

Greenforest Bank: Case Study

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The current business environment is a difficult time for small one unit banks. Government regulators are encouraging small banks to merge into large chains of banks. The government is also subsidizing and providing regulatory support to large too-big-to-fail banks. The new President of the Greenforest Bank must prepare a plan for the future. Can a small independent bank with only one office survive in a high income borough in metropolitan New Jersey in the current environment? If so, a plan to increase profitability despite the current recession must be adopted by the bank. The President must make recommendations to her board after considering other options- merge the bank into a bank chain, seek additional capital through selling new shares of common or convertible preferred stock or develop, creative new ways of working with other small banks to use shared services to reduce costs.

INTRODUCTION

Greenforest Bank is the only single office bank left in the Borough of Greenforest, New Jersey. There are thirteen other banks with offices in the Borough ranging in size from the Bank of America, which is one of the largest banks in the United States, to several small New Jersey based banks with branches in a number of locations. Some of these banks absorbed formerly independent banks in Greenforest and continue to operate the formerly independent banks in Greenforest as local branches of their chain of banks. Cities, townships and boroughs near the Borough of Greenforest have even more banking services available and there are now several internet banks serving New Jersey as well. There are other financial institutions serving the area such as savings and loan associations and credit unions which provide some banking services as well as the 14 national and state chartered banks in Greenforest. Competition among banks in New Jersey is fierce.

Greenforest Bank is named for the Borough of Greenforest and was founded and is currently controlled by persons who live or work in or near the Borough of Greenforest. The Greenforest Bank has no other offices and concentrates all its business efforts in the Borough of Greenfield through its one location but has some business relationships with persons and organizations located outside the Borough of Greenforest who like to bank in the Borough for some reason.

The Borough of Greenforest is one of the wealthiest municipalities in New Jersey. The Greenforest Bank caters to its upscale customers with an atmosphere and services that they like. For example, there are no bars or cages at teller locations and customers sit down in front of tellers across a desk instead of standing to complete their transactions. There are always fresh flowers at teller stations and free candy is available on the desks where deposit slips can be found as well as the usual free pens and free calendars that are always available. The bank president's office is where the whole bank floor can be seen and the president is available whenever she is in her office to meet and greet customers as desired on a walk in

basis. The president's administrative assistant sits outside the president's office and the administrative assistant acts as a greeter to all who come in the bank. There is free parking for all in the bank parking lot and there are drive in banking stations where customers can do their banking from their car. At the end of the month, the whole bank staff works late to quickly get out monthly bank statements to the customers dated on the first of the month. Customers are known by voice to the tellers who have usually worked at the bank for many years and can give out information to the customers on the checking and savings account balances over the phone because of their voice recognition without as much red tape because they know the customers personally.

More than half of the adult residents of the Borough of Greenforest are college graduates. Some of them work in the financial field with offices in nearly New Jersey cities or in Manhattan which is about an hour's commute by public transit from the Borough. Others work in managerial positions in the many corporations in Northern New Jersey or in New York City or they own their own small businesses. Many homes in the Borough are larger than in other New Jersey communities and a good number of these homes have been purchased for cash from Wall Street bonuses.

The president of the bank and all senior officers are active in the community by serving on community boards and participating personally and on behalf of the bank in community fund drives and other charitable causes. Each year the Greenforest Bank is usually one of the most generous corporate donors to local charities such as the local United Way and other long time local charitable organizations.

The Greenforest Bank was chartered by the State of New Jersey as a state regulated bank in 1982. It was founded with initial funding from owners of three large real estate firms in Greenforest. One of these firms has owned several office and commercial buildings on Main Street in Greenforest for three generations of their family. The grandson of the founder who now runs the real estate investments for his family and his sister control between them more than 25 percent of the stock in the bank. A second large owner of commercial properties in the Borough owns 10 percent of the bank stock and a third realtor who owns some office buildings but largely functions as a realtor of both commercial and residential properties in the community and nearby areas owns about 4 percent of the stock. The senior partner in the largest law office in the Borough owns about 5 percent of the stock and has served for many years as Chairman of the Board of Directors of the Greenforest Bank. Many shareholders of stock rely on the chairman's advice or the advice of one of the three big real estate investors in deciding how to vote their shares in the bank. Some small shareholders own as few as 5 shares and many own 100 shares.

BANK OPERATIONS

Small community banks like the Greenforest Bank everywhere in the United States are struggling today. Some large national banks have been deemed by the federal government to be too-big-to-fail and have been subsidized with TARP loans and in other ways and are not as regulated in some areas as closely as small banks. Large banks have some economies of scale in operating expenses and have some advantages compared with smaller banks in making commercial loans since they have more capital and can thus take on larger loans without the help of correspondent banks than can a smaller community based bank. Because smaller banks have fewer assets they cannot diversify them as well sometimes as larger banks. Therefore, regulators often expect smaller banks to make more conservative investments and loans and keep more liquidity than what regulators often expect from large banks.

The great recession has caused many challenges for small community banks such as Greenforest Bank. The local economy even in an upscale community such as the Borough of Greenforest has been significantly impacted by the great recession. Real estate values and employment have gone down significantly. For years the stockholders of the bank enjoyed a strong historical performance but in 2008 and especially in 2009 and probably in 2010 financial results have been less satisfactory to the bank.

Bank Capitalization and Recession Problems

During a recession like the current great recession, a bank's capital is the most important financial ratio for the stockholder's protection. The management and the directors at the Greenforest Bank have

accumulated the following levels of capital as of the end of 2009: Total Tier I Capital to Total Risk-Weighted Assets was 19.14 % compared with regulatory requirements of a minimum of 6%. Total Capital to Total Risk-Weighted Assets was 20.42% , compared to a regulatory minimum of 10 %. The bank has not had to issue new stock which in the current market would dilute the holdings of existing shareholders nor has it been required to seek TARP or other government aid.

Because of the downturn in the local real estate market, during 2009 the Greenforest Bank added \$4.48 million dollars to its loan loss reserve. Changes in the business cycle for 2009 and subsequently may require further additions to this loan loss reserve.

Industry wide increases in FDIC premium costs increased expenses for these costs to the bank from \$16,800 in 2008 to \$241,800 in 2009. In December 2009, the bank was forced by new government regulations to prepay three years of FDIC costs up front.

Because of the great recession, low interest rates have been set by the Federal Reserve System which has reduced the Bank's income from loans, investments and overnight federal funds. Supporting small businesses especially through construction loans has long been a major source of income to the Greenforest Bank. New construction projects have virtually disappeared due to the current economic recession and some present loans are in arrears due to the economy.

To further recognize the importance of maintenance of capital, the Bank has discontinued its dividend payments to stockholders and the regulators have imposed a moratorium on future dividend payments without advance permission from the regulators.

The common stock of the bank has declined since the start of the great recession in 2008 from a price of 42 dollars per share to a low of 18 in November 2010.

Attached as Exhibits One and Two of this case are the audited statements of financial condition of the bank.

New President and CEO

The long term (more than 15 years) president of the bank retired on December 31, 2010 for reasons of age and health. The directors of the bank chose a new president after a search with help from an executive search firm. The new president, Ann Franklin, started as president of the bank on January 1, 2011. She was born and raised in Lawrence, Kansas and received her Bachelor of Science in Business degree from the University of Kansas with a major in Finance. Her parents ran a local real estate firm in Lawrence and while working there she met a young professional engineer who was working as a consultant on a building at the university.

Ann and the young engineer were married a year after her graduation from the university and they moved to a small township in New Jersey a few miles from The Borough of Greenforest. Her husband worked for a New Jersey construction engineering firm until he retired five years ago. They had two children who have married and moved away from New Jersey. When the children were growing up, Ann worked as a teller at a local savings bank in their home town. Eventually she worked her way up the line in the bank and when the savings bank was merged with a larger New Jersey bank kept advancing until she became President and CEO of that bank four years ago. That bank has its headquarters in a large New Jersey city. After that bank was acquired by a hedge fund two years ago the executives of the hedge fund decided to add a new CEO they selected for the bank and Ann continued as President with reduced authority. She decided to take early retirement from the larger bank effective October 1, 2010 and became the President and CEO of Greenforest Bank effective January 1, 2011 at a salary somewhat lower than she was earning at the much larger bank. She states that she expects that her new job as President of the Greenforest Bank will be her last executive assignment before she retires to enjoy her grandchildren and share her husband's retirement.

Ann Franklin brings to the Greenforest Bank many years of experience in banking in New Jersey. She is well known in the area professionally and will likely bring some clients to the bank who have worked with her before. She is attractive for a woman of 61- looking much younger than her age. She is known for her friendly and somewhat laid back personality and for her short skirts and long brown hair and for always wearing very high heels because she is below average in height. She has a good sense of humor

and has a record of getting on well with bank employees and customers alike. Because of her long experience in banking in the next town and in the large city in New Jersey where she worked for some years as well as her acquaintance with government regulators in Washington and in Trenton, she is expected to bring added knowledge and experience in banking and in marketing to the Greenforest Bank.

She completed three months of transition until the retirement of the previous president so she has gotten to know more about the finances, policies and procedures of the bank and has gotten to know all the persons working at the bank as well as meeting many customers and local community officials.

Bank Management

The management of the bank begins with the Chairman of the Board who presides over the meetings of the board of directors. Ann Franklin, as President and Chief Executive Officer of the bank, reports to the Board through the Chairman. Reporting to Ann are eight key officers, five of whom are Senior Vice Presidents. Each of the key officers is in charge of separate departments such as loan administration, human resources, information technology, accounting, bank office administration, compliance, and new business development. The key officers are aided by staff such as tellers (personal bankers) and specialized staff such as deposit operations representative, loan operations and other specialists.

Options to Increase Bank Income

The Greenforest Bank has been very dependent upon construction loans to make profits in the past. Very few of these loans are being made currently because of the decline in construction due to the recession and the need to raise standards for making such loans due to increased possibilities of default in repayments due to the recession. If the bank is to succeed in the long run, Ann and her officers and the board must develop new sources of profit for the bank if it is to be profitable.

One possible new source of income is to enter the individual mortgage market with loans on privately owned homes. The bank tried this some years ago but ran into problems in servicing such loans and abandoned this possible source of revenue because of the expense and difficulties of loan servicing. One option is to begin to market individual mortgages but contract out all servicing to a larger bank that already has the facilities and staff to service loans at a reasonable cost to the bank.

Another option is to add service to try to attract new customers for existing products. Some of the bank's competitors have extended their hours to more evening hours and extended hours on Saturdays and even Sunday and holiday service. The costs of extending hours need to be compared with the possible profits from increased deposits and other services to see if this would be attractive. Perhaps other services such as money changing for foreign currency transactions for customers traveling abroad and for international business transactions could be pushed harder. Internet banking could be encouraged that might lead to increased business and might save on some costs by sending statements over the internet rather than mailing them. Perhaps more could be done in cooperation with other service firms such as local travel agencies and tax and other business services providers.

Perhaps this bank can get together with other smaller banks to share some services such as information technology and other operations so as to achieve some of the economies of scale used by larger banks to offer more services at a lower cost.

Other Opportunities

Another opportunity is to merge the bank into one of the larger banking chains operating in New Jersey that does not have an office in the Borough of Greenforest. Larger banks will purchase smaller banks like the Greenforest Bank for cash or for stock or for some combination of cash and bank stock. Since the stock in the Greenforest Bank is currently selling at a lower price than in recent years, most of the directors are unwilling to sell their shares in the bank at current prices. A takeover offer is likely to require a premium in price at this time. Such a premium might be justified by expected cost savings in operations after a possible merger of the bank into a larger bank chain.

Additional capital could also be raised by the bank by selling additional shares of bank stock or by selling convertible preferred bank stock. The low current price of the bank's stock and the dilution of

earnings per share that would occur to a sale of additional stock or convertible preferred stock makes such a sale of additional shares unattractive to many current stockholders.

Ann needs to prepare a plan to increase profits and to reduce costs where possible for the Greenforest Bank and to help the Board of Directors decide whether it can stay in business as a small independent bank in the future or should be sold to a bank chain or a large private investor probably at lower prices than the bank stock has sold for before the current recession reduced the market price of the stock.

Note: The name and location of the bank, the identities of the persons in the case and the financial statements have been disguised to protect the confidentiality of the bank and its employees.

Exhibit One- Financial Statements Greenforest Bank, New Jersey

Statements of Financial Condition December 31, 2009 and December 31, 2008
(All figures have been rounded to the nearest dollar)

ASSETS	2009	2008
Cash and due from banks	\$16,081,421	\$17,604,927
Certificates of deposit	3,500,000	9,100,000
Available for sale securities at fair value	2,795,501	3,457,510
Held to maturity securities (fair value \$8,524,408 in 2009, \$10,076,081 in 2008)	8,497,912	9,972,456
Loans receivable (net of allowance for loan Losses of \$3,941,052 in 2009 and \$2,358,027 in 2008)	88,508,159	93,853,488
Accrued interest receivable	401,461	602,923
Real estate owned	1,330,000	3,668,066
Federal Home Loan Bank stock at cost	743,120	743,120
Net premises and equipment	6,618,732	6,743,675
Net deferred tax asset	1,880,036	2,063,414
Other assets	3,087,598	1,025,506
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Total assets	\$133,504,391	\$148,835,085
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LIABILITIES AND STOCKHOLDERS EQUITY

Liabilities

Deposits		
Non interest bearing deposits	18,491,703	14,687,347
Interest bearing deposits	94,262,297	104,822,700
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Total deposits	112,753,999	119,510,047
Advances from the Federal Home Loan Bank	-	4,900,000
Accrued expenses and other liabilities	374,017	866,362
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Total liabilities	113,128,016	125,276,409
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Stockholders Equity

Common Stock, par value \$5, 1,400,000		
Shares authorized, 673,743 shares issued	3,368,715	3,368,715
Additional paid-in capital	4,015,789	4,015,789
Less Treasury stock at cost, 151,564 shares (2009) and 145,677 shares (2008)	(7,767,540)	(7,592,064)
Retained earnings	20,764,253	23,790,851
Accumulated other comprehensive losses-net Unrealized loss on available for sale securities, net of taxes	(4,843)	(24,615)
Total stockholders equity	20,376,374	23,558,676
Total liabilities and stockholders equity	\$133,504,391	\$148,835,085

Exhibit Two- Financial Statements Greenforest Bank, New Jersey

Statements of Income
Years Ended December 31, 2009, 2008 and 2007
(All figures have been rounded to the nearest dollar)

	2009	2008	2007
Interest Income			
Interest and fees and loans	\$5,749,800	\$7,219,644	\$8,421,526
Interest on securities	230,756	1,116,834	1,595,359
Interest on federal funds sold	-	55,762	422,860
Other	328,442	348,697	196,441
Total interest income	6,308,998	8,740,937	10,636,186
Interest Expense			
Interest expense on deposits	1,079,142	1,934,169	2,859,617
Other interest expense	50,600	155,297	42,427
Total interest expense	1,129,802	2,089,466	2,902,044
Net interest income	5,179,196	6,651,471	7,734,142
Provision for Loan Losses	4,480,000	-	-
Net interest income after provision for loan losses	699,196	6,651,471	7,734,142
Non interest Income			
Service charges and fees	167,436	208,870	234,324
Net losses on installment securities	(39,203)	(2,255,288)	-
Other	267,596	241,508	246,039
Total non interest income (loss)	395,829	(1,804,910)	480,363

Non interest expenses			
Salaries and employee benefits	2,289,206	2,543,236	2,468,110
Net loss on foreclosed real estate	548,841	10,368	-
Occupancy and equipment	522,008	490,605	468,016
Professional services	290,494	201,183	248,172
FDIC deposit insurance	241,032	16,216	13,961
Data Processing	202,201	196,893	200,581
Advertising	53,619	97,329	84,288
Other	722,033	769,038	834,891
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Total non interest expenses	4,869,434	4,324,868	4,318,019
Income (Loss) before income taxes	-----	-----	-----
	(3,993,245)	521,199	3,897,665
Provision for income taxes	(1,573,600)	118,300	1,467,300
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Net income (loss)	\$(2,419,645)	\$402,899	\$2,430,365
Basic earnings (loss) per share	\$(6.45)	\$1.05	\$6.24
Diluted earnings (loss) per share	\$(6.45)	\$1.05	\$6.22
Dividends per share	\$ 1.61	\$2.94	\$2.80

GREENFOREST BANK: INSTRUCTOR'S NOTE

CASE ABSTRACT

The current business environment is a difficult time for small one unit banks. Government regulators are encouraging small banks to merge into large chains of banks. The government also is subsidizing and providing regulatory support to large too-big-to-fail banks. The new President of the Greenforest Bank must prepare a plan for the future. Can a small independent bank with only one office survive in a high income Borough in metropolitan New Jersey in the current environment? If so, a plan to increase profitability despite the current recession must be adopted by the bank. The President must make recommendations to her board after considering other options- merge the bank into a bank chain, seek additional capital through selling new shares of common or convertible preferred stock or develop creative new ways of working with other small banks to use shared services to reduce costs.

OBJECTIVES AND USE

This case is intended to serve several purposes. First, it aims to acquaint students with the function of a small one unit bank in today's world of extreme competition among banks in an environment where government regulators favor large too-big-to-fail banks by subsidizing them and by harsher regulation of small banks which regulators would like to see merged into becoming parts of bigger banks. The price of bank stocks in small banks has often declined and speculators and larger banks are trying to purchase these smaller banks at prices lower than such stocks have sold for before the recession. The case contrasts the efficiency of large banks with the personal services and friendliness of a small one unit bank.

This case is also intended to help students understand the role of small one unit banks and whether they might still have a useful role in the future. The role of the bank president is important to the future of a small community bank. Students could be encouraged by the instructor to look at entrepreneurial ways to help a small bank compete in the current economy despite limited capital.

Understanding and analyzing this case requires some knowledge of finance, money and banking, relationships between business and society, management and governance. Accordingly, the use of this case is intended for graduate courses in management, business, money and banking, finance and business

strategy. It could also be used productively in a senior level undergraduate course in strategy provided there are a significant number of knowledgeable students to help the class understand all the issues in the case.

PEDAGOGICAL METHODS

Instructors will need to play an active role in teaching this case. Virtually every student in the class will have some experience in banking. Comparisons by students of large bank chains with small community banks will be helpful. Professors should welcome the opportunity to glean from student points of view the advantages and disadvantages of small community banks. Location and numbers in the case have been disguised to protect the confidentiality of the bank.

DISCUSSION QUESTIONS

1. Ann Franklin is the new president of Greenforest Bank. What should she do in her first months as president to help the bank?

Ann has considerable experience in banking including experience as a former CEO and president of a larger bank in a nearby big city in New Jersey. Bank presidents need to be joiners. Ann should join and become active in one of the service clubs in the community such as Rotary, Exchange, Kiwanis, Soroptimists or Lions Club after studying which service club is likely to be most important to the bank in the Borough of Greenforest. She also needs to get involved with other community activities such as United Way, Red Cross, a local hospital, other local charities and other ways to get known quickly in the community. She should try to write a guest column with the local newspaper or get interviewed by the local newspaper and local or regional cable TV station. She needs to get to know local and state government officials so as to be able to get their help when needed on regulatory matters. She needs to meet the New Jersey State bank regulators if she does not already know them and bring them up to date on what her bank is doing to serve its local community and customers. She also needs to get to know all of the members of her staff in a one unit bank. She should spend time with each employee to get to know all her associates at the bank. She needs to spend a lot of time with each officer of the bank to get to know them and to decide whether they are effective in their positions. If any officer is not effective, she needs to help them become effective if possible or move them to another position or terminate them if they will not benefit the bank in the future.

Ann needs to spend time with each member of the board of directors of the bank and with members of bank advisory boards. She needs to spend time with each major stockholder and especially needs to develop a good relationship if possible with the Chair of the Board.

She needs to meet with all big customers of the bank (depositors and loan customers). She needs to say "Hello" to as many customers as possible during the first few months as President of the bank. Her door to her office must be open as much as possible for anyone to wander in who wishes to talk with her about the bank.

If possible under her retirement arrangements with the larger bank, she can communicate with former customers of hers in her previous positions and let them know about her new position and solicit their business for her new bank directly where appropriate or through other senior officers of the bank where appropriate and ethical.

2. What can be done to make the Greenforest Bank more profitable?

The instructor should try to get as many ideas as possible from the class. Students who are entrepreneurial but not familiar with small banks may come up with some novel ideas that might be feasible in a small bank such as the idea of letting good customers of the bank advertise in the lobby of the bank or elsewhere in the bank at a small fee, or new ways of promoting the bank by sponsoring a new

community service such as bankers going to local nursing homes to directly meet the banking needs of persons unable to travel to the bank or using new social media such as Twitter and Facebook.

The instructor can also lead a discussion on the advantages and disadvantages of making loans on residences. Persons receiving a mortgage can often be requested to consider using other bank services such as a checking or a savings account or mortgage insurance through a company working with the bank or renting a safety deposit box or many other services. The disadvantage of the paper work required to service a mortgage can be discussed and the option of subcontracting of mortgage servicing discussed.

The instructor can also push the students to come up with ideas for other commercial type loans besides construction loans to present or future customers. For example, the bank may wish to get into the business of helping finance inventory or accounts receivable for businesses where security is adequate and the bank can train personnel to handle such loans.

Extended hours and days of service could be considered. For example, is 24 hour banking feasible or Sunday hours feasible and likely to bring enough profit to the bank to cover the cost of such service?

The instructor may also wish to look at possible cost savings through internet banking and sharing of some services such as IT with other banks.

One of the problems of a smaller bank that differentiates it from a large too-big-to-fail bank is that it cannot usually participate in the "Carry trade" whereby a bank borrows from the Federal Reserve and invests in short term treasury bonds. The spread in interest between the lower cost borrowing from the Fed and the higher interest paid by the treasury bonds is currently profitable to some large banks. Small banks usually do not have the capital nor the liquidity to be able to participate in the Carry trade because of the risk of changes in the treasury bond prices in the short term.

3. What other alternatives should be considered if it is likely that the regulators will require additional capital for the bank ?

If additional reserves are needed to protect the price of the stock for the shareholders and or to help build reserves as part of capital, the bank will need to consider other alternatives.

One alternative is to raise additional capital through a sale of additional shares of common stock or convertible common stock. Such an issue of stock would probably dilute the earnings of present shareholders but might be necessary for survival due to possible regulatory pressures to increase capital.

Another alternative would be to negotiate a merger with a bank chain. The disadvantages of this alternative may be the loss of control and dilution of equity of present shareholders although this would be preferable to a weakened capital structure that might lead to a government sale of the bank with possible loss of all equity to present shareholders.

A different alternative would be to create a new bank holding company which would buy this bank and other small banks but keep each bank with an independent name and administration but with some sharing of services.

Ultimately, the shareholders will need to decide this issue. Some shareholders may need cash now and might welcome sale of the bank to a larger bank if they can be paid off in cash now. Others would perhaps benefit more by an exchange of stock in the bank for stock in a larger bank which would not have any tax consequences at the time of the merger- capital gains taxes (if any) could be deferred until the new shares issued by the acquiring bigger bank in lieu of the present shares in the bank being acquired are sold by a stockholder.

If Ann and the directors decide to kept the bank independent, it would be helpful if Ann buys some shares in the bank to show her confidence in the future of the bank.

4. The better students will perform a financial analysis on the bank. The bank had to increase its reserves against possible bad debts on its construction loans to satisfy the regulators. This is the main cause of the loss in 2009. Perhaps government regulators may have required the bank to add too much to the reserves by valuing existing construction loans at too low a value because of present risks in the economy. If the construction loans are in fact better than the current market value due to these higher

reserves and the loans are repaid by the customers over time, the bank may show additional profits in the future. The instructor may wish to walk the students through the numbers so that students can better understand the financial situation of a bank in a time of recession. On the other hand, if the economy should deteriorate in the future the risk of these construction loans not being repaid will become greater and this could cause the bank to have inadequate capital ratios and lead the regulators to close the bank or to force its purchase by another bank with more capital or an investment group with loss of some or all the equity held by the current shareholders.