Need A Bank Bailout? Too Big To Fail? … Call 1-800-Feds-4-Us
Small Community Bank? … Call 1-800-Pay-Atty

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Abstract

The Great Recession's impact was disproportionally distributed in the commercial banking industry. By December 2008, various agencies of the federal government had committed to nearly $7 trillion in assistance to the financial service industry. However, one-half of the $250 billion capital bailout went to the 9 'too big to fail' commercial banks. Meanwhile more than 400 insured banks failed, 85 percent of which were community banks. During the crisis, the FDIC ignored systemic risk in community bank loan participations until a small community bank in south Georgia actually sued the FDIC. The lawsuit devised by an Atlanta based attorney became the model for community banks struggling to avoid FDIC receivership. This paper describes the systemic risk and details the struggles and triumphs of this small community bank. (Finance, Banking, Intermediation, FDIC, Bank Failures)

Keywords: Capacity Building, Management of Human Resources, Economic Growth, Sustainable Development

Introduction

The Great Recession's impact was disproportionally distributed in the commercial banking industry. By December 2008, various agencies of the federal government had committed to nearly $7 trillion in assistance to the financial service industry, TARP (Troubled Asset Relief Program) representing a mere $700 billion of these funds. However, one-half of the $250 billion capital bailout included in TARP went to the 9 'too big to fail' commercial banks. The 'too big to fail' doctrine led to the bailout of these large financial intermediaries, but community bankers were not afforded any such leniency from their federal regulators.[1] From 2007 through 2014, eighty-five percent of failed institutions were community banks.[2]

While systemic risk imbedded in the largest financial behemoths was rightly being evaluated by federal regulators during the crisis, the FDIC ignored systemic risk in community bank loan participations; at least it did until a small community bank in South Georgia actually sued the FDIC. The lawsuit devised by an Atlanta based attorney became the model for community banks struggling to avoid FDIC receivership from excessive losses associated with these participations.

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[1] Many cite the bailout of Continental Illinois by the FDIC in 1984 as the origin of 'too big to fail' policy. However, Spraque (1986) traces the origin to the 1971 bailout of Unity Bank in Boston.

[2] This paper adopts the common practice of defining a community bank at the bank charter level with a $1 billion limit on total assets [DeYoung, Hunter, Udell (2004)].

Most research seeks to find statistically significant determinants using a large sample size. In this case, the more relevant question is "How does a firm avoid being one of the statistically significant 85%?" This paper examines the anomaly: how a community bank fought the FDIC and survived the Great Recession. The paper begins by describing the systemic risk involved in participation loans; it then details the financial struggles of this small community bank, Farmers and Merchants Bank, located in Lakeland, Georgia and concludes with the bank's latest triumph of survival.

Loan Participations

A community bank, in addition to its asset size, can be characterized by how and where it conducts its business. The typical community bank focuses its investment activities on traditional banking products offered in its local community; consequently, community banks face significantly increased risk due to lack of diversification. For decades, these banks have used loan participations to diversify the loan portfolios, allocate excess capital, and reduce risks associated with significant loan concentrations. The housing boom, however, created a new twist to these standard products.

For example, in 2007 The Peoples Bank in Winder, Georgia whose assets totaled less than $450 million created a $100 million loan for an Atlanta real estate developer planning to convert 5,600 acres of scrub brush near Phoenix, Arizona into a mammoth residential community. The loan, however, exceeded Peoples lending capacity (its entire loan portfolio at the time totaled less than $300 million and its equity capital less than $47 million), so Peoples got more than 60 other lenders to 'share' or participate in the loan.Peoples Bank, the seller, is the lead bank which manages the loan. In the event of borrower default, any losses (or profits) are distributed among all the participating lenders based on how much of the loan the respective lender owns.

Table 1

Federal Deposit Insurance Corporation
Failures and Assistance Transactions
US and Other Areas
Effective Dates: 2007 – 2014

State	Number of Institutions			Assets	Deposits	Estimated Loss
	Total	Failures	Assistance Transactions			
Alaska	0	0	0	0	0	0
Alabama	7	7	0	31,429,417	25,299,585	5,540,633
Arkansas	2	2	0	2,087,309	1,988,205	1,058,764
Arizona	15	15	0	2,363,667	2,083,561	595,955
California	42	40	2	126,535,860	75,658,020	19,865,757
Colorado	9	9	0	7,816,412	6,618,907	2,112,552
Connecticut	1	1	0	26,368	25,715	7,800
District of Columbia	0	0	0	0	0	0
Delaware	2	0	2	179,236,550	17,047,612	0
Florida	71	71	0	38,764,257	31,259,568	11,853,392
Georgia	89	89	0	35,850,912	32,443,023	12,066,879
Guam	0	0	0	0	0	0
Hawaii	0	0	0	0	0	0
Iowa	2	2	0	595,223	476,336	144,843
Idaho	2	2	0	644,017	516,393	116,426
Illinois	61	61	0	35,979,853	33,230,033	5,171,518
Indiana	3	3	0	5,016,738	4,118,982	1,018,002
Kansas	9	9	0	4,772,259	4,193,622	1,154,423
Kentucky	2	2	0	611,133	549,807	143,470
Louisiana	2	2	0	626,347	555,541	83,835
Massachusetts	1	1	0	245,534	233,222	24,634
Maryland	10	10	0	2,337,935	2,117,851	433,354

Maine	0	0	0	0	0	0
Michigan	13	13	0	4,735,745	4,244,107	1,336,755
Minnesota	23	23	0	3,099,282	2,936,199	731,324
Missouri	16	16	0	2,611,332	2,300,194	749,190
Mississippi	2	2	0	288,777	268,518	57,383
Montana	0	0	0	0	0	0
North Carolina	8	7	1	1,474,121,234	956,806,560	617,807
North Dakota	0	0	0	0	0	0
Nebraska	3	3	0	3,066,243	2,381,925	153,985
New Hampshire	0	0	0	0	0	0
New Jersey	5	5	0	526,306	511,664	133,285
New Mexico	3	3	0	3,470,419	2,788,769	416,364
Nevada	13	12	1	1,522,535,078	426,058,250	2,510,104
New York	5	4	1	38,969,444	29,487,799	212,546
Ohio	6	6	0	12,324,830	9,354,838	2,785,348
Oklahoma	7	7	0	1,195,477	1,103,260	180,003
Oregon	7	6	1	13,852,118	2,190,072	340,849
Pennsylvania	8	8	0	822,185	745,063	178,272
Puerto Rico	3	3	0	18,931,660	14,810,801	5,849,842
Rhode Island	1	0	1	35,410,586	500	0
South Carolina	10	10	0	3,041,833	2,792,700	652,645
South Dakota	3	1	2	78,323,704	42,890,070	118,445
Tennessee	5	5	0	2,259,150	2,204,727	586,673
Texas	11	11	0	22,949,343	19,192,923	2,230,291
Utah	7	6	1	65,037,763	56,779,733	1,101,001
Virginia	6	5	1	119,390,570	44,949,093	366,218
Virgin Islands	0	0	0	0	0	0
Vermont	0	0	0	0	0	0
Washington	18	18	0	11,178,169	9,969,002	2,283,410
Wisconsin	8	8	0	2,121,439	1,809,473	451,775
West Virginia	1	1	0	103,965	100,901	39,381
Wyoming	1	1	0	70,188	66,598	32,924
Totals:	523	510	13	3,915,376,631	1,875,159,722	85,508,060

With the burst of the housing bubble, the Arizona property soon ended in foreclosure. In 2009, Peoples Bank was trying to sell the property for $45.8 million; in 2010, the FDIC placed Peoples Bank in receivership (Grantham and Donskey). Subsequently, the FDIC negotiated the sale of the failed bank's assets and deposits to another (other) enterprise(s). Since 1991, the FDIC has employed a loss share feature in many of its purchase and assumption transactions. Under a loss share agreement, the FDIC agrees to absorb a specified amount of losses on a specific asset pool. Thus the FDIC through its loss share agreement creates an in-the-money put option for the successor lead bank.

The successor lead bank, with the FDIC covering much of its potential loss, is incentivized to quickly foreclose and sell the collateral property even at a deep discount. The remaining secondary loan participants, however, are not insulated by the FDIC and often suffer significant losses as a consequence. Thus, in addition to subsidizing the 'too big to fail' entities, the FDIC also subsidized those intermediaries large enough to make these types of acquisitions. The only group that did not receive any subsidy was the community banks.

For decades, community banks relied heavily on loan participations. But like derivatives prior to this debacle, statistics on loan participations were not publicly disclosed, and nationalized data did not exist. The fact that eighty-five percent of all failed banks were community banks documents the systemic risk associated with loan participations; in Georgia, it was an even higher percentage: more than ninety-three percent.As a consequence of the real estate boom and subsequent bust, the state of Georgia led the nation in the total number of bank failures from 2007 – 2014 and was second only to California in the estimated dollar loss of these failures (see Table 1).

Farmers and Merchants Bank (FMB)

Farmers and Merchants Bank was founded in Lakeland, Georgia in 1907; its headquarters are located in the rural community of Lanier County which according to the 2009 U.S. Census had a population of approximately 8,500 and a median household income of $33,732.FMB is a state-chartered, Fed nonmember bank whose primary federal regulator is the FDIC. The state-chartered bank is owned by the Federal Reserve regulated holding company, FMB Bancshares, Inc.

Like The Peoples Bank, FMB engaged in loan participations; unlike Peoples Bank, FMB was a participant not a lead bank.FMB participated in a loan with Silverton Financial. By 2007, Silverton was one of the nation's largest intermediaries specializing in loan participations: it originated approximately $650 million in loan participations in 2007 and more than $800 million in just the first seven months of 2008. In 2008, FMB participated with Silverton to fund a suburban apartment complex in Flowery Branch, Georgia. On May 1, 2009, the FDIC placed Silverton, with more than $1.4 billion in participated loans, in receivership.

The failure of Silverton forced FMB to fund Silverton's original $21 million share of the loan to the developer; the FDIC had refused FMB's request for funding as receiver of Silverton. FMB argued that it had no choice but to fund the loan, more than twice FMB's lending capacity and one-half of its capital at the time (see Table 2), or get sued.

Table 2
Capital Data
Farmers & Merchants Bank
(dollars in thousands)

	2007	2008	2009	2010	2011	2012	2013	2014
Tier 1 Capital	$36,993	$35,643	$25,539	$19,053	$20,235	$16,234	$15,047	$19,069
ALLL Includable Tier 2	$5,143	$6,059	$6,034	$5,598	$5,245	$5,169	$4,842	$5,107
Tier 2 Capital	$5,143	$16,059	$16,034	$8,753	$5,245	$5,169	$4,842	$5,107
Total Risk-based Capital	$42,136	$51,702	$41,573	$27,806	$25,480	$21,403	$19,889	$24,176
Tier 1 Leverage Ratio	7.8585%	6.0060%	3.9155%	3.1561%	3.4167%	2.7360%	2.7049%	3.4777%
Tier 1 Risk-based Ratio	8.9055%	7.3517%	5.3473%	4.3077%	4.9022%	3.9884%	3.9341%	4.7301%
Total Risk-based Ratio	10.1435%	10.6640%	8.7045%	6,2867%	6.1729%	5.2583%	5.2000%	5.9969%
Average Total Assets	$470,740	$594,741	$652,256	$603,693	$593,119	$593,350	$556,286	$548,327
+Troubled Asset Ratio – FMBank	31.90	121.0	167.30	226.60	224.30	297.50	266.80	244.60+
+Troubled Asset Ratio – National Median	5.00	9.90	14.50	14.60	13.00	10.70	8.40	7.10+

+Investigative Reporting Workshop (American University School of Communication). (http://banktracker.investigativereportingworkshop.org/banks/georgia/lakeland/farmers-merchants-bank/). Data for 2014 is for the period ending September 30, 2014; all other data is for fourth quarter each year.

The borrower soon defaulted, and FMB had a big capital problem due to the more than $10 million loss from this one loan as evidenced by its troubled asset ratio (see Table 2).

"A "troubled asset ratio" compares the sum of troubled assets with the sum of Tier 1 Capital plus Loan Loss Reserves. It is derived by adding the amounts of loans past due 90 days or more, loans in non-accrual status and other real estate owned (primarily properties obtained through foreclosure) and dividing that amount by the bank's capital and loan loss reserves. It is reported as a percentage. Generally speaking, higher values in this ratio indicate that a bank is under more stress caused by loans that are not paying as scheduled"[3]

[3] Investigative Reporting Workshop (American University School of Communication). (http://banktracker.investigativereportingworkshop.org/banks/georgia/lakeland/farmers-merchants-bank/).

In 2007, FMB's troubled asset ratio was more than five times that of the national median; in 2014 it is an astounding thirty-three times the national median. Since December 1992, regulators are required to 'prompt corrective action' when an insured bank fails to maintain certain capital standards (see Table 3).[4] The FDIC Improvement Act stipulated these provisions. By 2009, FMB was undercapitalized, and on May 19, 2009 the FDIC filed an Order to Cease and Desist:[5] IT IS HEREBY ORDERED, that the Bank, its institution-affiliated parties, as that term is defined in section 3(u) of the Act, 12 U.S.C. § 1813(u), and its successors and assigns cease and desist from the following unsafe and unsound banking practices and violations: (a) Operating with a board of directors ("Board") that has failed to provide adequate supervision over and direction to the management of the Bank; (b) Operating with management whose policies and practices are detrimental to the Bank and jeopardize the safety of its deposits; (c) Operating with inadequate equity capital in relation to the volume and quality of assets held by the Bank; (d) Operating with inadequate liquidity in light of the Bank's asset and liability mix; (e) Operating with a large volume of poor quality loans; (f) Operating with an inadequate loan policy; (g) Operating with an inadequate allowance for loan and lease losses ("ALLL"); (h) Failing to have appropriate controls over insider transactions and conflicts of interest; (i) Operating with a business strategy that has resulted in unprofitable operations and poor asset quality; and (j) Violating laws and regulations, as identified on pages 12-14 of the FDIC Report of Examination of the Bank dated June 30, 2008 ("ROE").

The Federal Reserve Bank of Atlanta and the Banking Commissioner of the State of Georgia followed the FDIC's lead by filing a similar document against the institution's bank holding company, FMB Bancshares, Inc. on November 11, 2009.

Table 3: Specifications of Capital Categories for Prompt Corrective Action (2011)

	Well Capitalized	Adequately Capitalized	Undercapitalized	Significantly Undercapitalized	Critically Undercapitalized
Total Risk-Based Ratio	10% or above AND	8% or above AND	Under 8% OR	Under 6% OR	Under 2% OR
Tier 1 Risk-based Ratio	6% or above AND	4% or above AND	Under 4% OR	Under 3% OR	Under 2% OR
Leverage Ratio	5% or above	4% or above	Under 4%	Under 3%	Under 2%

Under extreme regulatory and financial pressures, an Atlanta based attorney, Richard R. Cheatham, devised a strategy that would give the bank the time it needed to recover from such a catastrophic loss of capital: the bank sued the FDIC in federal court on October 6, 2010.[6] FMB argued that, legally, it was entitled to keep a separate $10 million loan it obtained from Silverton to offset the loss, *i.e.* it too was entitled to an in-the-money put.

Conclusion

FMB still operates six offices in five Georgia counties today because it forced the FDIC to level the playing field for this specific community bank, but with litigation comes substantial costs. Over the next two years, attorneys filed sixty-one documents related to this case (see Appendix A). The FDIC and FMB settled on March 21, 2012. Later that same year, the Cease and Desist Order was terminated. FMB, however, still operates under a Consent Order filed by the FDIC on September 25, 2012.FMB had set precedent.

As a consequence, other community bankers have sought similar court intervention persevering to the highest state level; in June 2014 the Georgia Court of Appeals ruled in favor of the secondary participate, First Citizens Bank of Georgia, by upholding a preliminary injunction to prevent the sale of collateral property that would result in significant losses to First Citizens Bank (Leibel). The Appeals Court decision is final – Georgia courts will intervene to protect its community banks. Perhaps most importantly, a more than 100-year-old community bank demanded that a federal regulator afford it the same consideration as a 'too big to fail' bank and won.

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[4] These standards have since changed with the passage of Basel III.

[5] FMB's financial condition continued to deteriorate eventually being classified as significantly undercapitalized. At the holding company level, FMB Bancshares reported a 1.31% Tier 1 Leverage Ratio, a 1.85% Tier 1 Risk-based Ratio, and a 3.69% Total Risk-based Ratio as of September 30, 2014. The holding company was critically undercapitalized.

[6] Mr. Cheatham is currently Senior Counsel at Troutman Sanders in Atlanta, Georgia.

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APPENDIX A

1:10-cv-03204-SCJ Farmers and Merchants Bank v. Federal Deposit Insurance Corporation
Steve C Jones, presiding
Date filed: 10/06/2010
Date terminated: 03/21/2012
Date of last filing: 03/21/2012
History

Doc. No.	Dates		Description
1	*Filed:* *Entered:*	10/06/2010 10/07/2010	Complaint
2	*Filed:* *Entered:*	10/06/2010 10/07/2010	Electronic Summons Issued
3	*Filed:* *Entered:*	10/06/2010 10/07/2010	Certificate of Interested Persons
4	*Filed & Entered:*	10/07/2010	Notice (Other)
5	*Filed & Entered:*	11/05/2010	Return of Service Executed as to USA
6	*Filed & Entered:* *Terminated:*	11/30/2010 12/02/2010	Motion for Extension of Time to File Answer
7	*Filed & Entered:*	12/02/2010	Order on Motion for Extension of Time to Answer
8	*Filed & Entered:* *Terminated:*	12/17/2010 02/01/2011	Motion to Dismiss
9	*Filed & Entered:* *Terminated:*	12/29/2010 01/03/2011	Motion for Extension of Time
10	*Filed & Entered:* *Terminated:*	12/29/2010 01/03/2011	Motion for Extension of Time
11	*Filed & Entered:*	01/03/2011	Order on Motion for Extension of Time
12	*Filed & Entered:*	01/09/2011	Notice (Other)
13	*Filed & Entered:*	01/09/2011	Amended Complaint
14	*Filed & Entered:*	01/13/2011	Response in Opposition to Motion

15	*Filed & Entered:* 01/19/2011 *Terminated:* 01/24/2011	Motion for Extension of Time to File Answer
	Filed & Entered: 01/24/2011	Order on Motion for Extension of Time to Answer
16	*Filed & Entered:* 01/31/2011 *Terminated:* 08/18/2011	Motion to Dismiss
	Filed & Entered: 02/01/2011	Submission to District Judge
17	*Filed & Entered:* 02/01/2011	Withdrawal of Motion
18	*Filed & Entered:* 02/10/2011 *Terminated:* 02/16/2011	Motion for Extension of Time
	Filed & Entered: 02/16/2011	Order on Motion for Extension of Time
19	*Filed & Entered:* 02/28/2011	Response in Opposition to Motion
20	*Filed & Entered:* 03/04/2011 *Terminated:* 03/11/2011	Motion for Extension of Time
	Filed & Entered: 03/07/2011	Case Assigned/Reassigned
21	*Filed:* 03/11/2011 *Entered:* 03/14/2011	Order on Motion for Extension of Time
22	*Filed & Entered:* 03/28/2011	Reply to Response to Motion
23	*Filed & Entered:* 03/28/2011 *Terminated:* 05/10/2011	Motion for Oral Argument
	Filed & Entered: 03/30/2011	Submission to District Judge
24	*Filed & Entered:* 04/13/2011	Response to Motion
25	*Filed & Entered:* 05/02/2011	Reply to Response to Motion
	Filed & Entered: 05/05/2011	Submission to District Judge
26	*Filed & Entered:* 05/10/2011	Order on Motion for Oral Argument
27	*Filed & Entered:* 05/24/2011	Response in Opposition to Motion
28	*Filed & Entered:* 06/07/2011	Reply to Response to Motion
29	*Filed & Entered:* 06/08/2011	Notice of Hearing on Motion
30	*Filed & Entered:* 06/10/2011 *Terminated:* 06/10/2011	Motion to Continue
31	*Filed & Entered:* 06/10/2011	Order on Motion to Continue
32	*Filed & Entered:* 07/29/2011 *Terminated:* 08/18/2011	Motion for Leave to File
33	*Filed & Entered:* 08/04/2011	Order on Motion to Dismiss
34	*Filed & Entered:* 08/15/2011 *Terminated:* 08/17/2011	Motion for Extension of Time
	Filed & Entered: 08/17/2011	Order on Motion for Extension of Time
	Filed & Entered: 08/17/2011	Set Motion and R&R Deadlines/Hearings
35	*Filed & Entered:* 08/17/2011	Response to Motion
36	*Filed & Entered:* 08/18/2011	Order on Motion for Leave to File
37	*Filed & Entered:* 08/18/2011	Amended Complaint
38	*Filed & Entered:* 08/30/2011 *Terminated:* 09/02/2011	Motion for Extension of Time to File Answer
39	*Filed & Entered:* 09/02/2011	Order on Motion for Extension of Time to Answer
40	*Filed & Entered:* 09/02/2011	Transcript

41	*Filed & Entered:* 09/16/2011 *Terminated:* 03/21/2012	Motion to Dismiss
42	*Filed & Entered:* 09/22/2011 *Terminated:* 09/26/2011	Motion for Extension of Time
43	*Filed & Entered:* 09/26/2011	Order on Motion for Extension of Time
44	*Filed & Entered:* 10/14/2011 *Terminated:* 10/28/2011	Motion for Leave to File Excess Pages
45	*Filed & Entered:* 10/14/2011	Response in Opposition to Motion
46	*Filed & Entered:* 10/18/2011 *Terminated:* 10/28/2011	Motion for Order
47	*Filed & Entered:* 10/28/2011	Order on Motion for Order
48	*Filed & Entered:* 11/14/2011	Reply Brief
	Filed & Entered: 11/17/2011	Submission to District Judge
49	*Filed & Entered:* 12/08/2011	Notice of Appearance
51	*Filed:* 12/09/2011 *Entered:* 12/15/2011	In Chambers Conference
50	*Filed & Entered:* 12/14/2011	Transcript
52	*Filed & Entered:* 12/28/2011 *Terminated:* 03/21/2012	Motion for Order
53	*Filed & Entered:* 01/09/2012 *Terminated:* 01/10/2012	Motion for Extension of Time
54	*Filed & Entered:* 01/10/2012	Order on Motion for Extension of Time
55	*Filed & Entered:* 01/13/2012	Response in Opposition to Motion
56	*Filed & Entered:* 01/17/2012	Notice (Other)
57	*Filed & Entered:* 01/18/2012	Response (Non-Motion)
58	*Filed & Entered:* 01/19/2012	Response (Non-Motion)
59	*Filed & Entered:* 01/23/2012	Reply Brief
	Filed & Entered: 01/31/2012	Submission to District Judge
	Filed & Entered: 02/08/2012	Order
60	*Filed:* 02/29/2012 *Entered:* 03/09/2012	Response (Non-Motion)
	Filed & Entered: 03/21/2012	Clerks Entry of Dismissal
	Filed & Entered: 03/21/2012	Terminated Case
61	*Filed & Entered:* 03/21/2012	Stipulation of Dismissal