1 Introduction to financial institutions

Benton E. Gup

Financial institutions defined
In general terms, financial institutions are organizations whose principal function is managing the financial assets of business concerns and individuals. They bring savers and borrowers together by selling securities and services to savers, and then lending (or investing) those funds to borrowers. It is obvious that banks are financial institutions. But it is not obvious that casinos or card clubs are considered financial institutions under the Bank Secrecy Act and anti-money laundering (BSA/AML) laws in the United States.¹ This book is not about money laundering, but the BSA/AML laws provide another definition of financial institutions.

The term “banks” is used in the broad sense of the word. It includes commercial banks, all of the subsidiaries of Bank Holding Companies, Edge and Agreement corporations, US branches and agencies of foreign banks, savings and loan associations, and credit unions.

Other types of financial institutions include, but are not limited to:

- All federally regulated securities brokers, dealers, and investment companies.
- Insurance companies offering selected products.
- Money service businesses (MSBs, currency dealers or exchangers; check cashers, issuers of travelers’ checks, money orders, or stored value; sellers or redeemers of travelers’ checks, money orders, or stored value; and funds transmitters), the United States Postal Service is considered an MSB because it issues money orders.
- Persons subject to supervision by state or federal bank supervisory authority.
- Casinos.
- Card clubs.
- Futures commission merchants, including brokers, commodity pool operators, and commodity trading advisers.
- Individuals or groups engaged in conducting, controlling, directing or owning informal value transfer systems (IVTS) in the United States.

Some firms are considered “financial services firms,” but they are not financial institutions in the traditional sense of the word. For example, GE
Commercial Finance is one of the largest financial services firms in the world, with total assets of over $206 billion.² It provides a wide variety of finance and insurance products. This includes financing corporate aircraft, trucks and trailers, health care equipment, and so on. In addition, GE provides credit cards, personal loans, mortgage loans, and other consumer financial products.

In summary, there are various definitions of financial institutions. The exact definition is not important for our purpose, which is to help directors of financial institutions do their jobs better.

**Table 1.1  FDIC-insured commercial banks, September 2006**

<table>
<thead>
<tr>
<th>Asset size</th>
<th>Number of institutions</th>
<th>Total assets ($billion)</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>All insured institutions</td>
<td>7450</td>
<td>$9765.4</td>
<td>100%</td>
</tr>
<tr>
<td>Less than $100 million</td>
<td>3331</td>
<td>$173.9</td>
<td>1.8%</td>
</tr>
<tr>
<td>$100 million to $1 billion</td>
<td>3631</td>
<td>$1031.9</td>
<td>10.6%</td>
</tr>
<tr>
<td>$1 billion to $10 billion</td>
<td>401</td>
<td>$1095.3</td>
<td>11.2%</td>
</tr>
<tr>
<td>Greater than $10 billion</td>
<td>87</td>
<td>$7464.3</td>
<td>76.4%</td>
</tr>
</tbody>
</table>


Commercial Finance is one of the largest financial services firms in the world, with total assets of over $206 billion.² It provides a wide variety of finance and insurance products. This includes financing corporate aircraft, trucks and trailers, health care equipment, and so on. In addition, GE provides credit cards, personal loans, mortgage loans, and other consumer financial products.

In summary, there are various definitions of financial institutions. The exact definition is not important for our purpose, which is to help directors of financial institutions do their jobs better.

**Banks**

Commercial banks are the largest financial institutions in terms of total assets. As shown in Table 1.1, there were 7450 commercial banks used by the Federal Deposit Insurance Corporation (FDIC) in 2006. The overwhelming majority of commercial banks are small, with total assets of less than $1 billion. At the other end of the spectrum, 87 large banks with total assets of $10 or more accounted for 76.4 per cent of the total assets of all banks. In this group of large banks, the five banks listed in Table 1.2 account for 40 per cent of the total assets of all the FDIC-insured commercial banks. The data from Tables 1.1 and 1.2 show that we have a large number of small commercial banks; but that most of the assets are concentrated in a few large ones.

The banks listed in Table 1.2 are parts of bank and financial holding companies – companies that own one or more banks and engage in other permissible activities. For example, JP Morgan Chase Bank NA is part of JP Morgan Chase & Co. which operates in the USA and overseas. Management operations are divided into six reporting segments: asset
and wealth management, card services, commercial banking, corporate (including private equity and treasury businesses, as well as corporate support functions), investment banking, retail financial services, and treasury and securities services.3

Table 1.2 also shows that the top five banks hold about $122 trillion in derivatives. There are 908 other banks and trust companies that hold an additional $4 trillion in derivatives. Thus, the top five banks control the overwhelming majority of both bank assets and derivatives. Interest rate contracts (swaps, options, futures and forwards, and credit derivatives) account for about 82 per cent of the total derivatives contracts.

**Table 1.2 Total assets and derivatives of selected banks, September 2006**

<table>
<thead>
<tr>
<th>Bank</th>
<th>Total assets ($ million)</th>
<th>Total derivatives ($ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>JP Morgan Chase Bank NA</td>
<td>1 173 732</td>
<td>62 634 961</td>
</tr>
<tr>
<td>Bank of America NA</td>
<td>1 185 581</td>
<td>25 473 719</td>
</tr>
<tr>
<td>Citibank NA</td>
<td>816 362</td>
<td>24 476 944</td>
</tr>
<tr>
<td>Wachovia Bank NA</td>
<td>517 174</td>
<td>5 245 300</td>
</tr>
<tr>
<td>HSBC Bank USA NA</td>
<td>166 632</td>
<td>4 167 509</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>3 859 481</strong></td>
<td><strong>121 998 442</strong></td>
</tr>
</tbody>
</table>


and wealth management, card services, commercial banking, corporate (including private equity and treasury businesses, as well as corporate support functions), investment banking, retail financial services, and treasury and securities services.3

Table 1.2 also shows that the top five banks hold about $122 trillion in derivatives. There are 908 other banks and trust companies that hold an additional $4 trillion in derivatives. Thus, the top five banks control the overwhelming majority of both bank assets and derivatives. Interest rate contracts (swaps, options, futures and forwards, and credit derivatives) account for about 82 per cent of the total derivatives contracts.

**Asset concentration groups** The FDIC recognizes that not all banks do the same things. Some banks’ assets are concentrated in particular types of loans or activities. Thus, consumer-oriented credit-card banks are going to have a different focus and methods of operation than commercial lenders. The following are the FDIC definitions of asset concentration groups.4

- **International banks** Banks with assets greater than $10 billion and more than 25 per cent of total assets in foreign offices.
- **Agricultural banks** Banks whose agricultural production loans plus real estate loans secured by farmland exceed 25 per cent of total loans and leases.
- **Credit-card lenders** Institutions whose credit-card loans plus securitized receivables exceed 50 per cent of total assets plus securitized receivables.
- **Commercial lenders** Institutions whose commercial and industrial loans, plus real estate construction and development loans, plus loans secured by commercial real estate properties exceed 25 per cent of total assets.
Mortgage lenders  Institutions with residential mortgage loans, plus mortgage-backed securities, exceeding 50 per cent of their total assets.

Consumer lenders  Institutions with residential mortgage loans, plus credit-card loans, plus other loans to individuals, that exceed 50 per cent of their total assets.

Other specialized < $1 billion  Institutions with assets less than $1 billion, whose loans and leases are less than 40 per cent of total assets.

All other < $1 billion  Institutions with assets less than $1 billion that do not meet any of the definitions above; they have significant lending activity with no identified asset concentrations.

All other > $1 billion  Institutions with assets greater than $1 billion that do not meet any of the definitions above; they have significant lending activity with no identified asset concentrations.

Bank holding companies
Table 1.3 lists the top 10 bank holding companies in the USA. Some of these institutions are considered large complex banking organizations (LCBOs) because of their size, the complex composition of their organizations, and their international operations. Citigroup, for example, has operations in more than 100 countries. As shown in Table 1.3, Citigroup has 1642 affiliated entities in their organizational hierarchy. They are located in the US and abroad. The individual entities, such as Citicorp Holdings Inc., may have sub-units as well. Thus, the total number of entities is greater than 1642.

HSBC Holdings plc (London) is the largest banking organization in the world by asset size. It has more than 9500 offices in 76 countries and territories. HSBC's operating unit in the United States, HSBC North America Holdings Inc., has 360 affiliated entities in the US and overseas.

LCBOs are involved in banking, but they are also engaged in a wide range of other activities through their affiliated entities. Citigroup is an example of an LCFO. It offers consumer and commercial banking, insurance, brokerage services, corporate and investment banking, wealth management, and alternative investments including hedge funds. It recently bought a mortgage servicing business. It is also part of a consortium of nine large banks that want to build a European stock-trade-reporting system to compete with existing regional stock exchanges. In addition, Citigroup was considering buying into China’s Spring Airlines. In 2003, Citigroup spun off its property/casualty insurance unit of Travelers Insurance Group. In 2005, it sold its life insurance unit to MetLife. Thus, it is a dynamic organization that buys and sells various lines of business.
Similarly, Bank of America offers various banking and non-banking financial services and products in the US and throughout the world. It received permission to build and own a Ritz-Carlton Hotel at its corporate headquarters in Charlotte, North Carolina. Finally, Union Bank of California NA received permission from bank regulators to operate a “wind energy project” where wind turbines are used to generate electricity that will be sold.

The key point is that LCBOs are more than just “banks.” They engage in a very wide range of activities that are not traditionally associated with banks. Today banks, insurance companies, and securities firms can be included in an LCBO. For example, Macquarie Bank Group (Sydney, Australia) operates investment banking, commercial banking, and selected retail financial services markets in Australia and 23 other countries. In addition, Macquarie Global Infrastructure Fund acquired PCAA/Avistar, the largest provider of off-airport parking services in the United States. Macquarie Infrastructure Group/Cintra consortium operates and manages the Chicago Skyway toll road. In Europe, its acquisitions include an airport in Denmark, a toll road in France, a tank storage business in Germany, a gas and electric network in the Netherlands. In the UK it acquired two ferry services in addition to other businesses. The front page of its 2006 Annual Report shows an explosive device, because Macquarie...

Table 1.3  Top 10 bank holding companies in the USA, third quarter, 2006

<table>
<thead>
<tr>
<th>Rank</th>
<th>Institution</th>
<th>Location</th>
<th>Total assets $000s (30 Sept. 2006)</th>
<th>Affiliated entities</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Citigroup Inc</td>
<td>New York, NY</td>
<td>$1,746,248,000</td>
<td>1642</td>
</tr>
<tr>
<td>2</td>
<td>Bank of America Corporation</td>
<td>Charlotte, NC</td>
<td>$1,451,603,528</td>
<td>2191</td>
</tr>
<tr>
<td>3</td>
<td>JP Morgan Chase &amp; Co.</td>
<td>New York, NY</td>
<td>$1,338,029,000</td>
<td>1506</td>
</tr>
<tr>
<td>4</td>
<td>Wachovia Corporation</td>
<td>Charlotte, NC</td>
<td>$559,922,000</td>
<td>1667</td>
</tr>
<tr>
<td>5</td>
<td>Wells Fargo &amp; Company</td>
<td>San Francisco, CA</td>
<td>$483,441,000</td>
<td>1153</td>
</tr>
<tr>
<td>6</td>
<td>HSBC North America Holdings Inc.</td>
<td>Prospect Heights, IL</td>
<td>$473,711,105</td>
<td>360</td>
</tr>
<tr>
<td>7</td>
<td>Taunus Corporation</td>
<td>New York, NY</td>
<td>$430,384,000</td>
<td>504</td>
</tr>
<tr>
<td>8</td>
<td>US Bancorp</td>
<td>Minneapolis, MN</td>
<td>$216,855,000</td>
<td>20</td>
</tr>
<tr>
<td>9</td>
<td>Countrywide Financial Corporation</td>
<td>Calabasas, CA</td>
<td>$193,194,572</td>
<td>118</td>
</tr>
<tr>
<td>10</td>
<td>Suntrust Banks, Inc.</td>
<td>Atlanta, GA</td>
<td>$183,104,553</td>
<td>401</td>
</tr>
</tbody>
</table>

Group led a consortium to buy the international explosives company, Dyno Nobel, headquartered in Norway.14

Savings institutions
In addition to commercial banks, there were 1293 FDIC-insured savings (thrift) institutions in 2006.15 FDIC-insured savings banks and savings and loan institutions operate under state or federal banking laws. Qualified thrift lenders (QTL) must have 65 per cent or more of their assets in housing related loans (including mortgage backed securities) and other permissible loans such as educational and small business loans. They also qualify for low-cost advances from its Federal Home Loan Bank. Historically, many thrifts were depositor owned (that is, mutual savings banks), but they converted to stock ownership after the passage of the Garn-St Germain Depository Institutions Act of 1982. Most thrifts are located in the northeastern states.

Credit unions
Credit unions are nonprofit, cooperative financial institutions that are owned and run by their members. The term “nonprofit” is misleading because, like other financial institutions, they cannot operate for long periods at a loss, and they require adequate capitalization. There were 8695 credit unions as of 31 December 2005.16 Like banks, there are a few very large credit unions, but the majority of them are relatively small. The largest credit union is the Navy Credit Union (Merrifield, VA) with $24.6 billion in assets. State Employees Credit Union (Raleigh, NC) with $12.9 billion is the second largest, and the Pentagon Credit Union (Alexandria, VA) with $8 billion is in third place.

Insurance companies
The two largest groups in the insurance industry in the USA are life/health insurance companies and property/casualty companies. There were 4009 life/health and property/casualty insurance companies at the end of 2004.17 In addition, there are health insurance companies (for example, Blue Cross/Blue Shield), fraternal groups that provide insurance for their members, title insurance companies, limited benefit plans, risk retention groups, and others. Finally, reinsurance companies provide products that allow other insurance companies better to manage some of their risks.

Many large insurance companies offer a wide array of insurance policies as well as other financial services. For example, Metropolitan Life Insurance Company (MetLife), the largest life insurance company in North America, also offers non-medical health and property and casualty insurance, as well as banking (MetLife Bank NA), brokerage services as well as advisory services.
(MetLife Securities, Inc.), mutual funds and other financial products and services.\(^\text{18}\)

Some insurance companies also own thrifts that are regulated by the Office of Thrift Supervision (OTS). For example, State Farm Mutual Auto Insurance Company owns State Farm Bank, FSB (Federal Savings Bank).\(^\text{19}\) State Farm’s bank focuses on consumer-oriented financial products. It operates mainly through its insurance agents, call centers and the internet. Like other large insurance companies, State Farm Investment Management Corp. offers mutual funds.

**Corporate governance issues**

**Regulatory concerns**

LCBOs and non-traditional banking activities provide special challenges to managers, directors, and bank regulators. Federal Reserve Governor Susan Schmidt Bies said:

> the complexity of these organizations makes it more difficult for executive management to view risk in a comprehensive way, both in terms of aggregating similar and correlated risks, but also in identifying potential conflicts of interest between the growth of a line of business and the reputation, legal, and compliance risks of the firm as a whole. In recent years, large financial institutions have reported losses from breaks in these operating controls that in some cases have exceeded those in credit or market risk.\(^\text{20}\)

For example, JP Morgan Chase & Co. agreed to pay the Securities and Exchange Commission $135 million to settle allegations that it helped Enron to commit fraud. Similarly, Citigroup agreed to pay $120 million to settle SEC allegations that it helped Enron and Dynegy commit fraud.\(^\text{21}\) Part of the problem involved complex structured finance transactions (CSFTs).\(^\text{22}\) These have become widely used in both international and domestic capital markets. However, they have also been used to misrepresent the financial condition of firms to investors and regulators, and they have been used in illegal schemes. Therefore CSFTs may involve substantial legal and reputational risks such as those faced by JP Morgan Chase and Citigroup.

Other Citigroup problems included:

- **Japan** In 2001, Japan’s Financial Services Agency (FSA) had concerns about Citibank’s Japan Branch (the Marunouchi Branch of Citibank). In 2004, the FSA took administrative actions to close four offices of the Japan branch because several of the bank officers misled customers into investing in structured bonds and complex
securities in violation of Japan’s security laws, as well as numerous other violations.\textsuperscript{23}

- **Germany** Citigroup bond traders were accused of “market manipulation” using the “Dr Evil Strategy”. But that strategy did not violate Germany’s laws, and the charges were dropped.\textsuperscript{24}

- **Brazil** It is alleged that a Citigroup private equity manager tried to coerce a large investor into selling shares in a Brazilian telecom at below market prices. The manager was fired.\textsuperscript{25}

- **Australia** Citigroup faced a $715 million fine in Australia for insider trading in connection with a takeover bid of a large company.\textsuperscript{26}

- **New York** Citigroup settled Enron class action law suit for $2 billion.\textsuperscript{27}

- **Chicago** The headline in the *Chicago Tribune* online edition stated “Even big boys get scammed: A tense corporate drama unfolds when one of the nation’s major lenders finds its Chicago Operation enmeshed in mortgage fraud.”\textsuperscript{28} The major lender was part of Citigroup.

Collectively, these problems illustrate the fact that it is very difficult to manage LCBOs. They also reveal that these problems occurred at locations that were far from the corporate headquarters in New York. Stated otherwise, it is difficult to manage and supervise operations at distant locations.

**A board that failed**

Enron was considered an innovative and growing company with revenues of over $111 billion. The 2000 Annual Report said that “Enron’s performance was a success by any measure, as we continued to outdistance the competition.”\textsuperscript{29} On 2 December 2001 Enron declared bankruptcy. It was the seventh largest publicly traded company in the USA. The bankruptcy and scandal that followed caused shock waves throughout the financial community.

The Enron scandal was followed by bankruptcies and scandals at Tyco International, Peregrine Systems, and WorldCom that collectively contributed to the passage of the Sarbanes-Oxley Act of 2002. It is also known as the Public Company Accounting Reform and Investor Protection Act of 2002, or SOX. It provided for new and improved standards for all US public company boards, management, and public accounting firms.

Enron was very focused on its credit ratings, cash flows, and its debt burden. Enron also had an “asset light” strategy which means that it moved millions of dollars off its balance sheet into affiliated companies. Similarly, it made extensive use of complex accounting structures and derivatives. In
this sense Enron is similar to the LCBOs that were discussed previously. This does not imply that the LCBOs have done or are doing anything wrong – but there are some structural similarities. Size and complexity make it more difficult for directors to do their jobs.

Enron’s Board of Directors had 15 members, including two insiders, Kenneth L. Lay (Chairman) and Jeffrey K. Skilling (President and CEO). The 13 outside directors listed in Table 1.4 included very successful and high profile individuals. But they failed miserably in their duties as Enron’s board of directors. In legal jargon, directors have a fiduciary duty to the

<table>
<thead>
<tr>
<th>Name</th>
<th>Location and occupation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Robert A. Belfer</td>
<td>New York, NY, Chairman, Belco Oil &amp; Gas Corp.</td>
</tr>
<tr>
<td>Norman P. Blake, Jr</td>
<td>Colorado Springs, CO, Chairman, President and CEO, Promus Hotel Corp.</td>
</tr>
<tr>
<td>Ronnie C. Chan</td>
<td>Hong Kong, Chairman, Han Lung Group</td>
</tr>
<tr>
<td>John H. Duncan</td>
<td>Houston, TX, Former Chairman of the Executive Committee of Gulf &amp; Western Industries</td>
</tr>
<tr>
<td>Dr Wendy L. Gramm</td>
<td>Washington, DC, Director of the Regulatory Studies Program, George Mason University,</td>
</tr>
<tr>
<td></td>
<td>Former Chairman, US Commodity Futures Trading Commission</td>
</tr>
<tr>
<td>Ken L. Harrison</td>
<td>Portland, OR, Former Chairman and CEO, Portland General Electric Company</td>
</tr>
<tr>
<td>Dr Robert K. Jaedicke</td>
<td>Stanford, CA, Professor of Accounting (Emeritus) and former Dean, Graduate School of Business, Stanford University</td>
</tr>
<tr>
<td>Dr Charles A. LeMaistre</td>
<td>San Antonio, TX, President Emeritus, University of Texas M.D. Anderson Cancer Center</td>
</tr>
<tr>
<td>Dr John Mendelsohn</td>
<td>Houston, TX, President, University of Texas M.D. Anderson Cancer Center</td>
</tr>
<tr>
<td>Jerome J. Meyer</td>
<td>Wilsonville, OR, Chairman, Tektronix, Inc.</td>
</tr>
<tr>
<td>Paulo V. Ferraz Pereira</td>
<td>Rio de Janeiro, Brazil, Executive Vice President of Grupo Bozano, Former President and COO, Meridonalar Financial Group, and Former President and CEO, State Bank of Rio de Janeiro, Brazil</td>
</tr>
<tr>
<td>John A. Urquhart</td>
<td>Fairfield, CT, President, John A. Urquhart Associates, and Former Senior Vice President of Industrial and Power Systems, General Electric</td>
</tr>
<tr>
<td>Lord John Wakeham</td>
<td>London, England, President, Winokur Holdings, Inc., and Former Senior Executive Vice President, Penn Central Corp.</td>
</tr>
</tbody>
</table>

shareholders. This means that they are accountable to the shareholders for their actions. In the case of financial institutions, they are also accountable to regulators.

The legal duties of directors are the duties of obedience, loyalty, and care. The duty of obedience requires directors to avoid committing acts beyond the scope of powers defined by the corporate charter or the laws of the state of incorporation. The duty of loyalty prohibits directors from putting their personal or business interests above the interest of the firm they are directing. The duty of care requires directors to act in good faith and carry out their duties diligently and prudently.

A US Senate Committee report, “The Role of The Board of Directors in Enron’s Collapse,” examined more than one million pages of documents and interviewed 13 Enron Board members. The report found the following:

1) **Fiduciary Failure.** The Enron Board of Directors failed to safeguard Enron shareholders and contributed to the collapse of the seventh largest public company in the United States, by allowing Enron to engage in high risk accounting, inappropriate conflict of interest transactions, extensive undisclosed off-the-books activities, and excessive executive compensation. The Board witnessed numerous indications of questionable practices over several years, but chose to ignore them to the detriment of Enron shareholders, employees and business associates.

2) **High Risk Accounting.** The Enron Board of Directors knowingly allowed Enron to engage in high-risk accounting practices.

3) **Inappropriate Conflicts of Interest.** Despite clear conflicts of interest, the Enron Board of Directors approved an unprecedented arrangement allowing Enron's chief financial officer to establish and operate LJM private equity funds which transacted business with Enron and profited at Enron's expense. The Board exercised inadequate oversight of LJM transactions and compensation controls and failed to protect Enron shareholders from unfair dealing.

4) **Extensive Undisclosed Off-the-Books Activity.** The Enron Board of Directors knowingly allowed Enron to conduct billions of dollars in off-the-books activity to make its financial condition appear better than it was and failed to ensure adequate public disclosure of material off-the-books liabilities that contributed to Enron's collapse.

5) **Excessive Compensation.** The Enron Board of Directors approved excessive compensation for the company executives, failed to monitor the cumulative cash drain caused by Enron's 2000 annual bonus and performance unit plans, and failed to monitor or halt abuse by Board Chairman and Chief Executive Officer Kenneth Lay of a company-financed multi-million dollar personal credit line.

6) **Lack of Independence.** The independence of the Enron Board of Directors was compromised by financial ties between the company and certain Board members. The Board also failed to ensure the independence of the company’s auditor, allowing Arthur Andersen LLP to provide internal audit and consulting services while serving as Enron’s outside auditor.
Industry concentration and stock returns
The data reveal that the banking industry is highly concentrated in a few large firms. Their size can be both an advantage and disadvantage. On the advantage side of the argument, they can have diversified portfolios, which allows them to withstand economic shocks better than smaller firms. In addition, they are of sufficient size and have the resources to invest in new areas and acquire other firms. For example, Wachovia Bank acquired SouthTrust bank in 2005.

On the other side of the coin, a study by Hou and Robinson found that firms in concentrated industries earned lower returns than firms in competitive industries. They argue that firms in highly concentrated industries engage in less innovation and therefore they command lower expected returns. They also argue that barriers to entry insulated some firms from aggregate demand shocks, while exposing other firms to the distress risk. Industries with high barriers to entry are associated with lower stock returns. Hou and Robinson’s data revealed that firms in the highest quintile in the most competitive industries earned nearly 4 per cent more than those in the highest quintile of the most concentrated industries.

Small banks are not immune from management problems
As shown in Table 1.1, 6962 banks in the US have assets of less than $1 billion. Small banks can have management problems too. Consider the case of First Southern Bank. In March 2002, the FDIC and the Alabama State Banking Department issued a cease and desist order (C&D) to First Southern Bank, Florence, AL. According to the C&D, the bank had inadequate management, a large volume of poor quality loans following hazardous lending and lax collection practices, and so on.

The story behind these losses provides important insights about the corporate governance of small thrifts that convert into banks. Some parts of this lesson may be applicable to credit unions when they attempt to act like banks. First Federal Savings & Loan Association was chartered in Florence in 1935. It was a successful savings and loan (S&L). Sixty years later in 1995, management decided to convert from an S&L into a bank holding company and a state-chartered commercial bank – First Southern Bank. One reason for the change was because a bank could provide a wider range of loans and services to the communities served.

On the surface, First Southern Bank appeared to be a well-functioning organization. However, there were significant corporate governance problems that almost resulted in the demise of the bank.

The CEO of the bank made statements to the effect that he would run the bank just like he ran the S&L. The problem is that banks are
significantly different to S&Ls, and neither he nor his staff had experience in making, monitoring, or collecting commercial loans. Moreover, the CEO had an “alpha male personality,” that can be interpreted to mean “I’m the boss, I know how to run this shop, and I don’t like to be questioned.” The board must have thought that he did an excellent job, because he was one of the highest paid CEOs in banks of equivalent size.

The CEO was not a lender. He delegated the lending to his second in command. The loan committee rubber stamped most of the loans that were made. The bank’s outside audits were done by a local accounting firm that had little experience in banking. But they were socially close with the CEO.

The board of directors of the bank, like that of many small banks, consisted of successful people in the local community. The board of directors included the CEO, the second in command, and eight outside directors. However, the outside directors had little or no formal training concerning their roles as bank directors. They participated in various committees, audit, personnel, and the like. However, the outside directors passively followed the agenda set by senior management and did not fulfill their role to establish bank policies, to set strategic bank direction, and to oversee bank management. That was the CEO’s job, or so he told them.

The board members were given “board packets” as they entered the board of directors meetings. The board packets consisted of a few pages of information, simple financial statements, and other items that were on the agenda. This is the way it was always done. In hindsight, the outside directors did not have an accurate picture of the bank’s business or financial situation.

Everything appeared to be going well. The bank grew from $160 million in assets at the time of conversion to about $190 million in 2000. In management’s opinion the bank was overcapitalized, and they paid large dividends.

Shortly before a senior loan officer died in 2000, board members became suspicious that something was wrong with the loan portfolio. A number of problem loans began to appear, and provisions for loan losses were needed. Bad credit was a ticking bomb that was about to explode. The bottom line is that there was no control over the commercial loan portfolio and the bad loans almost wiped out the bank.

In order to save the bank, assets were sold, additional capital was raised, management was changed, and a qualified attorney was retained. By 2006, the bank was out from under the regulators’ umbrella because of their much improved financial condition.

The outside directors learned some important lessons about corporate governance. One of the outside directors said that there were three things that directors had to know – capital and management, capital and man-
agement, and capital and management. The outside directors also learned the importance of qualified auditors, and director training and responsibilities. With such training, they might have recognized obvious red flags. For example, the senior loan officer who died never took vacation time. The outside directors had no real oversight; they should control the audit committee and have meaningful contact with the outside auditing firm. Now the outside directors are in charge of the bank. It is not likely that they will make the same mistakes again. The cultures and operations of S&Ls and banks are quite different.

**Corporate culture and mergers**
Every organization has a corporate culture that can be defined as “the way we do things around here.” Corporate cultures are analogous to people’s personalities. Some personalities get along well together, and some don’t. Thus, corporate culture is an important issue in mergers, just as personalities are important in the case of marriage. About 50 per cent of marriages fail, and about the same number of corporate mergers fail – and one of the reasons for the failures is different corporate cultures.

Differences in corporate culture was the theme of a front page story in the *Wall Street Journal* – “Bank of America hits snag in bid to woo the rich.” Bank of America, a retail-oriented bank, acquired US Trust, a private-banking wealth management operation from Charles Schwab. The chief executive officer of US Trust quit after “disagreements over how the combined operation should be run.” The issues involved personal services to high net-worth clients versus the mass market.

In general terms, private banking and trust operations cater to high net-worth individuals who want to be pampered. US Trust requires a minimum of $2 million to open an account. A key point here is that trust departments have a fiduciary duty to act in the best interest of their clients.

In contrast, Bank of America is a financial supermarket. It wants its employees to cross-sell and promote all of their financial products and automated services.

Some of the differences between trust departments and retail banking center on the treatment of high net-worth clients. Should high net-worth clients accustomed to personal bankers should steered to toll-free telephone numbers for service? Should clients who entrust millions of dollars to their bankers now pay automated teller machine (ATM) fees? Should the bankers acting in the best interest of their clients be required to cross-sell the bank’s products?

**Corporate culture and operational risk**
Operational risk is defined as the losses resulting from inadequate or failed internal processes, people and systems, and from external events.
Operational risk includes accounting issues, damage to physical assets, fraud, legal issues, and so on. Corporate culture plays an important role in operational risk. Operational risks are commonly associated with corporate culture, lax internal controls, asset size, complex transactions, and compensation. Consider the case of General Re, a property/casualty insurance company that lost $173 million. Warren Buffet’s Berkshire Hathaway Inc. bought General Re. Warren Buffet’s (2003) letter to the stockholders explained the losses. He said that General Re’s culture and practices had changed and they were grossly mispricing their business. Buffet went on to say that “the reinsurance business and derivatives are similar: Like Hell, both are easy to enter and almost impossible to exit . . . Once you write a contract . . . which may require large payments decades later . . . you are usually stuck with it.” Another commonality of reinsurance and derivatives is that both generate reported earnings that are often wildly overstated. That’s true because today’s earnings are in a significant way based on estimates whose inaccuracy may not be exposed for many years. Finally, Buffet said that “derivatives are financial weapons of mass destruction, carrying the dangers that while now latent, are potentially lethal.”

Financial incentives are another hotspot. Executive compensation, and compensation to securities traders have frequently been associated with large losses. In 2002, Freddie Mac got into trouble for smoothing earnings in order to meet earnings targets. Finally, Barings Bank in England went bankrupt when a securities trader in its Singapore office bet more than $1 billion on the direction of the Japanese stock market and he and the bank lost. Barings had weak internal controls and rewarded the trader for his speculative gains.

Notes
6. Ibid.
18. For additional information, see www.metlife.com.
19. For additional information, see http://www.statefarm.com/about/companie.asp.
20. Bies, Susan Schmidt (2005), Testimony of Governor Susan Schmidt Bies Basel II implementation and revisions to Basel I Before the Committee on Banking, Housing, and Urban Affairs, US Senate, 10 November.
31. Ibid.
32. Ibid., p. 3.
34. This case study is based on publicly available information and information provided in a meeting at First Southern Bank on 20 April 2006, in Florence, AL, with several
members of the current board of directors. The author is indebted to J. Acker Rogers, Chairman of the Board of First Southern Bancshares, First Southern Bank, and part owner of Rogers, Carlton & Associates, Inc., Florence, AL; Robert “Bob” Walker, Baker Donelson, Beardman, Caldwell & Berkowitz, PC, Memphis, Tenn., for their helpful suggestions and comments. Any errors are mine.


References


Bies, Susan Schmidt (2005), “Basel II implementation and revisions to Basel I,” testimony of Governor Susan Schmidt Bies before the US Senate Committee on Banking, Housing, and Urban Affairs, 10 November.


Federal Deposit Insurance Corporation (FDIC) (2003), enforcement decisions and orders, “In the matter of First Southern Bank, Florence, Alabama,” docket no. 02-023b, 15 March.

FDIC (no date), glossary, accessed at www2.fdic.gov/qbp/Glossary.asp?menuitem=GLOSSARY.


FDIC (2007), Table III-A, first three quarters 2006, FDIC-insured commercial banks, Quarterly Banking Profile.


Jackson, David (2005), “Even big boys get scammed: a tense corporate drama unfolds when one of the nation’s major lenders finds its Chicago operation enmeshed in mortgage fraud,” *Chicago Tribune* online edition, 8 November.


Negishi, Mayumi (2004), “Citibank Japan ordered to close four offices over legal breaches,” *Japan Times*, online, 18 September.


