

De novo market could be warming up

BY NATHAN STOVALL

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After a long freeze, the market for de novo banks could finally be thawing.

There has been a dearth of banking startups since the credit crisis, with just three de novo banking applications receiving regulatory approval since 2010. That level of activity pales in comparison to hundreds of de novos that opened their doors between 1997 and 2007.

Some market observers have blamed regulators for the lack of de novo activity, while others have said investors simply aren't interested in backing banking startups. Even though those claims might have some merit, there are signs that more de novos could soon surface.

The most recent de novo, Newport Beach, Calif.-based Core Commercial Bank, received regulatory approval to raise capital in late November. Carpenter & Co., a private equity firm that focuses on advising and investing in the community banking sector, is representing the group backing Core Commercial. Carpenter & Co. Chairman and CEO Edward Carpenter said the application process for de novos is "considerably more difficult" and requires much greater preparation now than before the credit crisis, but he believes the industry is on the cusp of increased licensing activity.

"All I can say now is you can expect to see more applications in the relatively near future," Carpenter told SNL. "We believe that a new bank requires more capital than it did in the past. It requires a stronger and deeper management team than it did in the past. And it needs to make a more persuasive case than was often made in the past about community need."

Carpenter & Co. believes it has a persuasive case for Core Commercial. Edward Carpenter and the firm's executive vice president, James Jones, noted that the sheer number of banks in California has shrunk dramatically, falling to roughly 190 institutions from nearly 500 a little over 20 years ago. Today, there is a bank for every 60,000 people across the U.S., but in California, the eighth-largest economy in the world on a stand-alone basis, the number is closer to a state-based bank for every 150,000 people, they say.

Core Commercial Bank plans to target a fairly narrow customer base as well, catering to small and medium-sized businesses that might feel disenfranchised by the nation's largest institutions. Carpenter said any de novo likely will

have some bricks-and-mortar presence in their first office, but is unlikely to have full-service deposit-taking offices beyond that. Instead, he expects de novos will use an electronic platform and non-teller-driven locations to serve their communities.

"We see the market as a small business person who wants to talk to a senior officer in a bank, not a branch manager, not a centralized lending person who is 2,000 miles away, but someone who can sit down with their financial statements and have a good conversation about borrowing," Carpenter said.

Carpenter, whose firm has helped license more than 500 new banks, did not seem surprised by the lack of de novo activity in recent years. He said there is always an informal moratorium on de novos during a recession, and noted that regulators steer new capital targeting the banking industry during troubled times into existing banks that need to shore up their balance sheets. He said there were virtually no new applications during the downturn from 1989 to 1994, but three years after that recession occurred, de novo activity resumed. He said the same thing has occurred in the aftermath of the Great Recession and now licensing activity is resuming.

Others believe the recent lack of de novo activity stands apart from past periods. Just two new banks have opened their doors since 2010. The first de novo in the last five years came when Bank of Bird-in-Hand opened late in 2013, while Primary Bank in New Hampshire opened its doors nearly 18 months later in July 2015.

Candace Franks, commissioner of the state banking department in Arkansas, acknowledged that de novo banking activity certainly slows during a recession, but said prior downturns have been followed by a "generous" era of de novo applications. She said that certainly hasn't been the case this time around. Franks, the immediate past chairman of the Conference of State Bank Supervisors, said the lack of de novo activity is "very concerning to us," particularly in rural areas like Arkansas, where community banks serve as the engine of small business activity.

Some observers have argued that regulators were hesitant to grant new charters since many banks that failed during the crisis were de novos formed in early 2000s. The Federal Reserve discussed the issue on a handful of occasions. Robert Mahalik, director of applications at the Federal Reserve Bank of Dallas, said at a conference in April 2014 that he saw no hint that new charter activity or approval would be on the near horizon.

The FDIC, however, has held that there is not a moratorium on de novos. The FDIC and the Conference of State

Bank Supervisors also held a de novo application training session in September, which some observers saw as a signal that regulators would like to see more new bank formations.

Mike Stevens, senior executive vice president in the policy and supervision division at the CSBS, said any discussions likely related to the sense that the industry is on the verge of seeing increased de novo activity, and regulators simply wanted to dust off their books and discuss the chartering process.

"I don't think it's a lot but we're hearing one here, one there," Stevens said of de novo activity.

While regulators might be easy to blame for the dearth of de novos, Stevens noted that bankers have not painted a very attractive picture for parties considering entering the industry, often complaining about heightened regulatory burdens. Such rhetoric could serve as a deterrent to potential investors.

Some advisers say there simply are not many investors looking to form new banks. DD&F Consulting Group President Randy Dennis, who has helped launch a number of de novos in his career, said there is a whole new breed of investors that want to put money to work in the banking sector, but some are concerned they will not be able to receive regulatory approval. He further said the higher capital requirements facing de novo banks have limited investor interest.

The FDIC introduced enhanced supervisory procedures for de novo banks in August 2009, extending the higher capital requirements and more frequent examinations that newly formed institutions must face from three years to seven years. Some bank observers have argued that those rules make de novos a difficult investment proposition.

For instance, Tom Brown, longtime bank investor and CEO of Second Curve Capital LLC, said at a conference in mid-November that he understood why there is so little investor interest in forming a new bank charter. He believes the capital constraints on de novos make it difficult for investors to earn adequate returns on their capital.

"Who in their right mind would start a bank today? The FDIC requires \$35 million in capital to start a bank. And no one can pencil out an annual rate of return on \$35 million in the next five years, so you're not seeing new chartered banks," Brown said at the event.

The Carpenter & Co. team certainly believes Core Commercial can generate an attractive return and expects it to effectively compete with larger institutions.

Regulators might be warming up to the idea of de novos as well. Walt Moeling, senior counsel at Bryan Cave, said a group of regulators recently told him that they were surprised that they haven't already received more applications. Still, Moeling said the wave of de novos between 2000 and 2005 was a "real aberration," and bank formations in the coming years will not reach such a torrid pace. He said de novo organizers will have to demonstrate the need for a new institution, and prove that they have adequate capital and the ability to execute on a business plan.

"We're getting a little bit of a start on it because we think it's real," Moeling told SNL in mid-November. "You're not going to see hundreds."

Carpenter & Co.'s Jones expects more activity in the coming years across the country as the number of institutions in the banking industry continues to decline.

"I don't think we'll see the level of de novo activity that we saw in the 2000s, but given the consolidation that we think you'll see, we will see a number of applications really beginning in 2016 and 2017," Jones said. ❖