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DE NOVO BANKS: VIABLE BUSINESS MODEL OR QUAINT RELIC FROM THE PAST?

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I. INTRODUCTION

In his remarks to the Banking Institute seminar in Charlotte in March 2015, Tony Gaeta, an icon among banking counsel and a long-time friend, gave what sounded disturbingly like the Last Rites to *de novo* banking. I say disturbingly because, as the person in my agency responsible for processing some 95 *de novo* bank applications between 1984 and 2008, I knew Tony had represented more of the formations than perhaps any other of the several fine attorneys who represent banks in North Carolina. Surely he didn't mean it.

So after his speech, I spoke with him in the back of the room, and respectfully disagreed. Now Professor Broome at UNC School of Law has asked that Tony and I exchange dueling essays over the matter. We have agreed to do so, under the condition we remain friends. I happily accept that.

Let me begin by saying that, having heard his speech and read his remarks, I agree with most all of his premises and assertions—just not with his conclusion. A banking law attorney since 1974, there is little about banking Tony doesn't know or hasn't been involved with. There is no denying the facts. Since Coastal Bank & Trust opened for business in 2009, no new bank has been chartered in North Carolina and this drought has been a nationwide phenomenon. Between 2010 and 2013, there were no *de novo* formations in the U.S. That run was finally broken by the Bank of Bird-In-Hand, Lancaster, PA. Since then, only one bank, Primary Bank in Bedford, NH, has been opened, although another was recently approved by California to begin raising capital for a charter.

By comparison with the formation rates in the early 1990s through 2006, these have been lean times indeed.

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In past cycles, *de novo* bank formations were one of the earliest and best predictors of economic recoveries. Serious downturns often led to industry consolidation, which led to market opportunities, which led to new bank formations, which replenished the industry, though admittedly not enough to completely turn the tide of industry-wide consolidation that's been going on for decades. In fact, one of the best times to start a bank was on the heels of a recession, while incumbent banks were still saddled with legacy assets that inhibited their ability to go after new business.

So what's different this time? Many bankers and industry observers have blamed a "moratorium" on new bank insurance applications by the FDIC; I don't think this is true. There is little doubt the FDIC has tightened its standards for approval of applications on the heels of the Great Recession. Given the number of bank failures, and the typical pressures and finger-pointing from Washington, that was predictable, even inevitable. One can argue over whether the degree of tightening has been reasonable, but there has been no moratorium.

Some argue that regulatory burden is the culprit, pointing to the Dodd-Frank Act as a major factor. There is no question a growing thicket of new bank regulations, layered onto an already difficult tangle of old regulations and policies, has increased the industry's overhead costs significantly. It would be interesting to know empirically just how big that impact has been. Although the regulatory burden varies from bank to bank, at the very least, it puts large banks at great advantage to small ones. But I don't think that's the primary reason for the dearth of *de novos* either. Not yet.

What is much different from past cycles is the lack of economic drivers to form new banks. Banks are formed for a number of different reasons, but at the risk of sounding like an unrepentant capitalist (guilty), profit potential is a major motivation and a reasonable expectation of the founders and investors of any new bank.

We have experienced the greatest and most persistent economic downturn in our lifetimes. Indeed, we still suffer from the lingering effects of that downturn, as well as fiscal and monetary policies that prolong many of those effects. If not an L-shaped recovery, this is as close to one as we have experienced yet. As a consequence, margin compression, coupled with the higher overhead costs associated with regulatory compliance, have changed the dynamics for new bank

formations, including necessary capital and time to break-even.

Adding to the problem in varying degrees are investor and industry uncertainty over future regulatory actions and banking legislation, concerns about the economy, damage to the industry's reputation, and the availability of so-called "scratch 'n' dent" banks, sometimes called zombie banks; not quite dead, but not quite able to fully recover. In more normal recoveries, these banks were very often able to earn their way back to health as the economy healed. In this cycle, those wanting to get into banking have often looked to acquire these banks as a cheaper entrée to the industry than starting a *de novo* bank.

So, is Tony right? With all respect, I think not, for the following reasons.

II. RESILIENCY OF THE COMMUNITY BANK MODEL

First, we are again talking about *de novo* banks. If you had tried to start a conversation with someone about forming a new bank just a couple of years ago, people would think you mad, and not without some justification. Now, *de* novo bank formation is back in the marketplace of ideas and respectable thought, if maybe just a little on the edgy side.

In 2013, the Federal Reserve Bank of St. Louis and the Conference of State Bank Supervisors, recognizing the importance of community banks and the disturbing rate of their consolidation that seemed to endanger the species, collaborated to sponsor a conference on "Community Banking in the 21st Century" at the St. Louis FRB. First held in October of 2013 and now an annual event, this represents a concerted effort to foster academic research about community banks to find ways to enhance the viability of the model. Each conference is the culmination of a year-long effort, informed through academic and FRB research papers, as well as input from bankers at town-hall meetings hosted by state Commissioners around the country. Though not directly linked to *de novo* banking, this effort evidences the commitment of the Federal Reserve and state regulators to the community bank model, which has traditionally been the dominant form of *de novo* bank.

The first meeting was strongly influenced by a paper prepared by Alton Gilbert, Andy Meyer and James Fuchs of the St. Louis Fed that took the unusual approach of studying community banks that thrived

during and despite the worst of the financial crisis.[1] The community banks studied had less than $10 billion in total assets, and "thriving" was defined as maintaining a CAMELS rating of 1 throughout the years 2006 through year-end 2011.[2]The unusual things about this study were the novel concept of learning from institutions that clearly did things right rather than from failures and the conclusions, including that size did not matter.[3] A surprising number of very small banks did quite well.[4]

So an empirical study would seem to imply that there is still a market for small banks, and therefore *de novos* are feasible. Beyond that, this study and many others clearly demonstrate the importance of community banks to our economy, and especially to the communities they serve.

III. SPRINGTIME FOR DE NOVOS? REGULATORS AND INDUSTRY EXPECTING A THAW IN THE ICE

Next, in September of 2015 the FDIC and Conference of State Bank Supervisors put together a seminar on how to evaluate and process *de novo* charter and deposit insurance applications. The impetus behind this initiative was a recognition that (1) there was an increasing likelihood that we would soon begin to see a resurgence of these applications, and (2) it had been so long since anyone had seen one, and it was important to dust off the process and be prepared.[5] I had the privilege of helping instruct regulators from the FDIC, FRB, OCC, and over 30 states. While the consensus of the group was that no one was beating down their door to start a bank, many were hearing some chatter and interest was expected to pick up.

An *American Banker* article, reported in November of 2015 a perceived relaxation of standards for *de novo* bank insurance applications and efforts by the FDIC to clarify requirements.[6] This suggests a more

1. R. Alton Gilbert et al., *The Future of Community Banks: Lessons from Banks That Thrived During the Recent Financial Crisis*, 95 FED. RES. BANK OF ST. LOUIS REV. 115 (2013).

2. *Id.* at 116.

3. *Id.* at 137–38.

4. *Id.* at 118–19.

5. *See* Ian McKendry, *FDIC Gives Ground on De Novo Applications*, AM. BANKER, Nov. 25, 2014 (noting industry perception of FDIC guidance on *de novo* capital requirements as an indication of increased *de novo* applications in the near future).

6. Ian McKendry & John Reosti, *De Novo Drought May Finally Be About to End*, AM.

receptive attitude toward *de novo* insurance applications than we have sensed through most of the downturn and its immediate aftermath.

Certainly if you read the *American Banker* or the *Wall Street Journal*, you can't help but notice the increased level of interest in *de novos*, or at least the lack of them. People tend to talk about things that interest them.

It's unlikely anyone would view the Bank of Bird-In-Hand as a turning point in the *de novo* cycle,[7] but Primary Bank in New Hampshire does seem a bit more indicative of renewed interest in new bank formations,[8] and the state of California has conditionally approved a charter for a new bank in Newport Beach, their first since 2008.[9] Core Commercial Bank (Proposed) is being formed by Mark Simmons, who previously formed and then sold Commerce National Bank, also in Newport Beach.[10] What's particularly interesting about this proposal is the high level of competition in the target market; the proposed main office is directly across the street from the former home office of Commerce National, now a branch of the Umpqua Bank subsidiary of the $23 billion Umpqua Holdings .

Simmons proposes to follow the same business model as he used in his previous bank, which he described to the *American Banker* as a "typical, traditional, old-fashioned business community bank."[11] My guess is that, in the old argument whether customers bank with banks or with people, Simmons would go with the latter. It will be interesting to

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BANKER, Oct. 26, 2015.

7. Given the highly unusual nature of Bank of Bird-in-Hand's business model, it should not be viewed as representative of the broader community bank industry. Ryan Tracy, *A Local Bank in Amish Country Flourishes Amid Dearth of Small Lenders*, WALL ST. J. (Mar. 29, 2015, 9:11 PM), http://www.wsj.com/articles/a-local-bank-in-amish-country-flourishes-amid-dearth-of-small-lenders-1427677879. It was chartered to serve a specific community—the Amish—through business loans involving relatively small amounts of money. *Id*.

8. DIVISION OF RISK MGMT. SUPERVISION, FED. DEPOSIT INS. CORP., APPLICATION FOR FEDERAL DEPOSIT INSURANCE RE: PRIMARY BANK (2015), https://www.fdic.gov/regulations/laws/bankdecisions/DepIns/primary_bank.pdf; Saabira Chaudhuri, *New Hampshire Businessman Files to Set Up Rare New Bank*, WALL ST. J., (Dec. 15, 2014, 7:29 PM), http://www.wsj.com/ articles /new-hampshire-businessman-files-to-set-up-rare-new-bank-1418689778.

9. *Core Commercial Bank (Proposed) Granted Conditional Approval by California Department of Business Oversight*, BUS. WIRE, (Nov. 23, 2015, 9:00 AM), http://www.businesswire.com/news/home/20151123005281/en/Core-Commercial-Bank-Proposed-Granted-Conditional-Approval.

10. Andy Peters, *Proposed Calif. De Novo Prepares to Enter Competitive Lending Market*, AM. BANKER, Nov. 25, 2015.

11. *Id.*

follow his progress raising the minimum $25 million capital required by the State Commissioner. It will also be instructive to follow progress of the deposit insurance application through the FDIC.

IV. NOTHING NEW UNDER THE SUN: THE CURRENT BANK FORMATION CYCLE

In past consolidation waves, the loss of banks, especially community banks, to mergers, has often left pockets of demand by both consumers and businesses who appreciated and then missed the level of personal attention and the community service and involvement of the acquired banks. As a result, *de novo* banks would be formed to fill the vacuum. This is, I think, equally true in this cycle. And just as in these past cycles, consolidation is again displacing former bank directors and officers, many of whom still have a love of banking. Some of these may well want to start new banks to fill the void.

One piece of the dynamic that fueled some past *de novo* formations, touched on by Tony in his essay, is the desire to replicate the financial rewards experienced by investors in previous formations that culminated in highly lucrative sales of their banks. As Tony correctly points out, the days of acquisitions of small banks at large multiples of book value have left the market for the time being, but I think they will return, given more normalized interest rates and a stronger economy.

V. COOPERATIVE INNOVATION: FINTECH AND RECEPTIVENESS TO NEW BANKING MODELS

So what do we need to see for a true resurgence of *de novo* banks?

1. A stronger economy. This likely depends largely on a more predictable, business-friendly attitude from Washington.

2. A normalized monetary policy permitting market forces to drive interest rates and the yield curve.

3. Less aggressive regulation, informed by a realistic cost-benefit analysis of new laws and rules, especially on the consumer side.

4. Innovation—lots of innovation.

In the community banking model, relationships are still key, and that advantage still lives with the smaller, traditional community banks. However, all banks need to look at new ways of delivering old products and services and at market demands for entirely new products and services. Bankers need only look to the communications industry in the past ten to fifteen years as an analog for banking and financial services. Not long ago, the (practical) cell phone was introduced. Recently, the number of U.S. homes with landlines slipped below 50%. Tried to find a phone booth lately? There's no app for that!

Fintech and mobile applications are changing the face of the financial services industry, of which banking is the centerpiece. While there has for some time been a lot of speculation about what banks of the future will look like, perhaps a hint can be found in that hotbed of banking innovation, Weir, Kansas (pop. 661). While not a *de novo* formation, Citizens Bank of Weir, a tiny bank with $17 million in assets, is a poster child for bank innovation.[12] Acquired in 2009 by Suresh Ramamurthi, this bank has been transformed into a revenue machine, leading the *American Banker* to name Ramamurthi "Innovator of the Year" for 2015.[13] While this essay hasn't the room for a detailed description of how this was done, the key to the transformation has been Mr. Ramamurthi's embrace and incorporation of fintech into the banking platform,[14] generating ROE of nearly 21% in 2013 and almost 47% in 2014.

The secret sauce for all banks in the future, including small community banks and especially *de novos*, will be how they reimagine the banking industry, to retain the trust and loyalty of their customers that has traditionally been the linchpin of their success, while keeping up with the changing preferences and needs of those customers and those of new

12. Marc Hochstein, *Innovator of the Year: CBW Bank's Suresh Ramamurthi*, AM. BANKER, Dec. 17, 2015.

13. *Id.*

14. *See id.* For example, the bank's technology is speeding up payment processing for its clients to real-time money transfers. *Id.* Mr. Ramamurthi is also incorporating other company's cutting-edge risk management technology into his bank's product offerings. *Id.* ("One such feature uses Internet-connected sensors in cars to vet debit card purchases at gas stations.").

generations to come.

Which brings me to an equally critical industry need – we all know that banks are special because of their role in the economy and because they are predicated on the public trust. This is why they are highly regulated. Regulators are the gatekeepers for that public trust and for safety and soundness of the industry. It is not surprising then that regulators are possessed of a healthy skepticism and inquiring dispositions. I think it fair to say though that what they have not been particularly noted for is imagination. Thinking outside the box has not been their strength.

To some extent, this is good. In banking, we need a steady hand and, at times, someone to tap the brakes and take a cautious look at some of the racier ideas (and characters) driving the business. However, ours is an ever more diverse, complex, and rapidly evolving economy, and it is not best served by regulators who reflexively impede much-needed change and innovation.

In particular, with respect to *de novo* banks, I think it's a mistake to try to hold new entries to the marketplace to a single, plain-vanilla, community bank model. That model is still viable in some markets, but should not be the only acceptable mode of operation. If there is only one acceptable model, why would we need more than one bank?

North Carolina chartered, and the FDIC insured, Square 1 Bank in 2005.[15] Though looked at skeptically by some, it served a valuable need for emerging businesses, especially in the biotech and high tech fields, but has since been acquired by a California bank. It was very different from traditional banks, but highly successful. It landed in North Carolina because we were willing to hear about and think through the proposed model.

Similarly, Live Oak Bank, founded in Wilmington in 2008, has a highly innovative business model specializing in SBA lending to tightly focused lines of business.[16] Despite being a fairly radical departure from

15. DIVISION OF RISK MGMT. SUPERVISION, FED. DEPOSIT INS. CORP., APPLICATION FOR FEDERAL DEPOSIT INSURANCE IN RE: SQUARE 1 BANK (2005), https://www.fdic.gov/regulations/laws/bankdecisions/depins/Square_1_Bank_Durham_NC_7-1-2005.pdf. Square 1 Bank was primarily focused on providing loans and banking services to venture capital firms and venture-backed startup companies. David Ranii, *Durham's Square 1 Bank to Be Acquired*, THE NEWS & OBSERVER (Mar. 2, 2015, 5:57 PM), http://www.newsobserver.com/news/business/article11949419.html.

16. Amy Feldman, *Chip Mahan, First Internet Banker, Is Back With Tech-Enabled SBA*

traditional bank models, and operating in the most difficult of economic times, it has been extraordinarily successful, and is now the second biggest SBA lender in the nation.

The common theme here is that both banks engage in very specialized lending to very specific types of businesses. Very few banks, and no traditional community banks, are able to adequately and safely serve these businesses. That's the space where I think regulators need to be more thoughtful, more flexible, and more receptive if the banking industry is to evolve in ways that will accommodate a dynamic, fast-changing economy. Skeptical is good. Unwillingness to adapt and obstructing important innovation is not. We need to be partners with the industry in fostering safe, sound innovation.

VI. CONCLUSION

I recognize the challenging headwinds facing *de novo* bank formations; many of those same headwinds are buffeting the entire banking industry. But ours is a resilient industry that has already seen dramatic change. When Lawyer Gaeta and I first became involved with banking in 1974, computers were the new thing, and most bank applications were just beginning to be automated. There were still some Boston Ledgers in use.[17] Consumers clung to their savings passbooks and still received their cancelled checks at the end of each month. Many bookkeeping departments still posted accounts on ledger cards with 100-key Burroughs adding machines, some of them hand-cranked. Regulation Q and Glass-Steagall were alive and well, and 3-6-3 banking was just beginning to fade.[18] Sadly, bad hairdos, leisure suits, clunky shoes, and bellbottoms lingered on awhile longer.

Being in the middle of it all, it was hard to see what changes would come, but come they did, and the industry coped. Banking is the

Lender Live Oak Bank, FORBES (Nov. 17, 2015, 6:00 AM), http://www.forbes.com/sites/amyfeldman/2015/11/17/chip-mahan-first-internet-banker-is-back-with-tech-enabled-sba-lender-live-oak-bank/.

17. For younger readers, Boston Ledgers were manual posting systems where each transaction of the bank was entered by hand in a single ledger, which was then used to update the bank's general ledger.

18. Regulation Q limited interest rates that could be offered to depositors, the Glass-Steagall Act separated commercial and investment banking, and 3-6-3 refers to the 3% net interest margins banks earned from loans earning on average 6% funded by deposits on which an average interest of 3% was paid.

lifeblood of our local and national economies, and is much too important not to evolve and continue to play a central role. As "laboratories for experimentation" and as engines for community growth, I think *de novo* state banks will play an important role in that evolution. We're just beginning to see the stirrings of that renewal.