So You Want to Start a New Bank?

by Edward E. Furash & Claude A. Hanley Jr.

If there's a merger in the offing in your region, chances are there will be disaffected customers looking for a new community bank. Whether planning a de novo bank for relatively short-term profit or for the long haul, keep five commandments in mind.

Many investors and bankers believe that any new bank yields a pot of gold within a few years. There's some credibility to this belief, particularly if the bank is sold within a decade of its start.

Most bankers—and many investors—intuitively know that a significant number of consumers are driven away from a community bank after it merges with a larger financial institution. Some flee from an ensuing deterioration in customer service, while others want to escape higher fees. Still others simply prefer the personal service and local orientation that small banks provide.

Studies of de novo bank entry have found new banks can be particularly successful when formed after a large, out-of-area bank purchases a community bank. Presumably, new banks sprout in these markets because a substantial number of disgruntled customers are shopping for a new banking relationship. Deposit attrition between merging banks can run between 5% and 10%. Attrition can be even higher when the integration is botched.

Although the current branching frenzy has seized some large regional banks, many others lack the patience to build new positions in ethnic or community markets. Rather, they prefer to let others organize and develop networks and then purchase the start-up enterprise once it attains a meaningful size. This is especially likely if the start-up is located in a market with attractive economic characteristics.

Investors, well aware of this dynamic, view the ultimate sale of de novo banks as their return on investment, which typically is attractive. Consequently, capital has been readily available to start-ups. Also, there are a host of qualified bankers ready and eager to run their own shops.

Let's look at the evidence behind these assumptions and concepts and determine where de novo banking is headed.

A Look at the Numbers

Table 1 shows the number of independent banks formed in each of the last five years and their beginning equity capital. The numbers shown are signifi-

Table 1
Independent[1] De Novo Commercial Banks, 1999-2004

	1999	2000	2001	2002	2003	2004
Number of Banks Formed	168	156	98	80	98	76
Beginning Equity ($000-Median)	5,636	5,646	6,381	6,208	7,868	9,122

Source: Capital Performance Group estimate based on FDIC data.
[1]Figures exclude charters that were organized by a larger, existing organization and special-purpose charters.

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cantly less than the numbers of new charters as tallied by the FDIC—and more accurate of true community bank start-ups—because they exclude any charter that was established by a larger, existing bank holding company, as well as special-purpose charters. While the pace of formations lessened after the stock market decline, a substantial number of new banks have been formed. This confirms that many investors believe the community bank model remains viable.

Note that the median equity capital level among new formations has increased markedly over the past five years. Organizers of a new charter now must have, on average, between $8 million and $9 million. In part, this reflects greater capital requirements of increased operating costs and new regulations. In addition, regulatory agencies believe that low initial capital levels are a significant long-run predictor of failure for de novo banks.

Table 2 presents key performance metrics of new banks during their first five years of operation. On average, start-ups become profitable within their second full year of operation. However, their relative level of profitability, as measured by return on assets and return on equity, remains low compared to a typical mature bank.

Conversely, asset growth among new banks is quite high compared to most banks, if only because they are growing on a small base. This makes sense because new banks are prohibited from paying dividends, so they leverage their capital base through rapid growth. This fast growth allows the infant banks to become profitable quickly. Although not shown, small banks are supported almost entirely by retail deposits. To attract these deposits, these banks often have to pay higher rates than their larger competitors. To preserve the interest margin in the face of this higher cost of funds, such banks charge higher rates on loans to niche borrowers, defined as customers who do not fit the standardized underwriting criteria employed by larger banks. While this involves a somewhat riskier asset profile, risk-adjusted net interest margin improves as the bank adds more loans. Essentially, this is the traditional deposit intermediation business, which remains viable for community banks.

Finally, note the relatively high ratio of costs to revenues among start-ups, as expressed by the efficiency ratio. While the efficiency ratio improves markedly over time, operating costs for small banks, owing to their personal service model, remain relatively high compared to large banks. While managements of banks of all sizes chant the expense control mantra, it is especially important to de novo banks.

Table 2

Key Performance Metrics During First Five Years of Operation (Medians)[1]

	Year of Operation				
	First	Second	Third	Fourth	Fifth[2]
Net Income ($000)	(2780)	193	463	595	626
Equity/Assets (%)	13.57	10.35	9.26	9.06	9.06
Return on Assets (%)	-0.90	0.39	0.69	0.74	0.76
Return on Equity (%)	-5.24	3.33	6.96	8.03	8.35
Asset Growth (%)	150.6	48.7	30.4	23.0	18.7
Median Net Interest Margin (%)	3.84	3.89	3.99	3.95	3.94
Median Efficiency Ratio (%)	108.74	80.62	73.00	69.50	67.22
Median NPAs/ Assets (%)	0.00	0.01	0.08	0.17	0.18

Source: Capital Performance Group analysis of FDIC data.
[1]Independent *de novo* commercial banks formed during 1999-2003.
[2]Performance figures are year-to-date as of September 30, 2004.

Customer Preferences

Many consumers indisputedly prefer doing business with a smaller bank. The *American Banker*/Gallup 2004 Consumer Survey found that nearly 30% of consumer respondents either opened or considered opening a new account at a small bank or credit union in the past year.

As mentioned previously, many consumers and small business owners—the core patrons of small banks—prefer the face-to-face contact and personal service typically not available from large banks. They do not like to be "lost in the shuffle" of bureaucracy. This style of doing business can be manifested in several tangible ways:

- Customer service problems are resolved face-to-face.
- Customers are afforded direct access to decision makers, often including the president.
- Loan officers are long tenured and are expert in meeting the

needs of small business customers.

- Fees are not imposed for ordinary services.

The local focus of community banks and the personal relationships engendered are also an important point of differentiation. While they lack the origination volume to compete in automated lending businesses, such as residential mortgages and credit cards, community banks often possess superior knowledge of customers' personal situations. This enables them to serve borrowers who do not have long credit histories suitable for credit-scoring or other model-based lending practiced by large banks. Instead, community banks rely on the borrower's character, which they assesses through their local presence and personal interactions. The success of this approach is buttressed by empirical evidence. A study by the Federal Reserve Bank of Chicago concluded that small banks earned higher-risk-adjusted returns on business loans than large banks and those small banks made better choices in lending to businesses.

As small business lending becomes more homogenized and Internet banking becomes more widely accepted, customer preferences may change and small banks could become extinct. However, we believe the personal-service, local-oriented business model offered by small banks will remain viable for the foreseeable future.

Table 3

Acquisition Multiples in Deals Where Target Had Total Assets Less than $1.0 Billion

	1999	2000	2001	2002	2003	2004
Number of Mergers (#)	331	256	229	203	220	227
Median Price / Book (%)	199.46	186.69	158.11	164.81	171.82	198.23
Median Price / Tangible Book (%)	203.67	191.95	162.89	166.12	179.88	202.15
Median Price / LTM Earnings (X)	20.0	18.7	18.7	19.5	20.5	24.7

Source: SNL Financial, SNL DataSource.

Acquisition Activity

The viability of the small bank business model is apparent from the continued formation of new banks and their successful capital-raising activities. The industry has been profitable and asset quality has been sound during the last decade. Furthermore, organizers are often former community bank executives who are well known to investors. Perhaps most important, the recent increase in acquisition activity opens up the possibility of selling for rich multiples and reaping handsome returns on an investment.

Table 3 shows the trend of acquisition multiples paid for banks of less than $1 billion in total assets. Investors in small banks have received rich acquisition premiums, especially when measured in terms of the median price paid to earnings. Furthermore, acquisition activity within this segment of institutions has remained robust. Among the more than 200 transactions each year, the majority could be characterized as *franchise building*, where regional holding companies assemble profitable franchises through the deliberate, sustained strategy of acquiring small banks. Prominent examples of franchise builders include Alabama National Bancorp (Birmingham, Alabama), BOK Financial Corporation (Tulsa, Oklahoma), Sky Financial Group (Bowling Green, Ohio), and Southwest Bancorp (Houston, Texas).

The decision to sell may also stem from the need to access greater resources, including managerial talent, for competitive reasons. The larger company provides equity to fuel continued growth, provides larger lending limits, and helps spread the fixed costs—such as those associated with compliance and technology—over a larger asset base.

In many respects, technology is a double-edged sword. Turnkey solutions make it easy to start and compete as a de novo, but they also make it more difficult to stay independent. Capabilities such as customer relationship management systems can be used to become more efficient while maintaining personal service.

Hazards

In contrast to start-ups in other industries, almost all de novo banks survive their first years of operation. This makes sense given the regulatory scrutiny that new charters are subjected to as well as their large capital cushion. The period of greatest vulnerability begins after the first five years or so, when the bank has completed

its initial growth spurt and meaningful earnings growth becomes harder to achieve. A study by the Federal Reserve Bank of Chicago in 2000 found that the probability of failure for de novo banks comes in three periods:

1. Initially, new banks are less likely to fail than are established banks.
2. After some time has passed, they become more likely to fail.
3. Further along, the probability of failure for these banks converges with that of established banks.

The duration of each period depends on the business cycle and the prevailing economic and regulatory conditions present when the bank was chartered. Banks commencing operations just before a recession hits, for example, are much more likely to fail than those that were chartered a few years before. Substantial risk factors developed by some de novos make them more susceptible to economic conditions. For example, they may concentrate more heavily on real estate lending and may choose to be in rapidly growing markets that are more susceptible to sharp contractions.

Five Keys to Success

To have the best chance of success with a de novo bank, keep the following five commandments:

1. **Focus on performing a few traditional functions well.** Do not emulate the larger banks that operate multiple business lines. Instead, form alliances with other financial services providers to give customers access to non-core functions, such as securities brokerage, insurance products, and credit cards. Many banks fear that such third-party arrangements jeopardize the customer relationship, but this fear does not appear to have been proven.

2. **Pursue a niche strategy.** To truly prosper, your business plan must define specific target customer segments that are inadequately served. This is an important business discipline as well as a practical legal consideration. Your application for a bank charter will not receive regulatory approval without a business plan that demonstrates these facts.

3. **Locate in a market that is growing.** The fate of a small bank is tied entirely to the vibrancy of the local economy. This will also make the bank more attractive as an acquisition target. Ideally, locate in a growing market where a large bank merger occurred recently. Even well-executed mergers cause people to reexamine their existing bank relationships. Real estate values can become inflated in fast-growth markets, so be careful to avoid overexposure.

4. **Control noninterest expenses.** It will take time to grow earnings assets and revenue, so it's important to manage noninterest expenses. Outsource back-office and administrative functions to the extent that banking regulations permit. Closely monitor the relationship of earning assets to the number of employees. Spend money on the hiring and retaining of qualified personnel who have responsibility for generating revenue.

5. **Ensure the organizing group and board of directors have extensive business ties in the local community.** The initial success of the bank will depend largely on this group's ability to bring business to the bank.

De novo banks will continue to be successful in the next five to 10 years. Despite the narrowing of margins in community banks, the economic model remains highly viable. But at the five-year mark, the going can get rocky. So decide at the beginning whether you are creating a new bank to sell it or to make it a community institution. A *sell strategy* means planning the growth of the new bank to create the most attractive customer franchise for the potential buyer. Earnings are important, of course, but a customer base is really what an acquirer is paying for—if it can keep it. A *strategy of longevity* requires just enough continuing growth to cover an inevitably increasing cost structure, while at the same time producing a level of ROE and ROA that yields healthy dividends. Whether planning a sale or a long-term independent success, the crucial thrust of these five commandments is to create a defensible and profitable franchise. ❐

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