

# Tennessee Commerce's model grew fast, but couldn't last

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It all happened so fast.

Just minutes before 4 p.m. Friday, the string of Tennessee state patrol cars entered the parking lot and fanned out, officers filing into a back door to secure the location. Inside, regulators set to the bean counting, document collecting and other aspects of their historic task: closing Tennessee's first failed bank in the wake of the Great Recession.

Tennessee Commerce Bank, at that moment one week ago, completed its similarly quick transformation from a lender weathering tough times to one whose problems were insurmountable. Those problems — becoming fully apparent just last year and leading to a rapid decline — tie back to the basic elements of Tennessee Commerce's business model and how management executed it, according to a range of people knowledgeable of the bank's escalating troubles and final days. As someone who assessed the bank's loan portfolio put it, "It just became a cycle that nobody really wanted to put any more money into."

The Franklin bank operated in a niche, spurring growth that made it a tiny dynamo but also masked inherent problems that some knowledgeable of the bank and its loan book say trace back to its beginnings. By the time of the failure, regulators with the Federal Deposit Insurance Corp.

declared specialty lending and lack of oversight by the bank's board and management as the reasons they closed it down.

## **How they made their money**

Tennessee Commerce mainly handled loans and leases for trucking companies and other ventures in need of heavy equipment. It did so not just in Middle Tennessee but across the country.

Secondly, the bank fueled its loan growth with "non-core" deposits — mainly those it bought on the open market as opposed to collected from consumers — at a level far higher than other banks its size, according to FDIC data.

The expertise to do equipment lending ties back to chairman and CEO Mike Sapp, who made a lucrative business out of it during his days at First American and afterward — then faced the risks on a new level with a bank based largely on that opportunity. Art Helf, who co-founded Tennessee Commerce with Sapp in 2000 and remained on the board after retirement, once described their venture as a "vision to create a different kind of bank" focused on business needs with service top of mind.

The result was a small, but rapidly growing, bank — it topped out at \$1.5 billion in assets — specializing in lending that is usually just one line of business within larger institutions. While other banks made their bets on real estate, Tennessee Commerce largely operated in a whole different area.

Kenneth James, a Nashville analyst with Sterne Agee & Leach of Birmingham, Ala., who previously covered the bank, declined to comment in depth on Tennessee Commerce's business model, but said there's no question the bank was distinct from other lenders in the area.

"The situation was so unique," he said.

Tennessee Commerce can trace some of its issues to the broader recession, too. A good deal of the bank's model was tied to trucking, an industry often regarded as an on-the-ground indicator of economic conditions.

## How they lost their money

Jon Bruss, managing principal and CEO of Wisconsin-based investment group Fortress Partners Capital Management, said major operations — Wells Fargo & Co. and JP Morgan Chase & Co. — have shown that with proper safeguards “there is a lot of money to be made” in equipment leasing. But this arena also has unique challenges, like rapidly deteriorating and mobile collateral, that makes it a different kind of animal as a bank’s lead business line, he said.

“If they were concentrated that’s not a good idea,” Bruss said. “If they were scattered all over God’s green acre, that’s probably not a good idea, either.”

It all adds up to a picture that many who looked at the bank in its last days considered ugly.

Bankers and other financial professionals who reviewed its portfolio, received briefings or explored picking up Tennessee Commerce clients, said the distinct set of loans, the geographic diversity of the portfolio and a trend of loose underwriting left deals many lenders wouldn’t touch.

Other sources familiar or associated with the bank’s current and previous dealings say the economy deserves primary blame. Trucking was hit hard, they said, and Tennessee Commerce’s business wasn’t by definition more risky — just different, creating fallout that was particularly difficult to deal with for a bank of its size.

It also stands to reason, banking professionals said the portfolio got worse as Tennessee Commerce lost or sold its prime business while fighting to stay afloat. But some associated with the bank say aggressive lending in unfamiliar markets, without proper standards, was a problem, though there’s disagreement about how far back that stretched.

Brokered deposits, or those purchased on the open market, meanwhile, became a problem in the eyes of regulators, who prefer more stability from local customers stashing their savings, sources said. Buying deposits can help a bank quickly get money to fuel loan growth, but it can also be expensive — requiring more growth to pay for them.

Tennessee Commerce was in the top 25 percent among peer banks with “non-core” funding, which includes brokered and other types of deposits, from 2008 and 2009. That dipped in 2010 as the bank improved its deposit base, but by late 2011 Tennessee Commerce had four times the amount of non-core deposits as its peers.

## How a sweet story soured

The bank saw success for several years navigating its risk-reward scenario. But it also fought to shed accusations by former chief financial officer George Fort, who filed a whistle-blower complaint alleging, among other things, weak internal controls.

Fort and the U.S. Department of Labor argued he was improperly fired as a result of that, but Tennessee Commerce denied it. In 2011, the bank announced it had settled with Fort.

Reached this week, Fort declined to discuss his previous allegations. But he said the sort of matters that public documents lay out — court records recount his fears over internal controls — can indeed impact a bank’s long-term health.

“I’m just concerned (for) all the people who lost their money,” he said.

That does not include depositors, whose money is safe in the hands of acquiror Republic Bank & Trust Co. of Louisville, Ky., with the FDIC’s insurance of up to \$250,000 as a backup. But as the bank bounced from profit to loss on a quarterly basis in recent years, its stock price fell, logging major losses for investors in parent company Tennessee Commerce Bancorp (Nasdaq:TNCC). And in 2011, matters got worse. Negotiations with regulators over the value of a handful of loans led to the bank setting aside more money for potential losses, and spurred scrutiny that led to further write downs.

In November, Tennessee Commerce Bancorp disclosed a \$120 million third-quarter loss to investors, kicking off a search for capital and subsequent acknowledgments that its finances were unreliable. Later that month, major borrower Ed Lowery’s company, Citizens Corp., filed for Chapter 11 bankruptcy.

The issues with Lowery further strained the bank, and both parties engaged in battles in bankruptcy court over Citizens' assets — searching for ways to salvage what they could and show why the other side was responsible. Shortly before its closure, Tennessee Commerce disclosed a "forensic" review of past quarters that cast further doubt about its practices.

Tennessee Commerce management declined comment through an attorney, and Lowery's issues with other banks are ongoing. Republic has said it hopes to keep as many Tennessee Commerce people as it can, while declining to comment on management.

Steven Trager, Republic president and CEO, said his bank does some leasing business, and the bank did buy about \$120 million in loans while assuming the bank's deposits. But he said its offerings also include a range of general consumer and commercial banking options, too.

With that new portfolio, the business model that fueled major growth at Tennessee Commerce — and ultimately drew regulators to its doors — was officially gone by 4:06 p.m. Friday.

### **Staying the course**

The Haslam administration is expressing continued confidence in Tennessee's financial system as the industry wrestles with the implications of its first two bank failures of the Great Recession.

Tennessee Commerce Bank in Franklin became the state's first failed institution since 2002.

BankEast, a Knoxville bank with ties to former banking commissioner Fred Lawson, was closed minutes later, further tarnishing Tennessee's record as the largest state in the country to avoid a bank failure in the downturn and sluggish recovery.

Commissioner Greg Gonzales of the Tennessee Department of Financial Institutions — one of the few appointees Republican Gov. Bill Haslam kept from his predecessor, Gov. Phil Bredesen, a Democrat — said Tennessee's record still stands strong compared to many states and credited the industry.

"I think that says a lot for the banking system here," Gonzales said.

Bankers said Tennessee Commerce, which had a distinct business model, doesn't exemplify the health of Middle Tennessee or the state. And the direct fallout of both closures — possible lawsuits against boards or management and financial hits to other institutions — is yet to be seen.

But having no failures was a psychological boost, and without that, rumors of other troubled banks have heated up in private conversation. The debate over whether there are banks that need closure — some argue a lingering "zombie" bank simply drags down the system and prolongs pain — is alive and well.

Meanwhile, there are reasons to remain confident.

Richard Herrington, president of Franklin Synergy Bank in Franklin, said people should take comfort in the regional economy. His bank has remained steadily profitable from its Franklin home base, and he noted that others also are showing strength in Middle Tennessee.

"We're very fortunate to be banking in this community," he said.

Gonzales — who has worked to prevent failure by allowing banks time to work out their problems — remained resolute. Regulation requires a balance between monitoring soundness and freeing institutions to operate as they see fit for a robust economy, he said. In a statement, Haslam spokesman Dave Smith said most state banks remain well positioned, "a credit to prudent management."

The Federal Deposit Insurance Corp. will ultimately review whether it should have acted differently in its oversight. Gonzales, who cited state law prohibiting him from discussing individual institutions, said the state also plans to look for lessons while still tailoring regulation to each case.

— *Brian Reisinger*