenced on September 14, 2014 to five years in prison and ordered to pay $1.42 million in restitution.

[9] The leverage ratio is the ratio of the FDIC-supervised institution's tier 1 capital to the FDIC-supervised institution's average total consolidated assets as reported on the FDIC-supervised institution's Call Report minus amounts deducted from tier 1 capital under 12 C.F.R. § 324.22(a), (c), and (d). 12 C.F.R. § 324.10.

[10] The total capital ratio is the ratio of the FDIC-supervised institution's total capital to standardized total risk-weighted assets. 12 C.F.R § 324.10.

[11] FSB submitted its Capital Restoration Plan to the FDIC on December 17, 2018. The FDIC rejected the plan on February 1, 2019 noting that it did not contain sufficient information to support the capital ratios provided, did not appear realistic, and did not reconcile with FSB's 2019 budget. The FDIC requested that FSB submit a revised plan within 30 days.

examiners determined that FSB had never achieved compliance with the capital provisions of the Consent Order and that a capital injection of at least $9.8 million was required to do so. On April 3, 2020, the WVDFI closed FSB and appointed the FDIC as receiver.

Conclusion

FSB was the victim of an employee fraud scheme discovered in 2012 that impacted its financial condition. However, as identified in multiple FDIC examinations conducted from 2012 through 2019, the Board's oversight of the bank was also deficient and the bank's risk management practices were poor. FSB's Board and management failed to execute actions and address recommendations to improve FSB's safety and soundness, its capital levels and liquidity continued to decline, and the bank ultimately failed. We concluded that no unusual circumstances exist that warrant an In-Depth Review of the loss.