Wolters Kluwer

Due Diligence Checklist: Proactive Steps for Avoiding a Bank Failure

Introduction

This guide will assist in-house counsel, private practice lawyers, and corporate finance personnel in advising their clients and organizations regarding proactive steps to take to protect themselves from a bank failure. Although it can be difficult to know for certain if or when a bank will fail, completing thorough due diligence into the health and stability of a bank will help mitigate the risk of being impacted by a bank failure.

Step 1: Assess the Overall Health of A Bank

It is impossible to predict, with 100% accuracy, whether a bank will fail. There are, however, numerous signs and indicators that a bank may be in trouble. The presence of these signs should alert you to the need to take proactive measures.

Key Questions	Reviewed
Have you researched the stability of the bank?	
Is there a large number of uninsured deposits?	
Does the bank engage in excessive marketing and make it too easy for anyone to open an account?	
Is the bank a candidate for acquisition or sale?	
What is the bank's reputation in the financial community?	

1. Have you researched the stability of the bank?

Researching the stability of a bank is necessary when selecting a bank. Although the FDIC does not publish a list of weak banks, a bank's health and stability may be reviewed by reports prepared by private analysts. It is likewise important that you monitor a bank's financial reports continually. Be aware of the bank's Texas Ratio, or the ratio of its non-performing assets to its tangible common equity and loan-loss reserves.

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2. Is there a large number of uninsured deposits?

Deposits over $250,000 are not insured by the Federal Deposit Insurance Company (FDIC). If the majority of a bank's deposits are over $250,000, the bank may be more likely to fail if it gets into financial trouble.

3. Does the bank engage in excessive marketing and make it too easy for anyone to open an account?

Watch for signs that a bank has significantly increased its advertising from non-typical sources and seems willing to allow anyone to open an account. These can be signs that the bank is desperate for cash.

4. Is the bank a candidate for acquisition or sale?

News reports that a bank is being acquired or sold are often a sign that the bank is struggling financially.

5. What is the bank's reputation in the financial community?

The financial and banking community will often have opinions about the business operations of other banks. Certain banks may be known for dubious financial practices that would not be apparent to a party outside that community.

Step 2: Review Your Bank's Investments

A bank's investment portfolio can often be an indicator for the overall health and stability. Reviewing the portfolio prior to selecting a bank may provide some protection against banking with a riskier entity.

Key Questions	Reviewed
How diversified is the bank's investment portfolio?	
Are the bank's investments risky or unproven?	
Does the bank have good risk management practices?	
Have you reviewed analyst reports covering this bank and its peers?	

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1. **How diversified is the bank's investment portfolio?**

When money is deposited into a bank, the bank lends most of the deposited funds to other customers or invests it to make money for itself. Find out what types of investments the bank holds, such as stocks, bonds, real estate, or other securities. If a bank is heavily invested in one type of investment of a single sector of the economy, the bank is especially vulnerable to the market forces that affect that sector. Diversification is strength.

2. **Are the bank's investments risky or unproven?**

If a bank invests heavily in risky or unproven assets (such as cryptocurrencies), it is more likely to end up struggling financially. Risky investments may pay off, or they may fail. When they fail, they tend to fail spectacularly.

3. **Does the bank have good risk management practices?**

Assessment of the bank's risk management policies and investment procedures will help determine the bank's preparedness for handling volatile investment conditions. This assessment may include reviewing the bank's policies for both monitoring and mitigating risk.

4. **Have you reviewed analyst reports covering the bank and its peers?**

Banking analysts frequently publish reports reviewing the health and stability of banks. Frequent review of these reports will help you compare a specific bank to its peers and serve as a benchmark of both performance and risk.

Step 3: Ensure Your Bank Participates in Stress Tests

Federal law requires certain banks to undergo regular stress tests to evaluate the reaction of a bank to adverse economic conditions such as a severe recession or stock market crash. The test considers the impact of these adverse conditions on the bank's earnings, capital adequacy, liquidity, and asset quality.

Key Questions	Reviewed
Is the bank required to undergo regular stress tests?	
Are the required tests annual or biannual?	
How well did the bank perform relative to the criteria tested?	

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1. Is the bank required to undergo regular stress tests?

Banks with more than $100 billion in total consolidated assets are subject to stress tests by the Federal Reserve Board. The tests look at how the bank would perform in certain scenarios set by the Board.

2. Are the required tests annual or biannual?

Larger banks are required to undergo stress tests every year. The smaller banks among those subject to the Board's stress test requirement – those with assets of more than $100 billion but less than $250 billion - are required to participate only every other year, although those banks may opt-in to the annual testing.

Banks that are required to perform stress tests must submit the results to the Office of the Comptroller of the Currency by April 5 each year. Those results are available to the public, and must be published between June 15 and July 15.

3. How well did the bank perform relative to the criteria tested?

Reviewing a bank's stress test will help determine the potential for vulnerabilities in the event of adverse economic conditions. The results of the stress test will also assist in identifying whether the bank has adequate capital and liquidity to survive an adverse condition.

Step 4: Protect Your Deposits Beyond FDIC Depositor Protection

Key Questions	Reviewed
Is each bank that you use insured by the FDIC?	
Have you deposited money in more than one bank?	
Does any single account have more than $250,000 in it?	
Do you use a large bank for deposits over $250,000?	
Are large deposits in a bank that offers Insured Cash Sweep?	
Are there alternatives to keeping large amounts of cash in a bank?	

1. Is each bank that you use insured by the FDIC?

The Federal Deposit Insurance Corporation (FDIC) insures bank accounts up to $250,000. If the bank fails, customers with $250,000 or less in an account are guaranteed to get their money back. Most, but not all, U.S. banks are FDIC insured. Insured banks may be found by using the FDIC's BankFind tool.

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2. Have you deposited money in more than one bank?

A company's money should not be tied up in one bank. An organization should have at least two accounts in separate banks. If possible, each account should have a balance sufficient to fund the company's operations for at least one month.

3. Does any single account have more than $250,000 in it?

Because the FDIC does not insure accounts over $250,000, clients should avoid depositing more than $250,000 in any one account if at all possible. Checking and savings accounts owned by the same person at the same bank are not considered separate accounts, but joint and individual accounts are insured separately. Different accounts held by the same individual at different banks have separate insurance coverage. The FDIC has a calculator that will provide an estimate of coverage for a given account (NOTE: This calculator asks for a user's financial data, including bank account numbers). If there is a temporary need to have more than $250,000 in one account (for example, to meet payroll), the excess funds should be in that account only for the minimum amount of time necessary.

4. Do you use a large bank for deposits over $250,000?

If it is necessary or desirable to have more than $250,000 in one account, the FDIC will not insure those accounts any funds in excess of the $250,000 cap. Accounts with balances of that size should be kept in large U.S. banks because they are much less likely to fail than smaller regional banks.

5. Are large deposits in a bank that offers Insured Cash Sweep?

Insured Cash Sweep is a program in which accounts with balances of more than $250,000 are broken up into smaller accounts and dispersed among other banks. The program allows customers with large accounts to have their money in FDIC-insured accounts. If you anticipate holding a balance larger than $250,000, it may be beneficial to identify and bank with a bank that offers the Insured Cash Sweep, thereby ensuring greater protection of funds.

6. Are there alternatives to keeping large amounts of cash in a bank?

Evaluate how much money a company needs for liquidity and consider depositing any funds in excess of that amount in certificates of deposit (which are also FDIC-insured) or other short-term investments.

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Step 5: Regularly Monitor A Bank for Material Changes

Regular monitoring of the financial health of a bank will give you an indication of the time to take more decisive proactive steps.

Key Questions	Reviewed
Have there been layoffs, closures, decreases in services, increases in fees, or poor customer service?	
Have you reviewed the financial disclosures of the bank and have there been delays in the release of financial information?	
Has there been a decline in deposits?	
Are capital ratios declining?	
Are you monitoring financial news and the banks' social media accounts?	

1. Have there been layoffs, closures, decreases in services, increases in fees, or poor customer service?

When a bank is struggling financially, it will look for obvious ways to cut costs, such as laying off non-essential employees and closing branches. Given the increase in electronic banking, it is not unusual for a bank to close some of its branches over time. But if the bank suddenly announces a large reduction in its workforce or the closure of several branches simultaneously, this could be a sign of financial trouble. These layoffs and closures will, in turn, often lead to poor customer service. A sudden and sharp decline in customer service may be a sign of trouble. Banks that are trying to save money will also decrease their available services and incentives, like fee-free accounts and special interest rates for certain products. Similarly, a large fee increase, especially for existing customers, may indicate that the bank needs cash. If a bank engages in several of these activities at once, it is probably time to take a closer look at the bank's financial health.

2. Have you reviewed the financial disclosures of the bank and have there been delays in the release of financial information?

Reviewing the bank's financial disclosure will yield insights into the health of the bank. When reviewing, be aware of when a bank typically releases financial reports. If the bank announces that its financial reports will be delayed, this could be a sign that the bank is in trouble and should get your immediate attention. It is also prudent to continually monitor the bank's website and social media accounts for press releases regarding changes to its financial stability.

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3. Has there been a decline in deposits?

If a bank's deposits are declining, it could mean that the bank doesn't have enough money to pay depositors trying to withdraw their money. Moreover, if depositors are withdrawing their money, this could be a red flag that there is something wrong with the bank. It could also mean that there is a perception among the bank's customers that the bank does not have enough money, and customers are making large withdrawals which turns their perception into a self-fulfilling prophecy of insufficient funds. You can compare year-to-year deposits for a bank on the FDIC's website.

4. Are capital ratios declining?

The various financial ratios for a bank may be examined by looking up the Uniform Bank Performance Report. As the website explains: "The Uniform Bank Performance Report (UBPR) is an analytical tool created for bank supervisory, examination, and management purposes. In a concise format, it shows the impact of management decisions and economic conditions on a bank's performance and balance-sheet composition. The performance and composition data contained in the report can be used as an aid in evaluating the adequacy of earnings, liquidity, capital, asset and liability management, and growth management." In particular, the UBPR will show whether a bank's capital ratios are declining when compared to the ratios of other banks. If the ratios are declining, this could be a negative indicator of the bank's financial health.

5. Are you monitoring financial news and the banks' social media accounts?

The first signs that a bank is in trouble may come from financial news or social media. Monitor both and pay attention to any information about a bank being acquired or sold or delaying its financial reports. In addition, pay attention to what is being reported about the bank on social media. While it is not always prudent to believe rumors, persistent rumors about a bank's stability may lead other depositors to withdraw funds or close accounts, leading to very real problems for a bank. Contagion should not be overlooked as a factor causing a bank to fail.

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