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LESSONS IN RISK:

The Surprising Similarities Between Historic & Contemporary Bank Failures and What They Mean for Your Institution

By Rafael DeLeon

EXECUTIVE SUMMARY

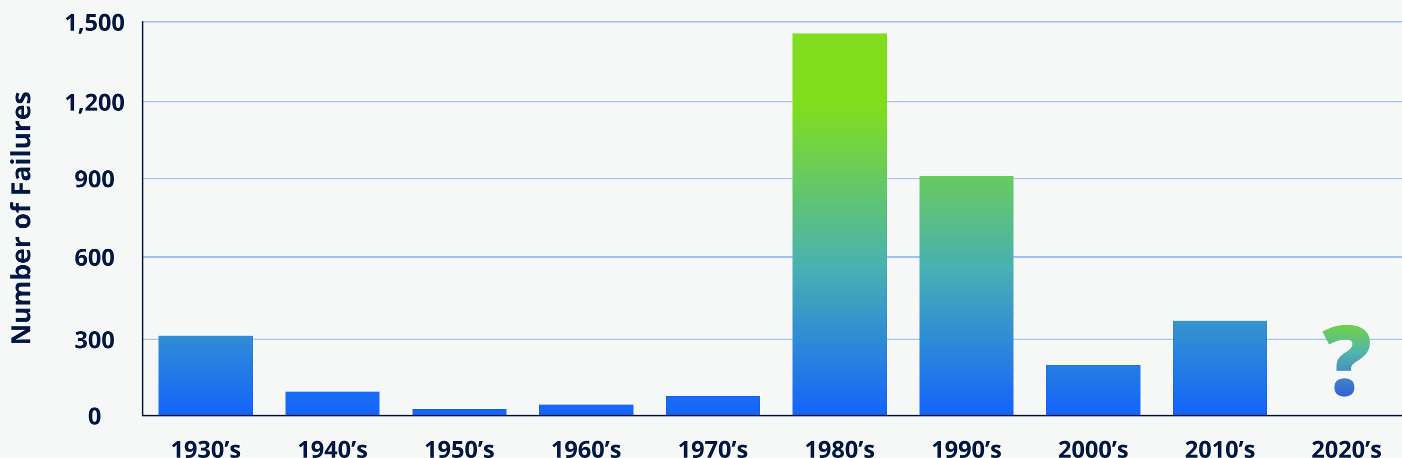
You know the cliché: those who don't learn from history are doomed to repeat it. It applies to everyone, including financial institutions.

There's a lot to learn from the failures of financial institutions – and the common themes that connect the failures of the past with more recent failures and the challenges all financial institutions face today.

There have been more than 3,500 bank failures since the 1930s – the overwhelming majority since the 1980s. While the details vary from institution to institution, the answer comes down to anxiety for income and risky behavior. These are institutions that failed because they pursued profits and neglected risk.

What happened to make these institutions feel anxious about income? Where did they go wrong? From the savings and loan crisis to today's operating environment – brimming with interest rate, credit, and liquidity risk, among many others – the details vary but the big picture stories are surprisingly similar.

This whitepaper offers a history lesson for bankers. Highlighting both historic and recent bank failures, we'll show you what went wrong, so you can avoid the catastrophic consequences of poor risk management and learn from the mistakes of the past.



\# OF FAILURES BY DECADE

THE COLLAPSE OF CONTINENTAL ILLINOIS: HOW CONCENTRATED IS YOUR RISK?

In the early 1980s, Continental Illinois National Bank & Trust, with $42 billion in assets, was not only the best bank to invest in—it was among the best companies on the exchange due to its rapid growth.

While other banks' stock prices barely budged during stagflation, Continental Illinois doubled its share price from $13 to $27 over five years from 1974 to 1979.

What investors didn't know was that Continental was overexposed to oil and gas loans purchased from a "freewheeling" Oklahoma City bank—Penn Square. When OPEC imposed an oil embargo in 1974, American energy producers went to work. Banks like Penn Square showered money on the domestic oil and gas industry.

The nominal price of a barrel of oil quadrupled in six years from 1974 – 1980 before beginning a steep decline. Domestic oil producers went from thriving to being unable to repay their loans by the mid-1980s. Losses in Continental Illinois' once high-growth portfolio of energy loans jumpstarted a run as investors caught wind of its deterioration.

When the FDIC seized Continental in 1984, it was the seventh-largest commercial bank in the United States. At the time, its failure was the most expensive in American banking history. How did the first megabank fail?

Continental Illinois collapsed because its board and leaders ignored concentration risk, becoming overleveraged in oil and gas.

Think it can't happen today? In November 2023, Citizens Bank in Sac City, Iowa, with $66 million in assets, failed when $14.8 million in loans to commercial trucking companies went south.

Over the past several years, the trucking industry has been anything but stable. Depreciation in the value of trucks combined with high diesel prices have caused many commercial trucking companies to fail.

Unfortunately, Citizens Bank overextended on loans to fledgling out-of-state commercial trucking businesses, according to a statement from the superintendent of the Iowa Banking Division.

While the size and scope of Citizens Bank's failure does not live up to Continental, it's had a huge impact on bank leadership, employees, and the 2,000 residents of Sac City who relied on their community bank.

Lessons from Continental Illinois' collapse demonstrate the importance of maintaining a diversified lending portfolio and implementing

robust risk controls. Community banks and credit unions may find controlling concentration risk more difficult than megabanks. In serving their communities, smaller financial institutions need to account for risks in any new market they enter—in the example of Citizens Bank, out-of-state loans to commercial trucking companies.

If smaller and mid-sized FIs conduct lending activities in a relatively concentrated niche, they must build a risk control environment that accounts for potential perils impacting a particular industry or business sector. An institution heavily focused on agricultural loans closely follows the weather report.

Before investing in an industry or geographic location, banks and credit unions need a thorough understanding of the risks involved.

THE S&L CRISIS: WHAT HAPPENS WHEN CRE COLLAPSES?

Savings and loan associations (S&Ls), or thrifts, trace their origins back to 18th century England where they were created to help the British working class save money for homes and their future. American S&Ls shared the same fundamental goal—to provide loans to borrowers traditionally underserved by larger commercial banks.

S&Ls played a prominent role in the post-WWII housing boom, helping to finance the construction and purchase of new homes. (The fictional Bailey Brothers Building and Loan from the film "It's a Wonderful Life" is the most iconic example of a thrift.)

In the early 1980s, many S&Ls began to experience problems with rising borrowing costs. After over a decade of ignoring chronic inflation, Paul Volcker's Fed dramatically raised interest rates. These hikes plunged the U.S. economy into a recession.

S&Ls were in a poor position to handle higher borrowing costs: they paid for long-term, fixed-rate mortgages with short-term deposits.

As the interest rate rose, so did cost of funds, putting S&Ls in a precarious position.

With higher interest rates threatening their profitability, S&Ls took on riskier investments. Government deregulation, intended to take pressure off S&Ls, allowed them to venture into commercial real estate (CRE) and high-yield junk bonds.

Credit deterioration in both CRE and junk bonds would end in disaster with the failure of more than 1,000 S&Ls by the decade's end.

Many banks and credit unions face similar struggles in today's high-rate environment.

Silicon Valley Bank collapsed in March 2023 after failing to manage interest rate risk. Following years of low interest rates, the $212 billion-asset bank parked money in seemingly low-risk (and higher-yield) Treasuries.

When the Fed began raising rates, the bank soon held unrealized losses in its bond portfolio of $21 billion. Eventually, news about the bank's losses rippled through the tech community, and investors began rapidly withdrawing money, quickly leading to insolvency.

High interest rates create other challenges for financial institutions. When interest rates are high, financial institutions encounter borrowers who are reluctant to take out new loans and refinance existing ones at higher rates. Borrowers with variable-rate mortgages may struggle to repay, increasing an FI's credit risk.

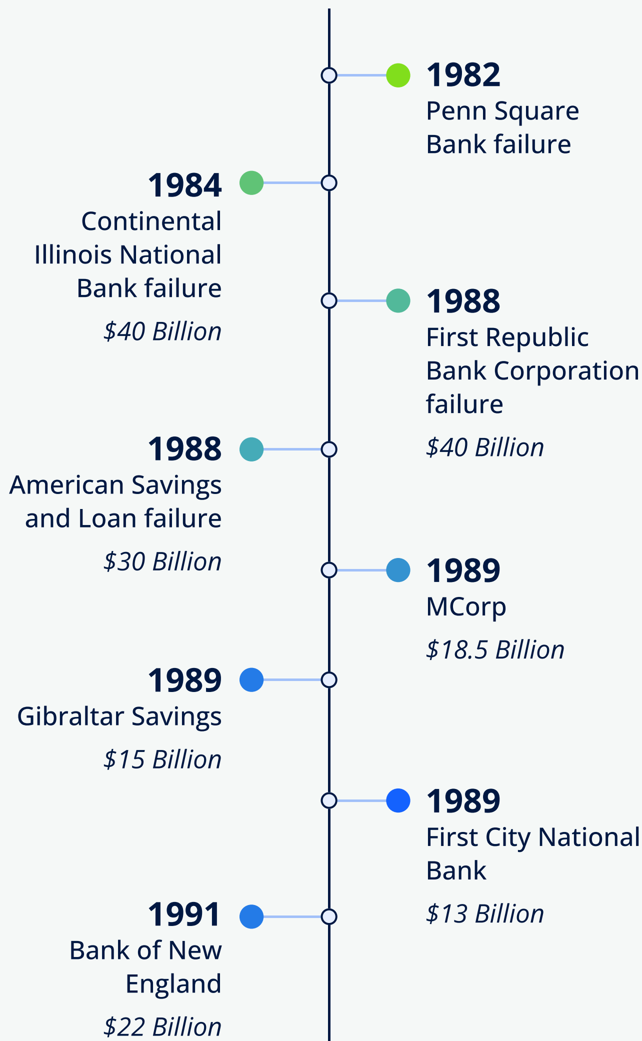
With interest rates at a 23-year high today, financial institutions are experiencing lower net margins and higher cost of funds. Growing core deposits is a vital concern to many FIs, but accomplishing this is easier said than done.

The looming threat is commercial real estate (CRE), particularly for small and mid-sized banks, which hold two-thirds of commercial real estate loans nationwide. CRE vacancy rates surged during the pandemic as many businesses went under or closed locations. Recent trends in remote work have added pressure to the market. As Berkshire Hathaway's Charlie Munger remarked: "The buildings don't go away…but the owners do."

The combination of higher interest rates and a weakened CRE market may push financial

institutions to seek innovative ways to maintain profits. But as we learned from the S&L crisis, diversifying revenue streams in response to interest rate hikes and deteriorating assets requires strong risk controls.

MAJOR BANK FAILURES: 1980-2000



THE 2007 FINANCIAL COLLAPSE: BANKING'S MAJOR LESSON

"Not every business cycle has a financial crisis. Frequently they do." Kenneth Arrow, Economist

Capitalist economies experience a contraction about every six years. While not every recession results in (or from) a financial crisis, the two frequently go hand in glove. The causes of the Great Recession of 2008 are well known:

- Lax lending standards for residential real estate—the so-called NINJA (no income, no job, no assets) loans to borrowers without the means to repay them
- Wall Street's hunger for mortgage-backed securities (MBSs) to sell to investors
- Collateralized mortgage obligations (CMOs) that broke mortgage-backed securities into tranches of risk traded in a shadow banking economy with little regulatory oversight
- Rating agencies that significantly undervalued the risk of these CMOs
- A decade-long low-interest rate environment that encouraged greater financial speculation

When the Fed began raising rates in 2004 to calm an inflationary housing market, it took three years before the housing bubble burst. From 2004 - 2007, housing prices continued to rise, enabling borrowers, especially those with subprime adjustable-rate mortgages (ARMs), to continue to refinance their mortgage debt.

But eventually, rates climbed high enough that borrowers couldn't afford the new, higher payments on their ARMs. Millions of homeowners defaulted, and once-celebrated mortgage giants like Countrywide and New Century Financial, which promised millions the American Dream of homeownership, became household names for the wrong reasons as they declared bankruptcy.

Mortgage-backed securities backed by NINJA loans became worthless.

Plummeting prices on these risky mortgage-backed securities pulled down the value of perceived safe MBSs held by large investment banks, including Lehman Brothers and Bear Stearns. Desperate to sell off these now "toxic" assets, banks discovered they had no willing buyers. The most prominent financial institutions sold bundled mortgage securities with a riskier profile to buyers eager for large returns, keeping AAA-rated MBSs on their books.

But as the bubble in the housing market spread, even those securities that had been rated AAA by agencies such as Fitch and Standard & Poor's lost value at a startling rate. After months of turmoil, Lehman Brothers declared bankruptcy in 2008.

The collapse of Lehman Brothers sent the Dow Jones on a death spiral – the index lost 500 points in a single day. Reverberations from the housing market crash were felt throughout the global economy, and the United States went into the most prolonged and deepest economic downturn since the Great Depression.

Congress passed the Troubled Asset Relief Program (TARP) for $700 billion to bail out large investment banks and injected another $800 billion into the American economy through the American Recovery and Reinvestment Act of 2009. The Fed slashed interest rates to 0%.

It wasn't enough. The unemployment rate peaked at 10% during Obama's first year in office. Fifteen million Americans lost their jobs. The retirement portfolios of many Americans dropped by 30% or more and wouldn't fully recover until 2012. Over six million Americans lost their homes due to foreclosure.

In response to poor underwriting standards by mortgage brokers and unsound risk management practices by banks, Congress passed Dodd-Frank in 2010 to curb excessive speculation and bring the derivatives market – where banks swapped trillions in collateralized debt obligations without government oversight – out of the shadows. The law also created the Consumer Financial Protection Bureau (CFPB) to protect borrowers from so-called "predatory" lending practices and to address the shadow banking system.

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The trauma of the 2007 financial collapse continues to haunt us. As late as August 2023, the Swiss bank UBS finally settled its last lingering fraud case from 2008 for $1.4 billion. Regulatory authorities contend that large investment banks made false statements about the value of mortgage-backed securities. Additionally, many penalties against financial institutions after 2008 stemmed from their supposed knowledge of poor underwriting standards in the mortgages backing bonds, violating consumer protection laws.

Fraud plays a pivotal role in nearly every financial crisis. The head of Continental Illinois' lending division for oil and gas faced indictment in 1984 for kickbacks from companies extended credit. Charles Keating became the poster child for 1980s financial malfeasance when he took Lincoln Savings and Loan Association from a sleepy mortgage broker to a $5 billion enterprise that illegally redirected money from FDIC-insured accounts into risky CRE developments.

Fraud and domineering CEOs like Keating have been behind many recent small and mid-sized banking failures.

WHAT CAUSES FINANCIAL INSTITUTIONS TO FAIL?

What common themes can we draw from the past 40 years of failing financial institutions and those of today? Let's examine some recent examples.

Pressure to Perform: In 2019, $22 million-asset Resolute Bank failed after it ventured into the origination and sale of government-backed and guaranteed mortgage loans without adequate capitalization or a sound strategic plan. The bank sought to grow profits but lacked the oversight and controls to manage new products. Like many of the S&Ls of the 1980s, Resolute was unprepared from a risk management perspective to move into another business line.

Poor Asset Management: The insolvency of City National Bank of New Jersey in the same year resulted from poor asset quality. The $120 million-asset bank suffered from an excess of non-performing loans and lacked the capital cushion to absorb losses from its portfolio. The question small and mid-sized FIs need to pose to themselves is: Do we have the capital to suffer a negative economic shock to any aspect of our lending portfolio?

Unforeseen Events: Following the collapse of SVB, Signature Bank in New York was shut down by federal regulators in March 2023. Among the reasons for Signature's sudden fall was its overexposure to cryptocurrencies and the implosion of FTX. More than 25% of Signature's deposits were crypto-based. Like the sudden plunge in oil and gas prices in the early and mid-1980s, the declining value of cryptocurrencies and Signature's overexposure to them caused the $110-billion giant to crumble.

Fraud and Arrogance: The story behind many recent bank failures frequently comes down to outright fraud, arrogance, and ineffectiveness by banking leaders.

- **Almena State Bank, Kan.** ($70 million in assets, 2020) – Although Almena State Bank suffered from poor governance and managerial oversight, it also fell victim to a $2 billion check-kiting and fraud scheme by owners of a local livestock barn.
- **Ericson State Bank, Neb.** ($100 million in assets, 2020) – The president of Ericson State Bank exercised excessive control over the financial institution's operations, particularly lending. The president managed loans related to his son's businesses, distributed funds to these entities without approval from the loan committee and failed to document and substantiate these loans.
- **Louisa Community Bank, Ky.** ($29 million in assets, 2019) – FDIC documents reveal that Louisa Community Bank's collapse can primarily be attributed to an ineffective Board of Directors and poor executive management.

Then there is the sad story of Heartland Tri-State Bank in Elkhart, Kansas. Shan Hanes, the 52-year-old CEO of Heartland and a respected community leader, was duped by a scammer who claimed he could help the bank profit through cryptocurrency investments in Hong Kong.

The Kansas Office of the State Bank Commissioner shut down the bank in July 2023 after an employee went to the board, alerting them that Hanes wired $12 million to the criminal(s). While details of this $139 million-asset bank scam are unknown, the devastation to the 1,800 people who call Elkhart home goes beyond FDIC deposit insurance.

When small and mid-sized community banks and credit unions fail, their insolvency may not threaten the entire financial system—but it devastates the people they serve.

THE FUTURE STATE OF RISK MANAGEMENT

Banking is by nature risky. Lending out money and counting on borrowers to repay it requires careful analysis and decision making

The same is true for other aspects of banking. These failures remind us that banks and credit unions need to look beyond the walls of their institution and their community to truly understand risk – and the myriad factors that impact an institution's performance and ability to survive choppy waters.

The common denominator among these failures is poor risk management. These institutions did not fully consider the risks of their strategies and decisions. They did not have controls to identify and quickly respond to changes in the risk environment.

Going forward, the banks and credit unions that embrace dynamic and flexible risk frameworks are the ones that will thrive. Needing longer sightlines is nothing new for the banking industry, but assessing long-term risks in any business climate presents challenges.

After all, who could have anticipated a global pandemic would lead to 9% inflation?

Robust risk management systems are necessary for financial institutions looking to align their internal controls, IT systems, and employees. Having risk management at the forefront of your institution's activities goes beyond simple compliance. It's about having tools to understand and respond to market risk, operational risks, interest rate risk, cyber risk, compliance risk, third-party risk management, and the other risks that require attention.

Creating a risk management, governance, and compliance (GRC) culture puts FIs in an optimal position to seize strategic opportunities and profit.

As financial institutions seek out new opportunities, they must weigh the potential risks as well as the rewards. Maybe it's a new and profitable business line. Perhaps it's partnering with a fintech to provide P2P lending for a steady income stream. The only way these initiatives will be successful is if the institutions involved have the risk control environment to actualize their ambitions.

> *Creating a risk management, governance, and compliance (GRC) culture puts FIs in an optimal position to seize strategic opportunities and profit.*

The way forward for financial institutions is clear. Focus on the resiliency of your institution. Ensure that you're doing the right thing, not simply settling for a pat on the back from examiners. Heighten your expectations and recognize the importance of governance in risk management.

There is no reason why your institution needs to repeat the mistakes of failed institutions. Your institution can prevail in the face of uncertainty by effectively managing risk.

ABOUT THE AUTHOR

Rafael DeLeon is a banker's dream—an extroverted former financial regulator eager to share what he's learned about regulatory compliance and risk management at financial institutions over his 30-year career. A frequent contributor to industry publications, he is a sought-after industry speaker and thought leader.

Prior to joining Ncontracts, Rafael oversaw educational programs for bankers and bank directors and provided counsel to senior agency officials about banking industry issues and outreach as Director for Banking Relations at the Office of the Comptroller of the Currency (OCC). He was also an OCC National Bank Examiner, trainer, and industry analyst for over 30 years.

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ABOUT NCONTRACTS

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