Garland W. Binns, Jr.
Dover Dixon Horne PLLC
Attorneys at Law
425 West Capitol, Suite 3700
Little Rock, Arkansas 72201
Telephone: (501) 978-9923
Facsimile: (501) 375-6484
Email: gbinns@ddh-ar.com
Web Site: www.GWBinns.com

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U P D A T E

News of Developments in the Financial Sector and Related Areas

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The FDIC conducted a survey to address such things as the ownership, management and financial performance of small community banks. The survey provides a detailed look at the organizational attributes of more than 1,350 FDIC-supervised, state-chartered community banks that operate in the Kansas City, Dallas, or Chicago Regions which encompass 21 states.

The survey noted that closely held banks may face operational challenges in raising external capital and recruiting future managers, especially in rural areas. At the same time, closely held banks may have certain operational advantages, including the ability to focus on long-term goals and to minimize principal-agent problems that may arise from the separation of ownership and operational control.

The survey compares the performance of closely and widely held banks as identified in the survey conducted by FDIC bank examiners and finds that closely held banks do not appear to be underperforming widely held banks in recent years. Closely held banks where the day-to-day manager is a member of the ownership group seem to outperform banks with a hired manager. The survey results suggest that almost 75 percent of community banks in these Regions can be regarded as closely held, typically on the basis of family or community ties.

By merging the survey results with Call Report data, the FDIC found that closely held banks have not underperformed widely held banks over the past six years, and that closely held banks in which the manager is a member of the ownership group, or is another insider, outperform both closely held banks with no overlap between ownership and management and widely held banks.

The survey reflected that community banks embody unique characteristics that distinguish them from other banks. Community banks are generally smaller in asset size than other banks. They tend to focus on traditional banking activities, making and holding loans, and funding themselves with core deposits. They hold relatively large amounts of equity capital relative to assets. Because they do business in a relatively limited geographic area, community banks are able to make operational decisions locally, frequently based on tacit, personal knowledge of their customers and market area, as opposed to relying primarily on models and standardized data. As a result, a defining characteristic commonly attributed to community banks is that of relationship lending, as opposed to a more impersonal, transactional banking model.

In a closely held bank, day-to-day operational control of the bank may reside with a manager who is either a member of the ownership group or can otherwise be considered an ownership insider. In other cases, the bank may be run by a hired manager who otherwise has no affiliation with the ownership group.

The FDIC found that the potential downside of significant overlap between ownership and control is the limited size of the talent pool from which to recruit qualified managers. When the ownership group comprises individuals with close family or community ties, those ties may also limit the pool of managerial candidates. Even if the owners of a closely held bank solve the principal-agent problem by finding a qualified manager in the ownership group, the bank may face the problem once again when that manager retires and the owners must find a qualified successor. Additionally, if the retiring manager wants to sell a substantial stake in the bank, the bank must also find a new owner as well as a new manager.

The survey reflected that 50 percent of closely held banks have not identified a potential successor for the key officer, compared with 54 percent of widely held banks. In addition, 38 percent of the closely held banks were not deemed to be "well-positioned to recruit qualified management talent from outside the bank," compared with 31 percent of widely held banks. Overall, the survey results indicate that succession planning remains a significant challenge for both closely and widely held community banks.

Closely held banks had average total assets of $264 million at year-end 2014, compared with $334 million for widely held banks. Closely held community banks are also more concentrated in rural areas than widely held banks and are more likely to be headquartered in depopulating counties. Banks headquartered in depopulating areas face challenges of declining customer bases and, in some instances, difficulty in attracting qualified management. Twenty-four percent of the closely held community banks were headquartered in depopulating rural counties, compared with only ten percent of widely held banks. Closely held community banks in the survey were also nearly twice as likely as widely held banks to specialize in agricultural lending.

The survey reflected that being closely held has not had a statistically significant effect on financial performance. Among community banks in the survey, closely held banks generally outperformed widely held banks in recent years when ownership and management overlap versus the manager being an outsider with no overlap. The average annual performance advantage for closely held community banks with management overlap was 21 basis points higher compared with closely held banks with no overlap, and 30 basis points higher compared with widely held community banks.

The survey noted that closely held banks raise external capital less often than their widely held peers, but they do not appear to be disadvantaged in their access to capital sources. One potential concern about the closely held organizational structure is whether it limits the bank's access to external sources of capital, thereby limiting the ability to respond to adverse shocks or to pursue strategic opportunities. The FDIC found that closely held banks surveyed have tended to rely more heavily on retained earnings to increase equity capital and to raise less capital from external sources than do widely held banks. Although closely held banks surveyed relied more on retained earnings to raise capital than did widely held banks, and raised external capital less frequently, there is little evidence that closely held community banks were at a decided disadvantage to widely held banks in terms of access to external capital.