

BARRON'SOnline

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Inside the Vault

Banks are doling out loans to directors and employees. Caveat depositor -- and investor

By JIM MCTAGUE

NOW THAT INTEREST RATES have begun climbing, investors in bank stocks need to keep a close eye on loan quality. Rising rates often expose questionable lending practices, some of them fatal. Over the past two decades, banks sank by the hundreds during periods of rising rates. Witness the S&L debacle of the 1980s, when 563 savings and loans failed and 333 others were forced to merge. That was followed by a commercial-bank debacle that claimed 286 banks in 1990 and 1991.

In examining those blowups, the General Accounting Office laid its finger on a common culprit: loans to insiders. The Congressional watchdog agency found that poorly underwritten loans to employees, directors and large shareholders were evident at 61% of the failed banks and were a major factor in 21% of them. The problem was that loans to bank insiders were based on less stringent credit standards than loans to others, and thus turned sour more quickly.

Still more troubling, the GAO found that bank regulators had not detected the extent of the insider loan problem until after the banks had failed.

Well, guess what? Insider loans are still flourishing throughout the banking industry -- and regulators, once again, appear to have less than a firm grip on the issue. For investors in bank stocks -- or folks who simply want to stash some savings at the neighborhood bank -- the message is clear: **caveat emptor.**

Tables: [Inner Circle](#)¹

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Using data supplied by the Federal Deposit Insurance Corp., *Barron's* has compiled a list of the 10 banks with the largest amount of insider loans in terms of dollars, plus four smaller banks whose insider loans are large compared with the banks' cushion of capital (see tables).

A bank with insider loans isn't necessarily headed for trouble, and the banks on our lists, including leaders like **Wachovia** and **Bank of New York**, generally look quite healthy. But as rates rise and a bank's portfolio of problem loans increases, insider loans at the institution can quickly become a concern, says Auburn University Finance Professor James Barth, who has written extensively about bank failures.

"It's an area not a lot of people are looking at anymore -- but it makes sense to look at it," says Sam Leaman, a senior financial analyst at Washington Analysis, an independent equity research firm.

Among all commercial banks, loans to insiders now amount to 4.7% of the industry's equity capital, says SNL Securities, a bank research firm in Charlottesville, Va. While that's less than half the ratio seen in the early 'Nineties, loans to insiders clearly haven't gone away.

At the 10 banks with the largest dollar volumes of insider loans, the loans represent anywhere from 4% to 14% of equity capital -- cushions meant to absorb any losses. But those ratios are allowed; sizable banks are permitted by the Federal Reserve Board to lend insiders amounts equaling up to 100% of capital.

Bank of New York's ratio of insider loans to capital is the highest of the group, at 14%. Those loans, by and large, are said not to be to individual directors but rather to the corporations that they represent.

Most banks add that many of their loans are fully secured. Atlanta-based **SunTrust** says 42% of its insider loans are backed by marketable securities with margin provisions. This means that the borrowers must increase their collateral if the value of those securities dips. A spokesman for First Hawaiian Bank, a unit of **BNP Paribas**, says that virtually all of its insider loans are commitments to lend rather than granted loans.

"Historically, regional bank-holding companies have put community business leaders and customers on their boards of directors," Milwaukee-based M&I Bank, a subsidiary of **Marshall & Ilsley** and No. 9 on the list, said in a written statement. "This is simply good business for us because we have qualified, successful business people on our board who know the markets in which we do business."

Insider loans are particularly common at small-town banks, because the local business people are often the best candidates to serve on the board. That's why banks with less than \$100 million in assets are allowed to carry insider loans amounting to 200% of capital.

But some banks with high ratios aren't so small. The four listed in our second [table²](#) each has assets of more than \$200 million and is part of a publicly traded company. One, Albany, Ga.-based Security B&T, reported insider loans of more than 100% -- but parent **Synovus** audited the bank after *Barron's* called and now claims it goofed in its FDIC filing by including \$5 million too many loans. The regulators never noticed.

Veribanc, a firm that rates banks for depositors, has decided to no longer give its top rating to any bank with insider loans of more than 35% of equity capital. And a bank can't win the Woonsocket, R.I., company's highest accolade if its insider loans total more than 15% of equity. That's because Veribanc, like the GAO, has found a high correlation between troubled banks and insider loans. "It's a moral-hazard gauge," says Veribanc's president, Mike Heller.

Banks with high loan-to-capital ratios offer a different view. Most of Iowa-based Dubuque Bank and Trust's insider loans are to outside directors who are businessmen in the community, says Douglas Horstmann, president and CEO of the unit of **Heartland Financial**.

How it Plays in Peoria

It was local businessmen who founded First Capital Bank of Peoria, Ill., eight years ago, says president Dan Daly. They didn't like the service they were getting from larger banks, and some now turn to First Capital for their borrowings. Daly says all of the bank's insider loans are secured by stock and certificates of deposit. **First Busey**, a publicly traded holding company, recently purchased the bank for \$42 million.

Bankers and federal bank examiners alike claim to have learned from the insider-loan failures of the past. In fact, regulations were tightened in 1993: No insider loan can now be made without full approval of the board of directors. But Barth of Auburn says it's difficult to be sanguine about regulatory scrutiny in light of recent problems at Washington D.C.-based Riggs Bank, whose significant violations of money-laundering rules escaped notice by two bank regulatory agencies.

Another reason to be vigilant: The U.S. Treasury Department's inspector general scrutinized seven big bank failures between 1993 and 2002 and concluded, in a June 7 report, that regulators either didn't identify early warning signs or did not act decisively on them.

When pressed by *Barron's*, the three main bank regulators -- the Fed, the FDIC and the Office of the Comptroller of the Currency -- were unable to produce annual statistics on insider-loan violations between 1994 and this year. In fact, each of the agencies told us to call the others.

That leaves investors and depositors on their own. Luckily, you can get a quick read on a bank's insider lending at the FDIC's Website, www.fdic.gov³. Double-click the Quick Link for Analysts in the right-hand column, then go to Call and



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Thrift Financial Reports in the Trends and Statistics column. Then double-click the Call Report and Thrift Financial bar on the next new page. Type in the name of your bank and look under the item called Memorandum for the insider-loan data.

The effort might go a long way if the history of the past two decades repeats itself again.

E-mail comments to editors@barrons.com⁴

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Here are the 10 banks with the largest volumes of loans outstanding to directors, employees and other insiders. Though the amounts are high, they're well within the 100% of capital allowed by regulations.

Bank	Location	Total Assets (bil)	Insider Loans (bil)	Percent of Equity Cap.
Wachovia	Charlotte, N.C.	\$364.5	\$1.540	5.1%
Bank One	Chicago, Il.	256.7	1.339	7.5
Bank of New York	New York, N.Y.	89.4	1.163	14.1
Suntrust	Atlanta, Ga.	124.3	0.825	8.4
Comerica	Detroit, Mich.	54.5	0.540	9.7
Southtrust	Birmingham, Ala.	52.7	0.431	9.9
Manufacturers & Traders	Buffalo, N.Y.	50.2	0.383	6.1
Commerce Bank	Kansas City, Mo.	12.3	0.355	3.9
M&I Bank	Milwaukee, Wis.	31.0	0.269	11.4
First Hawaiian	Honolulu, Hawaii	9.9	0.251	13.7

Among banks with the highest ratios of insider loans to capital, these are the largest ones owned by publicly traded parents.

Bank	Parent Company	Location	Banks' Assets (mil)	Insider Loans (mil)	Percent of Equity Cap.
Security B&T	Synovus*	Albany, Ga.	\$302	\$27.0	104.0%
Bank Trust	BancTrust	Mobile, Ala.	368	34.0	92.4
Dubuque B&T	Heartland Fincl	Dubuque, Iowa	747	50.0	80.4
First Capital	Busey Fincl	Peoria, Il.	210	12.5	75.3

*Synovus says it overstated its insider loans by \$5 million when filing with the FDIC. A revised total would be about 80% of capital.

Source: FDIC data

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