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Thinking of Starting a New Bank? Answer These Questions First

Jonathan S. Hightower[*]

For a variety of reasons, the time is right for the formation of new banks. This article discusses questions that organizing groups should ask as they begin a venture toward starting a new bank.

As market conditions and valuations of banks have generally improved over the last several years, there has been greater interest in once again starting new banks. Not long ago, the thought of starting a new bank was a daunting one given the uncertain regulatory environment and challenges to produce returns for investors. While there is greater certainty and optimism on these points today, many questions remain. This article discusses those questions and others that organizing groups should ask as they begin a venture toward starting a new bank.

DOES OUR PLAN WORK WITH BOTH REGULATORY AND INVESTOR DEMANDS?

Creating a new bank that will attract investors requires a certain amount of creativity. However, the regulatory attitude toward new banks still dictates that organizing groups put forward a business plan that will allow regulators to remain, to a large degree, in their comfort zone. Crafting a business plan that threads the needle of these contrasting demands requires thought and skill.

The business case for starting a new bank should of course drive the creation of the business plan. If the overall premise of the new bank (or any new business) does not attract investment, that is a clear indication that the market does not view the plan as viable. However, satisfying regulators as the gatekeeper to the creation of new banks is essential.

Therefore, organizing groups should first focus on the key aspects of the business plan that will make the creation of the new bank attractive to the investment community. To the extent that these components of the business plan also fit with the regulators' traditional notions of viable business plans, the work is done. However, to the extent that the key business premise is a bit "outside the box" or risky, organizers should complement the business plan with

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traditional bank lines of business. For example, if the key premise of the business is appropriately priced but higher risk consumer loans, organizers should surround that business line with conservative deposit gathering strategies and traditional lending products within the bank's defined market. By doing so, the regulators can evaluate the business plan as a whole, putting less pressure and scrutiny on the less traditional business lines.

WILL WE HAVE THE FLEXIBILITY TO ADAPT TO CHANGES IN MARKET CONDITIONS AND CUSTOMER DEMANDS?

The Federal Deposit Insurance Corporation ("FDIC") reduced the period during which de novo banks are subject to enhanced scrutiny to three years from seven in April. While this announcement was incredibly positive for de novo bank organizing groups, questions still remain.

Under the newly revised FDIC policy, organizing groups are required to submit three-year business plans when applying for deposit insurance. Upon the issuance of deposit insurance, the FDIC will require that any material changes to such business plan during the bank's first three years of operation be submitted to the FDIC for review and prior approval. While this requirement might seem fairly innocuous, it is quite onerous in practice.

The FDIC takes a very narrow view of what constitutes a material change in business plan. While one might anticipate that significant corporate actions such as acquisitions might require regulatory approval of a revision to the business plan, more innocuous changes can also require a revision to the business plan. Opening a loan production office or introducing a new product line could also trigger the regulatory process. FDIC guidance also indicates that adding a new vendor or replacing an existing significant vendor could lead to a requirement for regulatory review and approval of a revised business plan. To make matters worse, review is typically coordinated with the FDIC's staff in Washington, D.C. Given the volume of matters the staff handles and their general lack of familiarity with individual banks, review and approval of a revised business plan could take an extraordinary amount of time, sometimes nine months or longer.

To combat this risk, organizing groups should be very thoughtful about how they craft their business plans. Gone are the days when a consultant could simply change a few names and numbers in the last business plan he or she worked on. Going forward, business plans should be highly tailored and should truly contemplate all that the bank desires to accomplish during its first three years of operation. It should also be as broad and expansive as the regulators will allow, and organizing groups should discuss expectations regarding the adaptation of the business plan with regulators during the regulatory approval process. To the extent that a business plan can be crafted so that it can allow the business of the bank to evolve and adapt during the bank's first three years of operation, the bank will see an advantage.

CAN WE AFFORD TO ORGANIZE THIS BANK?

In prior cycles, an organizing group could reasonably expect to contribute $10,000 to $30,000 in cash each to fund the organization of the bank and to obtain a line of credit for the balance of the organizational expenses. These advances would be repaid when the bank opened, and the total expense of organizing the bank would range from $500,000 to $750,000. Toward the end of the last cycle, there was an uptick in organizational expenses as regulators required more members of senior management to be identified and hired earlier in the organizational process. By 2008, it was not uncommon for total organizational expenses to exceed $1 million.

Today, much has changed. While the timeframe for organizing a new bank has ostensibly remained the same, most expect that the organizational process will take longer as regulatory applications receive greater scrutiny. Subject to hearing a different answer from regulators, it is expected that executive managers will be identified and hired early in the process so that the management team of the new bank can be fully vetted prior to regulatory approval. It is likely that it will be more difficult to obtain debt financing for the organizational process as there is currently less certainty that new bank applications will be approved.

As an initial step in the organizational process, the organizers should create a detailed and inclusive budget for the organizing process that will allow for a certain amount of delay in the process. The organizers should then ensure that they have proper funding for the budget before expending resources on a process that they may not be able to afford to complete.

CAN I FOCUS ON MY STRENGTHS?

Many of the failures of new banks in the recent downturn were blamed on excessive concentrations in certain sectors by those banks, especially acquisition and development and other commercial real estate loans in the geographies hardest hit by the recession. Of course, the conclusion that having a great deal of exposure to a decimated sector of the market will be problematic is fairly intuitive. It is important to note that banks that were equally concentrated in sectors or geographies that were not as adversely impacted by the recession continued to prosper.

It is far more important for a de novo bank, which will generally have far less staff than a mature bank, to focus on the areas in which it has expertise than it is for the bank to be as diverse as possible. Of course, some degree of diversification of revenue streams and sources of recovery on loans is prudent, but this pursuit of diversification should not lead a new bank into areas in which it does not have the requisite management expertise to understand and manage the risks of those business lines.

Organizing groups should evaluate the skills and experience of its senior management team and focus only on areas where that experience and expertise is significant. If doing so leads the bank to have a business plan that the regulators would consider concentrated in one or more areas, the organizing group should work to get the regulators comfortable that the expertise of management and the board in those areas will help the new bank to manage any risks associated with those concentrations appropriately, rather than diversifying into areas where the group has less comfort.

CAN WE LEVERAGE TECHNOLOGY TO COMPETE AND SAVE ON EXPENSIVE TRADITIONAL INFRASTRUCTURE?

In certain respects, now is an ideal time to start a new bank. FinTech companies have introduced many new and innovative technologies to the market that can help a bank acquire customers, grow earning assets, and operate efficiently. Without the constraints of legacy infrastructure, a new bank would be ideally positioned to employ best of breed technologies and develop an operating model that is truly state of the art (at least for today).

Regulators are beginning to embrace these new innovations. The Office of the Comptroller of the Currency ("OCC") has published a white paper dealing with responsible innovation and the FDIC continues to study the effectiveness of emerging technologies in engaging underserved consumers, among other things. However, the culture of regulatory agencies is a difficult thing to change, and the regulators admit that their adoption of and comfort with new technologies is a work in progress.

As a part of developing the business plan for the new bank, organizing groups should spend considerable time evaluating technological platforms and products that they intend to employ. The regulatory applications should contain extensive descriptions of the technologies that the new bank intends to utilize during the bank's first three years of operation (which, given the pace of innovation, is difficult to forecast) and the efforts undertaken by the group to evaluate the firms with which it will partner to deliver these technologies, particularly when those firms smaller or new to working with banks. There is no reason why a new bank should not be able to leverage new technologies to better compete with larger, more established banks, but organizing groups should give special attention to those components of the business plan.

WHAT IS THE RIGHT LEVEL OF CAPITAL FOR THE NEW BANK?

This question is as old as the process for starting new banks, but it remains one of the most important. With all of the regulatory focus on maintaining higher levels of capital, the apparent answer would be "as much as possible." However, toward the end of the last phase of de novo bank formations, the regulators began to recognize that more capital was not always better. With more capital comes pressure to leverage the capital through faster growth in order to produce appropriate returns on the larger capital base.

As much as regulators favor higher capital levels, they abhor "excessive" growth since rapid growth funded by brokered or unique deposits was a hallmark of the failed de novos. In fact, for mature banks with less than $10 billion in assets, the FDIC's new deposit insurance assessment rules punish banks for growth that exceeds 10 percent of assets in a given year. As a result, organizers should carefully study "right sizing" the initial capital raise to an amount that fits the bank's business plan. The regulators recognize that required initial capitalizations may vary widely from bank to bank.

This capital planning process may also lead groups to focus on fee-generating business lines that are less capital intensive and promote profitability without impacting balance sheet growth as much as traditional lending and deposit gathering. For traditional banks, these business lines, such as Small Business Administration ("SBA") and mortgage lending, can help to effectively manage capital needs when properly executed.

CAN I FIND THE RIGHT MANAGEMENT TEAM?

With bank sales greatly outpacing the formation of new banks over the last eight years, there is no shortage of talented, successful, and experienced bankers who would enjoy starting a new bank if the opportunity presents itself. However, going forward, regulators likely will be very strict on the qualifications for executive officers of new banks. In order to support a smooth application process, organizing groups should identify and hire bankers who can demonstrate positive experience in running banks and, ideally, in starting new banks. The idea of appointing a banker to serve as the president of a new bank who has never served in that position before is risky at best in a new bank application.

While organizing groups should look for this experience when putting together the new bank's management team, this prospect can be difficult when the new bank will be focused in a specialized area that few bankers have managed before. For those types of plans, organizing groups may have to be creative in structuring a management team that has substantive expertise in the business of the bank but also the general experience in bank management that regulators desire.

CAN WE FIND, RECRUIT, AND RETAIN THE RIGHT DIRECTORS?

Answering this question may be the most difficult task of all in forming a new bank. In the wake of historic numbers of bank failures, the FDIC seemed to take every opportunity to discourage individuals from serving as bank directors. The FDIC's efforts to establish that simple negligence should be the standard for holding bank directors personally liable for losses incurred by the bank had a chilling effect on interest in serving as a bank director. When combined with the fact that new banks generally do not pay directors' fees until the bank is cumulatively profitable, many businesspeople have concluded that serving on a bank board is not an attractive prospect.

Obviously, the first step in recruiting directors is to demonstrate to them that the business plan of the bank is viable and something they personally desire to support. Second, potential directors should be given comfort with the quality of management of the new bank. Third, and perhaps, most importantly, the new bank should focus on obtaining the best director and officer ("D&O") liability insurance available.

In prior cycles, new banks purchased "off the rack" D&O insurance policies with the primary consideration being the amount of the premium and the secondary consideration being the aggregate limits of the policy, which was usually combined with other coverages such as bankers' professional liability and fiduciary risk insurance. Going forward, organizing groups should engage experienced, independent and unrelated professionals to evaluate the most appropriate coverages for the bank, giving consideration to its particular business plan. The terms of the policy should be carefully reviewed to ensure that no exclusions would operate to limit or eliminate the expected coverages of the policy. The terms of the policy should then be summarized for and discussed with the directors and potential directors to give them appropriate comfort.

Finally, director compensation should be considered. Even the best D&O policies cannot eliminate the particular risks that bank directors face. For example, the bank cannot insure against exposure to civil money penalties that regulators may seek to impose in adverse circumstances. As a result, it is perfectly reasonable for directors to ask to be compensated not only for their time but also for the risks that they are taking in serving on a bank board. Historically, the FDIC has limited director compensation for new banks to warrants to purchase additional shares of common stock at the initial offering price. These warrants have generally been limited to a warrant to purchase one share for each share the director purchased in the initial offering. For directors who have much expertise but little investment resources to offer, that mix may not be appropriate. While the FDIC has yet to indicate that its prior policy will change, it is reasonable to ask for additional director compensation under certain circumstances.

CAN WE LEVERAGE THE EXPERIENCE OF BANKERS AND DIRECTORS WHO SERVED WITH TROUBLED BANKS IN THE PAST?

In most industries, management officials who have experience with failed or distressed ventures are valued as providing unique perspective on what can go wrong under certain circumstances. In fact, the management of a bank that acquired many failed banks during the economic downturn sent all of its best young bankers to deal with the problems of those failed banks in order for them to gain valuable down-market experience.

However, the regulators officially take a different view with a new bank. The general attitude is that if a director or executive officer has been involved with a failed bank (or even a bank that was placed under an enforcement action), he or she is not fit to serve the new bank. The next generation of new banks needs the experience of the run-up to the downturn to avoid the same mistakes. Of course, there are some bankers and directors who simply did not and do not appreciate how sensitive bank balance sheets are to problem loans and do not fully grasp how to manage risk in a bank. However, there are many qualified individuals who served on failed bank boards who could add depth to risk management discussions in future new banks. To the extent that organizing groups desire to include one or more individuals in their proposal, they should be aware of the risks but also advocate for inclusion of these individuals under appropriate circumstances. As a second option, inclusion of individuals with this experience in advisory or non-executive roles can be beneficial to a new bank.

CAN I USE A QUALIFIED PLACEMENT AGENT TO ASSIST IN THE BANK'S INITIAL CAPITAL RAISE?

Toward the end of the last cycle of bank formation, several state agencies took the position that use of a placement agent or capital raise consultant should be disallowed as an indication that the organizing group did not have the connections and support in the bank's communities to attract capital. As a result, organizing groups were left to raise capital on their own without the help of a qualified professional. Unfortunately, the downturn produced a number of investor lawsuits that alleged violations of securities laws in the bank's capital raise.

To help manage these risks and ensure an appropriate process and procedures in raising capital, organizing groups should consider the use of an experienced placement agent. High quality placement agents not only help raise capital through introducing their contacts to the opportunity but also conduct extensive due diligence on the proposal to ensure that the organizing group is properly prepared to raise capital. They also help to conduct appropriate and compliant capital raise presentations, ensuring that organizers themselves do not go too far in describing the opportunity to potential investors in a way that could create risk if the expected benefits of the investment do not materialize. A qualified placement agent can add tremendous value in a capital raise, and organizing groups should consider engaging such a firm to assist with the capital raise.

WILL OUR PROPOSAL MEET THE REGULATORS' "CONVENIENCE AND NEEDS" TEST?

In evaluating a proposal for a new bank, the regulators will consider whether the proposal meets the "convenience and needs" of the market to be served. Typically, this analysis involves studying the geographic area that will be the bank's market area to determine if it needs a new bank. In recent years, certain regulators stated that if a community had a bank (not just a locally-headquartered bank), it likely would not need an additional bank. The regulators appear to have relaxed this requirement somewhat, but organizing groups should continue to think carefully about the definition of their markets to determine if a new bank proposal is viable.

There is a particular need to focus on this analysis when the community to be served is defined by characteristics other than a local geography. According to a recent FDIC research paper, more than 83 percent of banks formed between 2000 and 2008 were formed in a metropolitan statistical area ("MSA"), meaning that their markets were (or should have been) defined by more than geography if one assumes that a new bank cannot serve an entire MSA. For many new banks, the market to be served from a business plan may be defined by particular demographic groups or professional sectors.[1]

[1] When "market" is discussed here, it means the customers that will be targeted for the bank's primary services, rather than the Community Reinvestment Act ("CRA") assessment area. A bank will also need to define its CRA assessment area and insure it is properly serving that area.

The regulators recognize that many new banks in the prior cycle were not founded with a true "community" to support it. As a result, those banks were forced to serve a more general market, often leading to competing through offering more favorable terms to customers that were ultimately detrimental to the bank. Organizing groups should carefully craft a specific market to be served, analyze its need for a new bank, and demonstrate the bank's viability in serving that market in its regulatory applications.

WHAT ABOUT SPECIAL PURPOSE BANKS AND BANKS CONTEMPLATING NOVEL BUSINESS LINES?

While this discussion has focused on banks with more traditional business plans, many of the principles apply to special purpose or niche banks. The OCC recently commented that it is considering a limited purpose charter for FinTech companies. While supportive of this approach, there are reasons to be skeptical of its ultimate adoption by regulators. Regulators, the FDIC as insurer in particular, prefer a business plan that is at least modestly diverse. In addition, in a post-Dodd-Frank era, using a bank charter for the primary purpose of gaining preemption advantages has fallen out of favor. Therefore, organizing groups should focus on finding ways to implement unique business strategies within a more traditional and comfortable framework for the regulators.

CONCLUSION

The time is right for the formation of new banks. With the FDIC shortening the "de novo period" to three years from seven, it is showing signs that its policies need to be revised to support the creation of new banks. According to a recent FDIC research paper, 1,042 community bank de novos were formed between 2000 and 2008, and those banks represented more than 10 percent of the total number of banks in existence as of September 30, 2015. Importantly, far more of those new banks were sold or merged (205) than failed (133). Even in the worst economic environment since the Great Depression, the failure rate of de novo banks was approximately 13 percent, a relatively modest figure in comparison to the failure rate of start-ups in other industries.

De novo banks are valuable and viable enterprises in the banking industry and, in addition, are critical to the success of many underserved communities. With careful planning and good advice, an organizing group can now form a successful new bank. The industry and the regulators are inviting new entrants, and it is exciting to see these new businesses begin to flourish.