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Starting from Scratch

The De Novo Bank Report

By Debra Cope

Suddenly, it seems, startup banks are everywhere. Banks are being hatched at an increasing rate in 2005, according to Federal Deposit Insurance Corp. data. Between Jan. 1 and Nov. 10, 148 community banks opened for business, the largest number of startups since 2000.

More new financial institutions—formally known as de novo banks—are in incubation. "We are working now with 25 investor groups, from Florida to New Hampshire and out to the Midwest," said Donald Musso, president of FinPro Inc., a Liberty Corner, N.J., firm that is one of the leading consultants to startup banks. A St. Louis banker said that in his city alone—hardly a hotbed of de novo activity—at least six banks are currently in organization.

Approximately 1,000 banks have been launched since the beginning of 1999, and they now make up more than 11 percent of U.S. banking institutions, according to data collected from FinPro, the FDIC, and SNL Securities, and analyzed by *Community Banker.*

Banks in operation for three years or less are formally known as de novos, from the

Latin term "from the new." However, the term is commonly used to describe banks with 10 or even 15 years under their belts.

The de novo banking trend confirms something many community bankers already know: Local banks occupy a vital place in their communities, in the hearts of employees, and in the eyes of investors. Indeed, Musso noted, FinPro's research shows that "where ever there was consolidation two to three years prior, that market tends to be ripe for de novos."

Face-to-Face Banking

Investors recognize that at a community bank, "You can go down and talk to the president and get your loan decision," said Rich Buckner, senior vice president in the investment banking group of Washington, D.C.-based Milestone Advisors LLC, which specializes in advising community banks and thrifts. "Banks can consolidate all day long, but customers still want to deal face-to-face with decision makers at the bank."

New banks are being formed because investors see business opportunities that other banks are bypassing. Startups are quick to capitalize on the executive and customer fallout that follows bank mergers, and are deft at snatching bright, productive workers from rivals. The best of the de novo breed have highly engaged board members who are motivated to bring in new business. "These guys are built for growth," Musso said.

"I can't tell you that's there's anything fancy about what we're doing," said Michael Sutton, president and chief executive officer of Bank of Evansville, a $193 million-asset bank in Evansville, Ind., that was founded in 2001. "The attraction is that we are not bogged down in tremendous bureaucracies and processes that make it difficult to get the transactions done." As of June 30, the bank boasted a return on average assets of 1.03 percent and a return on average equity of 11.04 percent.

Bankers at established institutions say they welcome the competition, and admire the entrepreneurial spirit that de novos exemplify. At the same time, they are keeping tabs on de novos, to learn from them and to understand how they are changing local banking markets.

"The de novos are important, and they are having an impact," said William A. Donius, chairman and CEO of Pulaski Bank, a $788 million-asset St. Louis bank founded in 1922. "In an effort to grow quickly, they can disturb the rational pricing in a market," Donius said. "They can have a tendency to offer more aggressive rates on deposits, and we've also seen examples where they try to buy the business on the lending side."

One challenge for de novos is that "they can't out-small the other small banks in the market," Donius said. "And if their maximum loan size is a million or two, they will have a limited audience they can get to." Still, it's no mystery why new bank formations are going strong: "Customers prefer working with locally managed and owned institutions, and investors recognize that. That is exactly why de novos form."

Executives at some de novo banks say there is room for more players, particularly in the business banking arena and in growth markets, such as California, Georgia, and Florida. Consider Los Angeles-based American Business Bank, which has grown to $500 million in assets since it opened its doors in 1998. CEO Don Johnson, a veteran of Union Bank of California, said his bank is feasting on the crumbs left behind by larger rivals.

"When I started at Union Bank, bigger banks would concede companies with $2 million or less in annual sales," Johnson said. "Now, bigger banks are conceding $30 million-a-year companies."

However, de novo bankers say not everyone can be a winner. "Do I think de novo banking is a sure bet? I really don't," said Martin Lapera, president and CEO of Frederick County Bank, a profitable $190 million-asset bank in Frederick, Md., that opened its doors in 2001. "With the economy strong and interest rates low, anyone can make money. With challenging economic conditions, we'll find out who the good operators are."

What About GMAC?

Arguably, the biggest start-up community bank of 2001 was Greenville, Del.-based GMAC Bank. The savings association's assets had grown to $6 billion as of June 30, 2005. So why was it excluded from ACB's ranking?

The Internet bank is, statistically speaking, an outlier. The General Motors Corp. unit has a built-in funding mechanism that no other bank in the class of 2001 can duplicate. "GMAC Bank is getting all the escrow deposits from all the loans GMAC Financial Services makes," said Nick Ketcha, managing director of New Jersey-based FinPro Inc. "Instead of giving away the float, they take in those deposits." While GMAC solicits retail and wholesale deposits, they are simply icing on the cake.

Smart strategy, and lucrative too. GMAC Bank's return on average assets stood at 2.44 percent at midyear, and its return on equity was an eye-popping 22.07 percent.

But is GMAC Bank a de novo community bank by any reasonable definition of the term? In a word, Ketcha said: "No."

– D.C.

The Class of 2001

What are startup banks doing right? Where are they going wrong? To answer these questions and examine how startups are reshaping the industry, *Community Banker* trained its sights on the De Novo Banking Class of 2001.

These 120 startup banks, which mark their fifth anniversary in 2006, are a microcosm of the de novo phenomenon. They are spread across 37 states, and boast $21.5 billion in assets and $16 billion in deposits.

Having passed the critical three-year mark, when de novos operate under the tightest regulatory control, the Class of 2001 is on the threshold of maturity. As Buckner put it, "Five years is a relatively short time to create value, but it's a pretty good benchmark for assessing who is in the best position to succeed. The big winners will become evident soon."

Musso concurs. "By three years, we want our de novos to have demonstrated rapid loan and deposit growth, sustainable profitability, and the value continuum starting to swing," he said. "By five years, you're at a decision point. You're either going to be able to build value and stay independent, or you're going to pull the trigger and think about selling."

No one is predicting trouble, given the general strength of the banking industry. But disappointment may be in store for investors in de novos that have failed to prove their staying power. "A lot of the de novos were founded with the idea that in 10 years they'll be sold," said Lapera of Frederick County Bank. "The difference is, they were expected to command a premium." Instead, he predicts, "A lot of them will be sold just to recover the investment."

The majority of startup banks in the Class of 2001 were born and bred in the community, with funds scraped together by local investors, business executives, and veteran bankers. Another group of the banks comes from less modest beginnings, with startup capital provided by deep-pocketed investors, such as insurance companies, brokerage firms, and international banks.

This article looks at an outstanding example of each type of de novo bank. Frederick County Bank is a pure startup, formed with local capital and staffed with local bankers who were looking for new opportunities after being downsized in a merger. Signature Bank, meanwhile, was funded with a capital infusion from Israel's Bank Hapoalim, a $55 billion-asset bank. Since Signature's initial public offering in March 2004, Bank Hapoalim has slashed its controlling stake, and now owns 5.6 percent of Signature's public stock. Both are community banks to the core, intent on serving the needs of local businesses.

Frederick County Bank

Frederick County Bank is shaping up as a Class of 2001 success story. As of June 30, its return on average assets stood at 1.07 percent, and its return on average equity at 12.64 percent. Lapera says strong capital underpinnings, the support of investors with a long-term perspective, a team of seasoned community bankers, and a rigorous credit culture give his bank an edge.

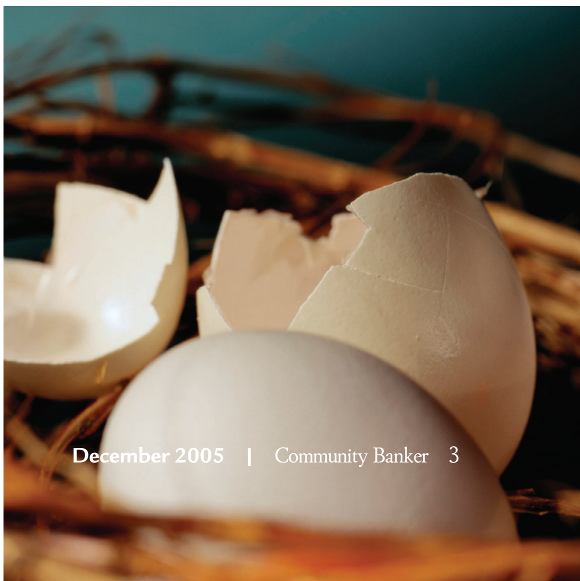
The first hurdle for any de novo is to pull together approximately $8 million in initial capital, the minimum amount regulators typically require. For Frederick County Bank, everything was proceeding smoothly until the tragic events of Sept. 11, 2001, nearly derailed the bank's plans to open in October.

"Our initial stock offering was set to close on Sept. 14," said Lapera. On Sept. 11, he and the founder group were working the phones to bring in investors. Moments after the first hijacked airliner hit the north tower of the World Trade Center, he and Raymond Raedy, the bank's principal organizer, happened to be conferring by phone.

"I was watching CNBC, and he was watching CNN," Lapera recounted. "Suddenly, there was silence on both ends, and I said, "Did you see that?" The second plane had just crashed into the south tower.

Suddenly, a bank formation that had been all but sewn up was in danger of coming apart at the seams. "We had six or seven individuals who had promised $100,000 or more," Lapera said. Some faced technical obstacles—the markets were closed, and transferring assets was impossible. And once the markets did reopen, the steep decline in prices meant that several investors "weren't in a position to do it anymore."

Some investors bowed out, but others upped their commitments, and the minimum capital was raised in time for the bank to open as scheduled. But the founder group—which ran the stock



offering without help from an investment bank— missed its goal of raising $10 million, so the subscription period was extended to Nov. 1. The initial offering ultimately brought in $9.5 million, and a secondary offering yielded $5.2 million less than a year later.

Looking back, Lapera admitted he was nervous, but added, "We never really lacked the confidence we could do it. We had a lot of support in the community."

Frederick County Bank started with 35 employees, most of them from FCNB, a local bank that was acquired in January 2001 by BB&T Corp. Lapera was FCNB's chief operating officer and executive vice president, and could have stayed with BB&T, but opted not to. The team that helped launch the de novo saw themselves as continuing a tradition of local service and control that made FCNB a great workplace and a vital part of the community, Lapera said.

"We were all community bankers at heart," Lapera said. "Neither I nor any of the other people that joined the bank were that motivated by money. Just about everyone took a cut in compensation, because we enjoyed doing what we could for the community." The bank went after commercial customers in the growing Frederick market, offering unusual services such as deposit pickups by courier. Lapera also credits a savvy technology partner—Aurum Technology, since absorbed by Fidelity National—with helping bank operations get off to a fast start.

Signature Bank

Another Class of 2001 standout is New York's Signature Bank. It has become an expert at landing the small fry, companies with annual revenues between $5 and $100 million. "We have a single line of business: Attracting privately owned businesses," said CEO Joe DePaolo.

This approach is tailor-made to the New York metro area, which is 75 percent controlled by megabanks that tend to focus on large customers.

Signature is at the top of its class by two key measures: it's the largest bank by deposits and assets among its de novo competitors, boasting nearly $3 billion and $4 billion, respectively. Loans, however, make up just 22 percent of assets, a figure DePaolo hopes to increase to 30 percent by yearend 2006. The bank became profitable in its 21st month, 10 months ahead of projections, but initially placed critical mass in deposits ahead of earnings and loan growth as a priority, and had its first full year of profitability in 2003. It is now "poised for strong earnings growth," DePaolo recently told an investor conference.

Unlike the behemoth banks, Signature doesn't advertise or do market research. Instead, it asks employees for ideas. "We hire the team, then we ask: Where do you need to be to drive your business? Then we build an office there," DePaolo said. And while he says most banks pay employees for bringing in business, Signature pays bankers twice: once for new business, and again for keeping clients in the fold.

Signature borrowed its best practices from DePaolo's former employer, Republic National Bank, which was acquired in 1999 by HSBC. During the acquisition, DePaolo and his colleagues saw many small businesses floundering as they lost a personal relationship with their banker. "These [small business] clients never recognized the bank, but they recognized their bankers by name," DePaolo said.

DePaolo seized the opportunity to start a new bank focused entirely on relationships with smaller clients. "The whole idea is: if you're busy running the business—whether it's a candy company or a manager for entertainers—there's only one banker," DePaolo said. Signature hires only experienced managers, typically with 25 years of experience or more, to bring in new business.

During the next five years, DePaolo said he wants Signature to become a $10 billion bank. "When you think of Connecticut and New Jersey, the market could be so much bigger. But I don't see it in the next year or two," he said.

Leigh Chowdhary contributed to this report.

Everything Old Is New Again

Banks with roots in ethnic and religious groups are a time-honored fixture of the U.S. banking scene. This trend remains alive and well with the de novo Class of 2001.

A spot check of the Class of 2001 list turned up at least four banks that are continuing the tradition. Three were created by and for newcomers to America; the fourth, by a religious organization.

Korean-Americans founded Uniti Bank of Buena Park, Calif., and Pacific International Bank, of Seattle. A group of Mexican entrepreneurs formed Plus International Bank, of Miami. And the Mennonite Church U.S.A. organized tiny MMA Trust Co., of Goshen, Ind.

More such banks are starting up. "We're working right now with a lot of groups—Hispanic, Asian, Greek, Indian," said Donald J. Musso, president of New Jersey-based FinPro Inc. "It's a resurgence of the old phenomenon." The newcomers should fit right in alongside names like Pulaski Bank, Magyar Bank, and Asian American Bank and Trust Co. – D.C.