

De novo banks at the crossroads

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Abstract

The history of de novo banks (new bank) in the United States is one of ups and downs. These ups and downs have not followed a consistent pattern that always moved with the current economic environment. This study examines the history of de novo chartering as well as the prevailing environment for chartering de novo banks, and the literature in the field of de novo banks. It reflects a higher rate of failure of the de novo banks than the seasoned, established banking institutions. Another issue besides failure is the absorption of a de novo through merger and acquisition. The banking regulatory authorities have increased the regulations as well as the regulatory oversight of de novo banks. With all of issues of the 2008 financial crisis, there were no new de novo banks between 2011 and late 2013 when one new charter was granted.

Keywords: De Novo, Banks, Regulation, Financial Crisis, Mergers

INTRODUCTION

Between the periods in which there were two of the most severe financial collapses since the Great Depression in 1929, there were 4,888 de novo (new) bank charters granted between 1985 and 2010, conversely there were no de novo charters granted until the end of 2013. While the data will show that there were two new charters granted in 2010, these were to provide a charter for takeover of failed banks. At the end of 2013, one new charter was granted to a Lancaster, Pennsylvania group.

From the history of chartering de novo banks, two distinct scenarios have played out in the granting of bank charters. First, during the period of the mid-1980s to the early 1990s, more banks failed than at any time in history except during the Great Depression of 1929; yet, over 4500 de novo banks were allowed to be chartered. Perhaps, learning from history, the regulators drastically slowed the chartering of new banks once the Financial Crisis of 2008 occurred. The question to be determined is with the financial condition of the economy recovering, how long will it take for de novo charters to be granted on a volume basis as in the past, if ever?

Over the years, a pattern developed when de novo banks were established in large volume. This pattern had two distinct scenarios. For a de novo bank that utilized most of their capital and had not reached profitability, acquiring banks could merge the de novo into their bank at a “fire sale” price thereby relieving the de novo owners of the responsibility of infusing more capital into an unprofitable situation. The second scenario allowed banks interested in acquiring a successful de novo bank in a desirable market to pay a reasonable price without taking the risk of a start-up bank.

LITERATURE REVIEW

The literature relating to de novo banks falls into two distinct categories. Most of the literature falls in the period prior to and during the financial crises in the 1980s and 1990s.

While there is less literature relating to the period of 2000 up to the Financial Crisis of 2008. Perhaps, the lack of current literature is a result of the limited number of de novo banks chartered since the crisis. A positive resulting from older literature on the subject is the similarity between the banking crises of the 1980s to 1990s to the current financial crisis impacting banking, with the exception of increased regulatory oversight during the recent crisis. Cope (2007) indicated that a well thought out business plan is the key to a de novo bank's success. DeYoung (2003) noted that one in four new (de novo) commercial banks failed during the 1980s resulting from the banking crisis. In a study that is contrary to most of the literature, Hunter and Srinivasan (1990) determined over an eight-year period over 70 percent of the de novo banks were financially successful as a result of effective credit policies, expense controls, and higher capital. They concluded that economic conditions were not a factor. To the contrary, Brislin and Santomero (1991) found that de novo banks tended to focus on riskier loans which made success more difficult. DeYoung (2003) examined financial structure, business mix, and external environment for banks chartered between 1980 and 1985, which was immediately before a financial crisis. He found that the de novo failure rate was four times that of established banks at years six to eight primarily because of their exhausting capital, however, those making it to years twelve to fourteen had essentially the same rate of failure as established banks over 25 years old. Moving four years closer to the Financial Crisis, Hanley and Norwell (2007) were seeing some trends that could cause a crisis. They noted that every three days a de novo bank was chartered in 2006, which was near the record high in 1999. In April before the Financial Crisis of 2008, Flemming, et al (2008), three de novo chief executive officers, discussed the greatest challenges facing de novo banks. They noted, terrorism, regulation, compliance issues, capital erosion, risk management, and loan underwriting as the biggest challenges for their new banks.

PRE FINANCIAL CRISIS OF 2008

With the impact of the crisis being felt across the entire financial spectrum, Motley and Harahan (2009) evaluated the largest 50 of the 73 de novo banks chartered in 2008 and examined their results after one year of operation. The results were telling with only three of the banks reporting a profit while in the remaining 47 de novo banks of the 50, one bank reported a negative return on average assets of 23.33 percent, two others had a negative 9 plus percent return, and most of the remainder on average reported a negative 4.00 percent return on average assets. A negative return of average assets over a several year period would erode the capital which would seriously impact a bank's ability to continue to be solvent. To put this in perspective with similar pre-crisis results for the 50 largest de novo banks prepared by Mazur and Cope (2007) wherein they reported that 20 of the 50 largest de novo banks chartered in 2005 were profitable after one year in 2006. Only one de novo bank reported a negative return on average assets of over 4.00 percent. From these examples, it is obvious that the financial condition was a major factor in post crisis charter de novo banks.

Given the impact of the crisis, Glasser (2009) reported in a news article that the Federal Deposit Insurance Corporation issued a letter to all de novo banks that extended special reporting and examinations from five years to seven years. What the extension means is banks will continue to be subjected to higher capital requirements, supervised lending limits, and more frequent examinations. The issue behind this extension was more than 80 banks failures in 2009

with approximately 20 percent in operation less than 7 years. Regulators believe this extended time close supervision will tend to help reduce de novo bank failures.

Of the near 800 de novo banks opened since 2002, Terris (2011) found that approximately 9 percent have failed. He said, “Banks that were established from 2005 through 2007, just before the onset of the deep depression, had slower ramp-ups to profitability than the de novos of previous years. But failures have been more frequent among banks launched from 2002 to 2004. Nearly 17 percent of the banks established in 2003 have failed....” (Page 14)

PASSAGE OF RESTRICTIVE LEGISLATION

The financial crisis of 2008 substantially weakened the economic markets and alarmed Congress which brought about major regulatory reform. The factors that contributed to the financial crisis were the inability of the investment banking houses to honor their commitments due to a lack of liquidity and the housing markets severe decline resulting in a collapse of the real estate values. Mortgage backed securities contained a substantial number of mortgages that were not performing, destroying their value. The relaxed trend of regulations requiring mortgage documentation as well as non-traditional products such as interest only loans also played a key role in the collapse of the economy. In an attempt to mitigate the liquidity crisis the Troubled Asset Relief Program of 2008, creating a \$750 billion dollar bailout fund to assist the largest 20 banks in the nation. The bailout fund did not provide any assistance to the de novo banks or other smaller banks.

In an attempt to mitigate the impact on the collapsed real estate market, Congress passed Housing and Economic Recovery Act (2008) which included several legislative acts. Also in 2008, the Fed amended Regulation Z, Truth in Lending Act, to provide consumer protection. The continuing decline from the financial meltdown of 2008 brought about serious debate in Congress resulting in the passage the Dodd-Frank Wall Street Reform and Consumer Protection Act (2010.) Passed as a response to the financial crisis, it brought the most significant changes to financial institutions in the United States since the regulatory reform that followed the Great Depression of 1929. It made changes in the American financial regulatory environment that affect all federal financial regulatory agencies and impacted every part of the financial services industry. The Act was designed to reduce the risk within the financial industry that became apparent after the 2008 crisis and to hopefully reduce the potential for future financial meltdown. One of its goals was to address the issue of regulatory inadequacy and give more power to financial regulators to mitigate the systemic risks within the system. Another structural issue was how to reduce nonbank financial institutions susceptibility to liquidity issues and bank runs. The amount of leverage used by large financial institutions firms to address liquidity concerns was addressed. The Act addressed the regulation of “nonbank” activities. The most contentious provision of the Act was the creation of the Consumer Protection Agency which would have total authority over all consumer issues, with no appeal from its actions.

FIRST DE NOVO CHARTER SINCE 2010

Berg (2013) reported that the first new charter since 2010 was granted to an Amish group in Pennsylvania for a bank near Lancaster to be known as Bird-in-Hand Bank with a substantial \$20 million in capital, which doubles the amount required to start a bank in past years. He noted

that most of the group that formed the bank had previously started another bank and sold it therefore, most of them were experienced bank operators or investors. In Berg's article, he quoted Charles Ingram, a managing director at Commerce Street Capital LLC who said, "It is a minefield right now trying to figure out what they (regulators) want." (Page 10).

In a Financial Times article Alloway (2012) noted that perhaps the reason for a possible lack of interest in chartering new banks was the purchase of a failed bank was less expensive and did not require time-consuming approvals. For example, in 2011 approximately 300 banks were failed by the regulators with 198 of those failed banks purchased by other banks or individuals.

So when will increased de novo charter activity resume? While it is probably anyone's guess, Barba (2014) in an interview with Camden Fine, the chief executive officer of the Independent Community Bankers Association of America reported he was of the opinion that activity will increase in 2017 or three years. Fine thought there would probably be no more than 50 de novo banks a year by 2020 with a much slower start of 10 to 15 a year.

IMPACT ON MERGERS AND ACQUISITIONS

Barba (2014) noted that the impact on mergers and acquisitions will be substantial and have ripple effects in areas causing consolidations, lack of innovation, and poor customer service. Basically, the end result is a lack of competition. Competition is the driver to build better banking institutions. This moratorium on de novo charters has driven firms to focus more on purchasing failed banks which can be obtained at substantially lower prices than existing banks and there are still a number of problem banks that could be failed by the regulatory authorities. When the failed banks are absorbed, de novo banks will once again become important to the acquirers.

POSSIBLE SOLUTIONS

Bexley (2013) noted that some of the members of Congress, most bankers, and a number of consumers are upset with the overreaching effect of the latest pieces of regulation that, in fact, still has approximately 400 pages to be filled-in. Perhaps, the most informed and notable critic of the Dodd- Frank Wall Street Reform and Consumer Protection Act of 2010, is former Federal Reserve Chairman Paul Volcker. Morgenson (2011) quoted Mr. Volcker in a recent article as follows:

"By now it is pretty clear that it was faith in the techniques of modern finance, stoked in part by the apparent huge financial rewards, that enabled the extremes of leverage, the economic imbalances and the pretenses of the credit rating agencies to persist so long."

Some of the proposals suggested by Mr. Volcker included increasing capital requirements, standardizing derivatives, and insuring that auditors are truly independent. He also noted that the enactment of Gramm-Leach-Bliley broke down the "firewalls" that separated banking, investments, and insurance. Volcker has proposed a return to a "firewalls" approach.

Inertia and accepting not doing anything is easier than making changes that might make re-election more difficult is certainly a problem. The difficulty of convincing Congress and the President to change or modify bad regulation is the need for good data to show the damage caused

by the subject regulation. Also, public pressure and resistance to the regulation can often bring about change.

CONCLUSION

Problems in the financial system were uncovered during the economic crisis which limited the chartering of de novo banks, and resulted in the passage of the Dodd-Frank Act which brought about a tightening of financial regulations and severely impacted the conduct of banking activities in the financial system. It is obvious that regulators saw the mistakes made by continuing to charter de novo banks in the earlier financial crisis. While the supposed intent of the regulation was to provide balance to financial system; however, the reactive nature of the legislation has especially impacted de novo bank chartering. There are many questions that remain unanswered as Congress seeks to correct the system. The numerous financial agencies that have authority over the financial industry are designed to provide a safe banking environment for the nation; however, there is substantial confusion as to which agency has authority to regulate some of the provisions of the Dodd-Frank Act. Further complicating the regulatory environment is the creation of the Consumer Protection Act of 2013, which gave the consumer agency authority over all regulators, without oversight. Given all of the regulations, it would still appear that the chartering of de novo banks will once again occur on a regular basis over the next few years.

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