
NOW IS THE TIME FOR HEALTHY BANKS TO DO SOME CAPITAL PLANNING

When Jeff offered the chairman 8% instead of 1%, he had his attention. Would he get yours?

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I have received a number of calls lately from healthy (yes, that is right, healthy) community banks looking to do some capital planning and contingency capital planning. (Yes, they are different).

I met with four separate banks regarding these matters. The process generally involves determining whether the organization has an actual capital need, which means capital would actually need to be raised, or whether the planning is simply contingent. For a bank holding company under \$500 million in total assets (not subject to consolidated capital guidelines), capital instruments at the holding company can be as varied as the imagination. Anything that generates cash for the holding company can be utilized, because it does not have to meet the test of "capital" at the holding company level. There is no consolidation at the holding company level for capital adequacy purposes.

Once the consolidated bank holding company exceeds \$500 million in total assets, then capital planning becomes a little more interesting. (That was the case with several clients involved with capital planning in the last couple of weeks.) That's because after that threshold, the holding company must consider what is considered holding company capital and what is not. Bank capital remains the same. Anything the holding company can generate as cash and inject into the bank becomes bank capital.

Once the holding company determines the short-term or the long-term need, then the question is, what is the source?

If the holding company is a publicly reporting firm, then possibly the holding company would have access to public capital markets.

If the holding company is a Subchapter S, then the question becomes, how much ownership dilution is the ownership group willing to accept?

The general test is "control." In most states, for a bank holding company, that means that the current ownership group (or family) needs to retain at least 50.1%. In most cases, this still would allow a significant equity issuance by the holding company.

Of course, a critical part of capital planning, contingency or otherwise, is to decide the order of preference of all of the alternatives. The general order of preference for most bank holding companies is to use debt capital at the holding company level; next, some type of equity, common, preferred, hybrid; next, sell assets; and last, sell the company.

I was recently with a multi-billion-dollar holding company that was fairly closely held. When I began to discuss debt financing to generate cash at the holding company to put equity in the bank, I mentioned the possibility that the control family could make a loan to the holding company.

The Chairman, one of the controlling shareholders, looked at me with eyes wide. I had his interest.

His eyes grew wider when I advised him that the rate on the loan to the holding company could be as high as prime or a little bit under or over. (Understand, this is a healthy holding company.)

He currently had on deposit in the bank about \$8 million-at about 1%-that he would just as soon lend to the holding company. He viewed this as a better alternative than the 1% he was getting at the bank. Step 1 of the Capital Plan is a loan to the holding company by the family. Step 2 of that Capital Plan is a line of credit by the holding company in the event the principal shareholders want to get paid back in the short-term.

The other steps are still in the process of identification, but overall this will provide a healthy contingency plan for this healthy bank holding company.

If your bank holding company has not engaged in capital planning or contingency capital planning, now is the time to consider it. Capital for opportunities will be necessary and likely available. Also, if you have any concerns about your next exam, capital contingency planning or stockpiling now, also makes sense.

About the Author

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Gerrish formerly served as Regional Counsel for the Memphis Regional Office of the FDIC, with responsibility for all legal matters, including cease-and-desist and other enforcement actions. Before coming to Memphis, Gerrish was with the FDIC Liquidation Division in Washington, D.C. where he had nationwide responsibility for litigation against directors of failed banks.

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