Who Wants to Start a Bank?

Virtually no new banks have opened since the Great Recession began. What's behind this drought, and should we be worried?

BY TIM SABLIK

In late 2013, the Bank of Bird-in-Hand opened its doors in Pennsylvania's Amish country. Even in normal times, a bank featuring a drive-through window built for a horse and buggy would have drawn curious onlookers. But the Bank of Bird-in-Hand made headlines for another reason: It was the first newly chartered bank anywhere in the United States in three years. According to the Federal Deposit Insurance Corporation (FDIC), there have been only seven new bank charters since 2010. By way of comparison, there were 175 new banks (or "de novos," as they are called in the industry) in 2007 alone. Indeed, from 1997 to 2007, the United States averaged 159 new banks a year.

To be sure, the number of banks has been falling for decades. Before the late 1970s, banks were prohibited from operating branches in most states, which inflated the number of unique banks in the country. States gradually did away with these unit banking laws in the 1970s and 1980s, a process that culminated on a national level with the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. The total number of banks has fallen by about 9,000 since the mid-1980s, as weaker banks merged with stronger ones. (See chart.) But there was always a steady influx of new banks to replace some of those lost — until now.

"It has been many years since anyone even talked to us about starting a new bank," says Wayne Whitham Jr., a lawyer in the Richmond office of the law firm Williams Mullen who has worked with banks and financial institutions since the early 1980s.

When it comes to de novos, the last seven years stand out in stark contrast to any time before. (See chart.) What can explain this trend, and what does it mean for the future of banking?

Keeping Up with Regulations

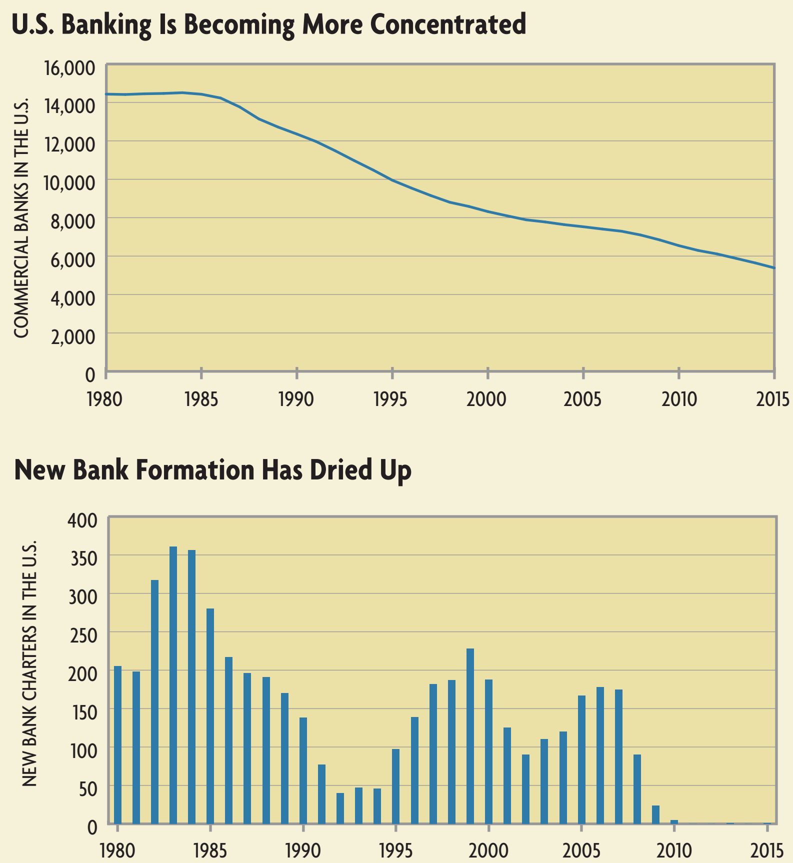
As in any industry, the decision to start a new bank involves weighing the expected costs and benefits. One of those costs is complying with regulations. While there is no direct measure of the regulatory burden on banks, one possible proxy is the size of banks' quarterly financial report to regulators, known as the Call Report. According to a 2015 Dallas Fed article, Call Reports have grown an average of 10 pages each decade starting in the 1980s. But this pace seems to have accelerated since the financial crisis. From 2007 to 2015, the size of the Call Report jumped from about 50 pages to 84. Moreover, the Dallas Fed notes that the number and complexity of banking laws has grown steadily since 1970.

Longer and more complex regulations require more specialized personnel to interpret and ensure compliance. Thanks to economies of scale, large banks can devote more resources to this task than smaller banks but a smaller share of their workforce.

"In the case of a small community bank, there may have been one person who oversaw risk management and regulatory compliance in the past," says Pat Satterfield, the community bank relationship manager at Williams Mullen. "Now there might be five or six people in that same space." For a community bank with a small number of employees, that burden can be significant.

In a 2013 survey of about 200 small banks by the free-market-oriented Mercatus Center at George Mason University, most banks reported increased compliance costs, and more than a quarter of them said they anticipated hiring additional compliance personnel sometime in the next year. For the smallest institutions, hiring additional personnel dedicated to compliance rather than business can be a serious cost. According to estimates by the Minneapolis Fed, hiring just two additional people for compliance would make one in three banks with less than $50 million in assets unprofitable.

This is especially relevant for new banks, most of which start out (and stay) small. According to the FDIC, more than 90 percent of banks in the United States had less than $10 billion in assets. And between 2000 and 2008, 77 percent of newly chartered banks opened with less than $1 billion in assets.



SOURCE: Federal Deposit Insurance Corporation

"Historically in a startup bank, people wore a lot of hats," says Fred Green, president and CEO of the South Carolina Bankers Association and a former director of the Richmond Fed. "To start a bank today, you need dedicated human resources for compliance-related issues, which creates a higher fixed cost."

New banks are already subject to higher capital requirements and more frequent examinations from the FDIC in their first years, adding to their fixed costs. But in 2009, the FDIC increased this window from three to seven years, noting that many of the banks that failed in 2008 and 2009 were less than seven years old. Requiring new banks to hold more capital may make them less prone to failure, but it also raises the barrier for them to get off the ground in the first place. Perhaps recognizing this, the FDIC returned the enhanced supervisory period back to three years in April. Announcing the decision, FDIC Chairman Martin Gruenberg said "the FDIC welcomes applications for deposit insurance."

But not everyone in the banking community has found the process for starting a new bank entirely welcoming. Starting a new bank has never been easy. But organizers of the Bank of Bird-in-Hand reported a longer and more difficult application process than in years past. Other industry veterans also say there has been a shift following the financial crisis. Chip Mahan started his first bank in 1987 and his latest one, Live Oak Bank in Wilmington, N.C., 20 years later. "The two experiences could not have been more different," he says. In the first case, he doesn't even remember talking with the FDIC directly, while in the case of Live Oak, he had two meetings with Sheila Bair (then the head of the FDIC) to present his case.

But regulations are only one piece of the puzzle. "Everyone likes to blame everything on the regulators," says Mahan, "but that just doesn't cut it."

Low Rates, Low Profits

While new regulations can weigh on bank profits, bank organizers may be even more sensitive to changes in interest rates. According to the FDIC, community banks earn as much as 80 percent of their revenue in the form of net interest income, or the spread between the interest earned on loans and the interest paid to depositors. Near-zero interest rates since 2008 have made that spread less than in years past.

This not only puts pressure on existing banks but may also play a role in dissuading new bank formation. In a 2016 *Review of Industrial Organization* article, Robert Adams and Jacob Gramlich of the Federal Reserve Board of Governors found that new banks have historically held a much higher percentage of federal funds reserve deposits and earn even smaller interest spreads than both large and small incumbent banks. Perhaps in part because of this, the number of new bank charters has closely tracked the federal funds rate going back as far as the 1970s. Using an econometric model to analyze the data, Adams and Gramlich attribute at least 75 percent of the recent decline in new bank formation to nonregulatory factors like low interest rates and the weak economy. In a 2014 article in the Richmond Fed journal *Economic Quarterly*, however, former Richmond Fed researchers Roisin McCord and Edward S. Prescott noted that net interest income has been similarly low in previous recessions without a complete collapse in new bank entry. This would suggest that low interest rates, too, tell only part of the story.

Still, it is clear that even large, established banks have struggled to profit in the post-recession economy. Bank stocks lagged behind the rest of the market in the first quarter of 2016. In an effort to trim costs, Bank of America has cut more than 70,000 jobs since 2010 and announced another round of cuts in May. In this climate, organizers interested in starting a new bank may have difficulty finding investors who share their enthusiasm.

"In the old days, a lot of de novo banks had a five- or six-year plan: open, grow, and sell," says Green. "Those sales prices were generally very attractive, something like two or more times the book value of the bank. You're not going to see that today. So it's hard to model a compelling reason for someone to invest in a new bank versus publicly traded companies that are already doing well."

Mahan argues that new banks can still succeed, but they need to think outside the box. His bank has rejected the traditional community banking model of taking deposits and making traditional loans. Instead, Live Oak built an online platform for making loans to specific businesses qualified for the U.S. Small Business Administration's 7(a) Loan Program. Live Oak's clients are an eclectic mix of industries, including dentists, veterinarians, and craft breweries. Mahan says his bank earns most of its profits from selling the loans it makes on the secondary market rather than relying on interest income.

"Following the traditional banking model with interest rates at an all-time low is a failed strategy," says Mahan. "You need to think of something a little bit different."

Why Care About Bank Entry?

Is there any reason to worry that there are far fewer new banks? Some have suggested it could matter for segments of the economy that have relied on traditional community banks.

Some economists have long thought that small banks may be better equipped to serve small businesses. Those firms have a difficult time obtaining funding because they typically do not have access to public equity markets and can struggle to signal their creditworthiness to lenders. To overcome this difficulty, small firms may depend on "relationship lending" with local banks. Lenders who build relationships with business owners and entrepreneurs in the community can use that information to supplement more formal means of assessing credit worthiness. In a 2002 article, Allen Berger of the University of South Carolina and Gregory Udell of Indiana University found that small banks are organizationally better equipped to engage in this sort of relationship lending than large banks.

"I firmly believe that community banks build better communities," says Jim Marshall, president and CEO of blueharbor bank in Mooresville, N.C. A third-generation community banker, Marshall values the ties between small banks and their community. Blueharbor maintains a presence in clubs, churches, and civic organizations in Mooresville, and Marshall sees these links as vital to serving local businesses. "Community banks try to find ways to mitigate any weaknesses that an entrepreneur might have, whereas the big banks tend to just look at a credit score."

If small businesses are primarily reliant on banks for funding, they may face troubling effects from the dearth of de novos. According to a 2014 working paper by Karen Mills and Brayden McCarthy of Harvard University, small-business owners surveyed by the National Federation of Independent Businesses reported tighter credit markets than before the financial crisis of 2007-2008.

Additionally, Marshall says regulations have increased the number of steps needed to process each new loan, making smaller loans less attractive for banks. "If you can process a $100,000 loan one time versus processing 10 $10,000 loans 10 times, and all carry the same expense to review and book, you'd rather have the $100,000 loan," he says.

Another potential issue from the decline in bank entry comes from the fact that banking has become increasingly concentrated at the top. Even before de novos started drying up, small banks were disappearing by the thousands. According to the FDIC, banks with fewer than $100 million in assets account for virtually all of the decline in total banks since the 1980s. Over the same period, total assets held by the four largest banks grew from $228 billion in 1984 (6.2 percent of industry assets) to $6.1 trillion in 2011 (44.2 percent of industry assets). With no new banks entering the system, this consolidation seems likely to continue, if not accelerate.

True, industry consolidation can bring a number of benefits. Allowing more efficient firms to absorb less efficient ones can improve the profitability of the sector. Larger firms are often better able to take advantage of economies of scale, allowing them to offer cheaper services to their customers. But evidence on the benefits of consolidation in the banking sector has been mixed. While studies in the late 1990s and early 2000s found that consolidation improved bank profit and payment system efficiency, there was little evidence that consumers enjoyed many cost savings.

Changing Lending Landscape

There is also some evidence that the recent changes in banking may be part of a longer trend. Small banks have been facing greater competition for small business loans from large banks. According to a 2015 paper by Julapa Jagtiani of the Philadelphia Fed and Catharine Lemieux of the Chicago Fed, community banks held 77 percent of of loans worth less than $1 million in 1997, but this share had fallen to 43 percent in 2015. For loans valued at less than $100,000, the decline is even more dramatic, with the share held by community banks falling from 82 percent in 1997 to 29 percent in 2015.

To the extent that big banks are stepping in to provide loans to small businesses, policymakers may be less concerned about fewer community banks. In fact, in a 2013 paper updating his work on relationship lending, Berger, along with William Goulding of the Massachusetts Institute of Technology and Tara Rice of the Fed Board of Governors, found no evidence that small businesses actually prefer community banks for financing. The authors suggest that while small banks may have once enjoyed an advantage in this area, changes in technology (such as the adoption of credit scoring in some small-business lending) and the relaxation of branching restrictions have enabled large banks to more easily provide loans to local businesses.

On the other hand, there are signs that banks in general have been moving away from small-business lending. According to a 2013 paper by Ann Wiersch and Scott Shane of the Cleveland Fed, the share of banks' nonfarm, nonresidential loans worth less than $1 million has fallen steadily from just above 50 percent in 1995 to less than 30 percent in 2012. Some of this decline more recently may be due to increased competition from nonbank online lenders. While their share of consumer lending is still small, it is growing: In 2014, these marketplace lenders equaled under

4 percent of traditional consumer lending, but by 2015 their share had jumped to more than 12 percent.

These many changes highlight the uncertainty of banking's future. Will new bank entry bounce back as interest rates eventually rise? And if it does, will those new banks look like the community banks of previous generations?

Marshall says blueharbor is sticking with the old model. "We're just a good old-fashioned, general consumer community bank. If we tried to specialize in any one thing, we wouldn't be serving our community," he says. At the same time, he recognizes the environment is changing. His daughter is studying banking and finance in college (he hopes she will be the fourth-generation banker from his family), but he says many of the young bankers he meets or works with have expressed frustrations with current regulatory and economic conditions. "There are a lot of folks who say it's just not worth it to start a bank today," he says.

Mahan thinks the future is bright for new banks — if they're willing to adapt to changing consumer demands. "You've got to be focused on technology and deliver products and services with a beautiful user experience," he says. "Because at the end of the day, who wakes up and thinks about their bank?" **EF**

Readings

Adams, Robert M., and Jacob Gramlich. "Where Are All the New Banks? The Role of Regulatory Burden in New Bank Formation." *Review of Industrial Organization*, March 2016, vol. 48, no. 2, pp. 181-208.

Berger, Allen N., William Goulding, and Tara Rice. "Do Small Businesses Still Prefer Community Banks?" Federal Reserve System Board of Governors International Finance Discussion Papers No. 1096, December 2013.

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WEB EXCLUSIVE: See sidebar "Opening Your Own Bank."

NUCLEAR REACTIONS *continued from page 17*

substantial cost savings from learning-by-doing. "It's not that there is no learning," he says. "It's just that it's hard because we are not building enough of these anywhere to really get down the cost curve — not in the United States, not in Asia, not in France, not anywhere."

Davis admits, however, that he is intrigued by the 20-plus nuclear reactors currently under construction in China. "It's a huge priority to figure out how China is able to do this," he says. In addition to lower labor costs, he suspects that the Chinese nuclear program benefits from a more favorable regulatory regime.

Settling the Bet

As of May 2016, Vogtle's projected cost per kilowatt of capacity was $5,327 — well above Davis and Rothwell's over-under threshold of $4,200.

So it appears Davis will win the bet. He also is sticking with the conclusion of his 2012 article: "In 1942, with a shoestring budget in an abandoned squash court at the University of Chicago, Enrico Fermi demonstrated that electricity could be generated using a self-sustaining nuclear reaction. Seventy years later, the industry is still trying to demonstrate how this can be scaled up cheaply enough to compete with coal and natural gas."

Rothwell vehemently disagrees. "Nuclear power plants have an expected lifetime of 60 years. So even though there are low gas prices now, there is no reason to believe they will stay low for the next 60 years," he says. "And if you use standard discount rates, you make the value of electricity inconsequential from years 31 through 60. So if you are trying to provide for generations of consumers, then you have to come up with a way of valuing electricity for future generations."

As for the bet, Rothwell concedes that he *might* someday owe Davis $20, but he's not quite ready give up the cash. "We still need to determine the 2007 overnight costs in 2007 dollars," he insists, "because it is likely that the $5,327 value is in 'as-spent' dollars. We won't know until the plant is producing electricity, all the costs have been identified for the regulators, and the economists have analyzed the data. Let's not be hasty in our judgments. Our work is not yet done!" **EF**

Readings

Davis, Lucas. "Prospects for Nuclear Power." *Journal of Economic Perspectives*, Winter 2012, vol. 26, no. 1, pp. 49-66.

"Fourteenth Semi-Annual Vogtle Construction Monitoring Report for Plant Vogtle Units 3 and 4." Georgia Power, February 2016.

Rothwell, Geoffrey. *Economics of Nuclear Power*. New York: Routledge, Taylor & Francis Group, 2016.

"V.C. Summer Nuclear Station Units 2 and 3." South Carolina Electric & Gas, Quarterly Report to the South Carolina Office of Regulatory Staff, March 31, 2016.

WEB EXCLUSIVE: See sidebar "Nuclear Power and Global Warming."