De Novo Banking in the Third District

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Much has been written about the number of bank failures and mergers in the last decade. To read the newspapers, one would think that the banking industry was losing members without end. It's true that the number of banking organizations in the United States has declined over time, but this isn't the entire story. As some banks go, others come. In fact, a major story is the rapid growth in the number of new banks that have opened.

Institutions that have been in existence for less than five years are termed "de novo" banks for purposes of the quarterly Call Reports all banks must file with their federal regulators. In an evident trend, the number of de novos has increased both across the nation and in the three states of the Third Federal Reserve District—Pennsylvania, New Jersey, and Delaware.

As the number of de novos in the Third District grows, the local press heralds their arrival. But little has been written about these banks' strategies for success or about the pit-

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falls they may face along the way.

Previous studies have shown de novo banks having high mortality rates. Remarkably, all institutions chartered in the Third District since January 1985 still exist today. However, as will be shown below, special conditions are required for new entrants to do well in the banking industry. These include good management, rapid growth in assets, good credit decisions, and a healthy economy. Thus far, the institutions in the Third District have achieved profitability for the most part, but challenges remain.

DE NOVO ACTIVITY IN THE THIRD DISTRICT

While the total number of Third District banks has declined slightly over the past five years—to 283 from 298—some 38 new commercial banks (excluding special-purpose institutions) started operations in the Third District between January 1985 and December 1989. Of this total, an overwhelming percentage have been concentrated in the greater Philadelphia metropolitan area. In the last quarter of 1989, these de novo institutions represented 13.4 percent of all banking institutions in the District, and their assets have grown rapidly. (For the 38 institutions' dates of establishment and asset sizes as of January 1, 1990, see *New Banks Established*.)

Growth in Assets. Despite representing more than 10 percent of the District's banking organizations in the last quarter of 1989, the 38 de novos held assets that accounted for only 1.26 percent of the District's total assets. Additionally, the average de novo was 9 percent the size of the average Third District bank in that quarter. This contrast owes primarily to the de novos' infancy.

Assets of de novo banks have grown rapidly over the last five years. In the final quarter of 1989, the average growth rate for the de novo group's assets was 82 percent (annualized), compared to 17.3 percent for the Third District as a whole. As a de novo bank grows, however, its annual growth rate of assets declines. For a typical de novo, annual asset growth is 85 percent at the end of its second year of operation and declines to 35 percent by the end of its fifth year.

Assets and Liabilities Composition. In the early stages of operation, each of the 38 banks had a substantial portion of its assets in money market instruments, securities, and the "other assets" category—primarily premises and equipment. It takes time for new firms to find good loans and other profitable opportunities. Over time, however, they continuously increase the fraction of their assets in loans, at the expense of the fraction devoted to securities. In addition, fixed assets decline as a percentage of the total. For a de novo at the end of its first quarter of operation, total loans on average represent 30.7 percent of assets. This figure rises to 72.7 percent by the end of the second year. After making this transition, the average de novo holds approximately the same percentage of assets in loans as the average Third District bank. Within the securities category, the average de novo consistently holds more U.S. Treasury securities and fewer municipals than the average Third District bank.

The funding of de novos evolves much like their assets. Starting with primarily capital investment, the liability structure expands in both core deposits and money market liabilities. By the end of the first year of operation, 68 percent of the average de novo's liabilities are in these categories. This number had risen to 86 percent by the end of the fifth year of the study, but even then amounted to only 79 percent of the average figure for Third District banks. On the other hand, the ratio of demand deposits to assets was simultaneously about the same for the average de novo in the group as for the average Third District bank.

Income and Expenses. De novo banks see noticeable growth of interest income over the first few years of operation. For the 38 de novo

New Banks Established in the Third District Since March 1985*

Name of Bank	City, State	Established	Assets (1/1/90)
Berks County Bank	Reading, PA	12/01/87	$76,111,000
Bank of Brandywine Valley	West Chester, PA	08/01/88	$20,350,000
Bank of Delaware Valley	Fairless Hills, PA	10/31/89	$4,441,000
Bank of Gloucester County	Deptford, NJ	11/06/89	$6,569,000
Burlington County Bank	Burlington, NJ	03/02/88	$26,623,000
Carnegie Bank	Princeton, NJ	03/09/88	$45,723,000
Chestnut Hill National Bank	Philadelphia, PA	05/09/85	$50,927,000
The Coastal Bank	Ocean City, NJ	02/26/88	$42,926,000
Constitution Bank	Philadelphia, PA	06/02/86	$124,980,000
Commerce Bank of Harrisburg	Camp Hill, PA	06/01/85	$59,161,000
Commonwealth State Bank	Newtown, PA	04/08/87	$37,975,000
Community National Bank of NJ	Westmont, NJ	10/02/87	$39,449,000
Equitable National Bank	Upper Darby, PA	04/13/87	$15,146,000
First Bank of Philadelphia	Philadelphia, PA	07/22/87	$73,778,000
First Capitol Bank	York, PA	11/21/88	$18,590,000
First Commercial Bank of Philadelphia	Philadelphia, PA	10/24/89	$5,517,000
First Executive Bank	Philadelphia, PA	11/03/88	$45,503,000
First Pennsylvania Bank (NJ), N.A.	Marlton, NJ	11/02/87	$64,449,000
First State Bank	Wilmington, DE	11/21/88	$30,531,000
First Sterling Bank	Devon, PA	06/01/88	$42,319,000
First Washington State Bank	Windsor, NJ	12/04/89	$6,569,000
Freedom Valley Bank	West Chester, PA	06/09/86	$81,826,000
Founders' Bank	Bryn Mawr, PA	07/14/88	$33,319,000
Glendale Bank of Pennsylvania	Upper Darby, PA	12/18/87	$37,330,000
Jefferson Bank of New Jersey	Mount Laurel, NJ	08/25/88	$29,964,000
The Madison Bank	Blue Bell, PA	08/16/89	$12,459,000
Metrobank, N.A.	Philadelphia, PA	06/01/89	$21,149,000
National Bank of the Main Line	Wayne, PA	03/18/85	$109,395,000
Pennsylvania State Bank	Camp Hill, PA	04/24/89	$8,205,000
The Pocono Bank	Milford, PA	11/09/88	$15,200,000
Regent National Bank	Philadelphia, PA	06/05/89	$90,614,000
Republic Bank	Philadelphia, PA	09/06/88	$35,887,000
Rittenhouse Trust Company	Philadelphia, PA	04/01/87	$18,974,000
Security First Bank	Media, PA	08/01/88	$28,368,000
Security National Bank	Pottstown, PA	09/27/88	$21,173,000
Sun National Bank	Medford, NJ	05/06/85	$39,188,000
Trust Company of Princeton	Princeton, NJ	01/24/87	$45,082,000
United Valley Bank	Wayne, PA	02/04/88	$68,918,000

*This list excludes savings banks, credit-card banks, other special-purpose banks, and one subsidiary of an existing holding company that entered the market at an unusually large size. It does, however, include several subsidiaries of existing bank holding companies that were created to enter new markets but that appeared in other respects to behave similarly to the independent banks in the de novo sample.

banks, interest income accounted for 74 percent of total income in the initial quarter of operation and 98 percent in the most recent quarter.

The composition of expenses for all de novos changes substantially over time. Overhead expenses account for 92 percent of total expenses in the first quarter of operation of a typical de novo. Interest expenses in the first quarter are only 5.3 percent of total expenses, as the bank has not yet had time to attract a substantial deposit base. But in subsequent quarters, the relative importance of interest expenses increases; overhead falls proportionately. For de novos at the end of their fifth year of operation, the expenses on average consist of approximately 70 percent interest and 27 percent overhead.

New organizations inevitably run losses at early stages of their development. Then, as assets increase, interest income grows to more than offset these expenses. These results are not surprising. Of note, however, is the speed with which Third District de novos have reached profitability (Figure 1).

ROE and ROA. This performance can be illustrated by examining the sample institutions' average return on assets (ROA) and return on equity (ROE) for the first 20 quarters of operation. ROA measures how well the bank is utilizing its assets. ROE measures the return on invested capital in the bank. Both are used to evaluate an institution's profitability. In the Third District, de novo banks' average ROA and ROE turn positive around the seventh quarter of operation. However, ROA stays approximately constant over the remaining quarters in our sample, while ROE fluctuates and continues to grow.

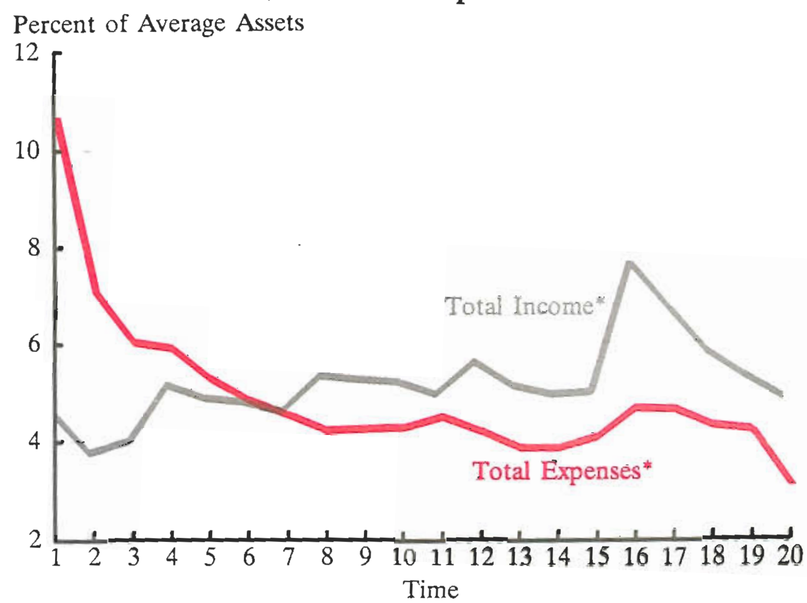
FURTHER COMPARISON TO THIRD DISTRICT PERFORMANCE

The first two years of a bank's life are unique in many ways as it struggles to become profitable. By looking at a special subset of de novos—those in existence at least two years as of December 1989—we can learn more about

FIGURE 1

Income and Expenses of De Novo Banks

(38-Bank Sample)



* Net of interest expenses, to normalize for interest rate movement across the sample.

Source: Federal Financial Institutions Examination Council, Quarterly Reports of Condition and Income for Insured Commercial Banks the challenges facing de novos and the strategies by which they confront those challenges. Nineteen of the 38 de novos established since 1985 meet this criterion. Let's restrict the comparison of performance in this section to these 19 banks and the average Third District institution.

Profitability. Average ROA and ROE of all Third District banks have been relatively stationary over the entire sample period, at approximately 1 percent and 12 percent, respectively. Like those of all 38 de novos described above, the ROA and ROE of the 19-bank subsample grew rapidly at first, then remained constant over the last year of operation, at approximately half the average for the Third District (Figures 2 and 3). This results in an ROE for the sample of near 5 percent, which might seem a less-than-stellar return to the average investor in these new banks and unacceptable as a long-run return to invested equity capital. Such a judgment, however, may be premature given the recent origin of these banks.

Portfolio Composition. The fraction of assets these de novos held as loans in the last quarter of 1989 (66.5 percent) was only slightly greater than the percentage held by Third District banks in general. Within this loan category, de novo banks hold, on average, approximately the same amount of real estate loans, more commercial and industrial (and other) loans, and fewer consumer loans than the average Third District bank. These proportions, however, appear to change over time. For example, the concentration in real estate loans changed from approximately 23

FIGURE 2
Average ROA of Banks in the Third District

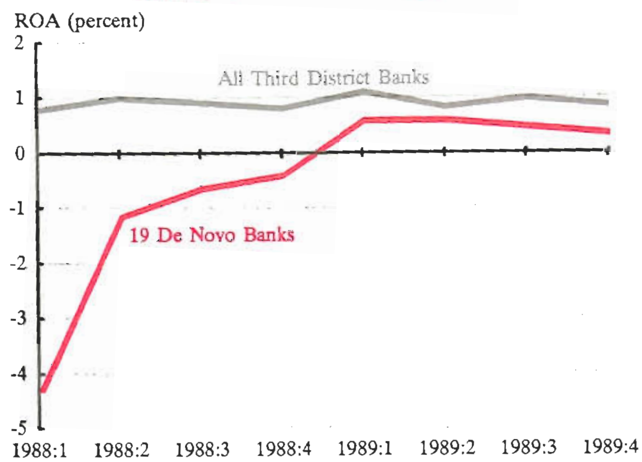


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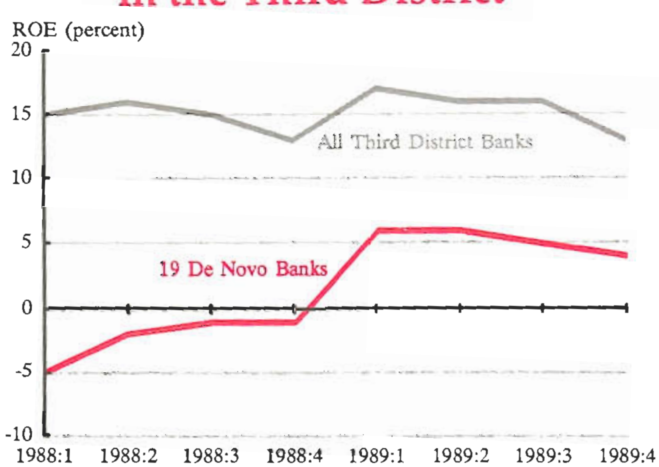
FIGURE 3
Average ROE of Banks in the Third District



Source: Same as Figure 1

percent of total loans in the first quarter of operation to over 47 percent in the last quarter, while the proportion of commercial and industrial loans fell from 38 percent to 30 percent (Figure 4).

As researcher James McAndrews points out in an article on Third District banks in the 1990s, high loan-to-asset ratios are typical of Third District banking. The new entrants seem to have followed their District counterparts in maintaining high loan-to-asset ratios and low securities-to-asset ratios. In the absence of defaults, loan yields exceed securities yields, making this a profitable strategy. At the same time, however, high loan-to-asset ratios and correspondingly low securities-to-asset ratios generally suggest that a bank is relatively illiquid and may therefore have difficulty adjusting to changing economic conditions.

Securities-to-Assets Ratios. Besides having slightly higher loan-to-asset ratios than the District average, the older de novos also tend to substitute "other assets"—a category that includes these banks' own brick and mortar—for securities. This emphasis may be regarded as a strategy of investing in the means of both attracting additional deposits and generating additional loans. Overall, the average de novo bank seems to focus its growth of assets in the direction of acquiring loans and other assets as opposed to securities.

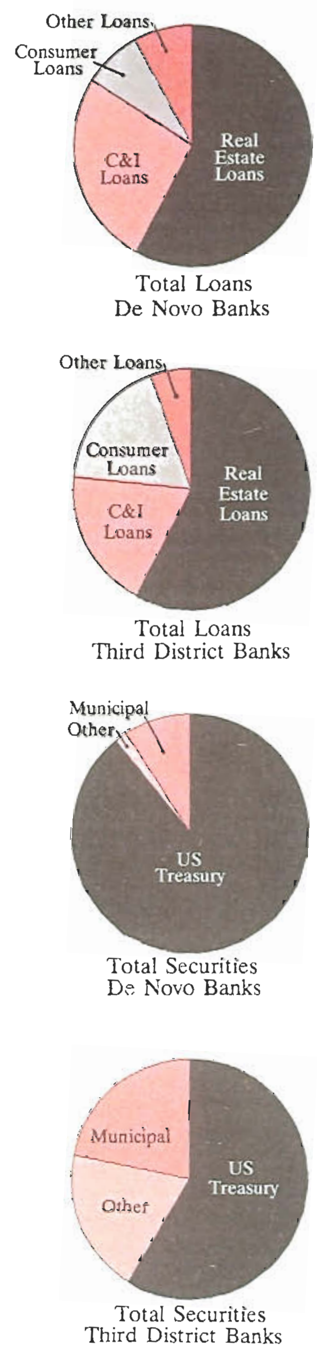
The composition of securities held by these de novos, moreover, differs from Third District averages (Figure 4). Compared to the District average, the 19-bank de novo sample holds more U.S. Treasury securities and fewer municipals and other securities. This is probably due to de novo banks' special need, at least initially, for high-quality liquid assets that can be quickly converted to loans as opportunity arises and yet pose no credit risk of their own. However, they seem to be decreasing their holdings of other securities and increasing their holdings of municipals over time.

Deposit Financing. The average de novo

FIGURE 4

Comparison of Asset Composition of De Novo and Third District Banks

1989Q4 (19 Banks)



bank's liability structure is similar to that of the average Third District bank. In the last quarter of 1989, the established de novos' average core deposits per average assets were approximately 87 percent of the Third District average, while average demand deposits of de novos were 98 percent of the Third District average.

These comparisons provide some indication of what de novos have accomplished and where they are headed. The growth rate of these banks has been rapid, more than four and a half times the District's average asset growth rate as of the end of 1989. Together, the substantial asset growth, high loan-to-asset ratios, and reliance on core deposits suggest that de novos provide a useful function in their marketplace. Their profits, however, while positive on average, have yet to achieve a level comparable to the industry average or to their established Third District counterparts.

ARE ALL DE NOVOS ALIKE?

In the comparisons above, we have been treating all de novos as a group. But that treatment may mask some significant differences in their strategy and performance.

Winners and Losers. While the average de novo has reached profitability by the end of the second year, this has not been true for all the institutions. In fact, the return on assets after two years of operation varied from -1.22 percent to 1.58 percent for the 19-bank sample. A median value of 0.32 percent therefore masks substantial differences. For new institutions these differences are most important, for they may indicate the ability of these banks to find a long-run place in the Third District marketplace.

In addition, average balance-sheet structure and loan-to-asset ratios overlook significant differences in strategy within the de novo group. For the 19 banks operating for at least two years, the loan-to-asset ratio averages 66.5 percent of total assets. The range, however, is between 45 percent and 83 percent. Four institutions—First Pennsylvania Bank (NJ), N.A., Chestnut Hill National Bank, Glendale Bank of Pennsylvania, and United Valley Bank—had more than 75 percent of their total assets in the form of loans.

Loan Specialization. Within the loan category, most banks tended to specialize. The most common specialization was in the area of real estate lending, to which these institutions, on average, devoted more than 50 percent of their loan portfolio after two years of operation. Carnegie Bank, Trust Company of Princeton, and Equitable National Bank committed more than four-fifths of their lending activity to this segment of the market. On the other hand, Sun National Bank and Rittenhouse Trust Company reported no such loans, and First Pennsylvania Bank (NJ), N.A., had less than 20 percent in this category.

Commercial and industrial lending made up one-third of the loan portfolio, on average, but varied widely within the sample. Constitution Bank clearly targeted this area for concentration by devoting 92 percent of its loans to this category, and Burlington County Bank devoted 57 percent of its portfolio to this segment. By contrast, Community National Bank of New Jersey, Commonwealth State Bank, Glendale Bank of Pennsylvania, and Equitable National Bank had less than 10 percent of their portfolio in commercial loans.

Consumer lending traditionally begins slowly for new banks. Accordingly, it is not surprising that, after two years of operation, less than 10 percent of these banks' loans were made to consumers. Consumer lending at Constitution Bank, First State Bank, and Equitable National Bank was negligible. However, Rittenhouse Trust Company, First Pennsylvania Bank (NJ), N.A., and Chestnut Hill National Bank had more than twice the average percentage in their consumer portfolio.

While this evidence suggests that many de novos have been trying to specialize in various ways, the measures of product specialization

De Novo Market Entry: How Is it Done?

Unlike most businesses, entrepreneurs wishing to enter the banking market cannot do so without constraint. They must first obtain a charter from either the State Banking Commissioner or, if a national bank, from the Office of the Comptroller of the Currency. In addition, in order to obtain deposit insurance, new entrants must make application to the Federal Deposit Insurance Corporation.

In judging the merits of a charter request, the State Banking Commissioner and the Comptroller of the Currency have traditionally used two criteria. The principal criterion is the proposal's worthiness, as evidenced by the financial capital behind the new venture, the expertise of management, and the intended business strategy. In addition, the charter proposal must satisfy a "convenience and needs" test, which considers the social desirability of the proposed institution. In essence, the regulators ask if there is a demonstrated need for a new entrant in the marketplace. The relative importance of these two criteria has changed over time and may differ across chartering authorities; for example, in 1984 the Comptroller of the Currency reduced the emphasis on the "convenience and needs" test in the evaluation process.

If the charter is accepted by the banking authorities as potentially viable, the relevant regulatory authority interviews the applicants and reviews the management team. Community reaction to the proposal is solicited at this point and, in some states, public hearings are held. Recommendations resulting from this process are forwarded to either the State Banking Commissioner or the Comptroller of the Currency. If the authorities view the application favorably, the organization is granted a charter and the management team is permitted to proceed to serve the market.

Clearly, banking is viewed as an activity that requires supervision. At both the state and national levels, attempts are made to restrict entry so that only entities meeting certain criteria operate in the market. Some contend that such a process is overly restrictive and that it enhances existing banks' monopoly positions. Others argue that entrance to the payments system must be restricted to only the highest-quality participants.

The perceived likelihood of successfully obtaining a new charter has changed over time. Prior to 1984, new applications were rarely filed and, some observers contended, not encouraged by the regulatory authorities. Since then, however, some have argued that new entrants should be encouraged because they enhance the competitive environment. This may have contributed to the spate of de novo applications both in the Third District and in the nation over the past five years.

available in the Call Reports fall short of identifying a single banking strategy. For example, the data do not reveal such customer specialization as a full-service private-banking strategy, which might include concentrated lending to high-income customers, or a commercial-lending strategy, which emphasizes business lending to middle-market customers.

Some researchers have suggested that successful established banks tend to follow one of these specialized strategies; on the other hand, a bank serving more than one market may be able to achieve a more stable earnings flow. The dynamic tension between a narrow focus for higher average profitability and diversification for safety in adverse times remains a challenge for de novo banks in the Third District, and each bank must find its own way.

Funding from Deposits. On the funding side, the average bank had raised, by the end of its second year, more than two-thirds of its funds from demand deposits and retail savings accounts. These quantities, which are typically from local sources, included both consumer and commercial deposits. The remaining one-third was obtained from owners' equity and borrowed funds in the regional money market. However, institutions such as Trust Company of Princeton, Commerce Bank of Harrisburg, First State Bank, and National Bank of the Main Line needed little additional money to support their activities. Each had more than 80 percent of its portfolio supported by core deposits.

In summary, the de novo trend in the Third District includes institutions of various characteristics. They share a common experience: entrepreneurial adventure in a dynamic banking market. Yet each institution has chosen its own path, as illustrated by significant differences in financial performance, asset composition, and liability structure. Changes in the economic conditions under which these institutions function may have a further impact on relative performance and the ability to survive and prosper.

THE FUTURE OF DE NOVO BANKS

Previous studies find that de novo banks have had difficulty creating a stable market niche and that their profitability has been inconsistent.[1] Moreover, recent studies suggest that nearly half of de novos cease to exist within 10 years.[2]

Many reasonable explanations have been offered for the relative vulnerability of de novos. These banks need time to acquire a customer base and consumer loyalty. Meanwhile, they incur losses associated with large fixed costs and a general lack of experience in their chosen markets. Further, to break even requires substantial asset growth, good credit judgment, and, at times, good luck. Their small size and vulnerability due to lack of loan diversification make them less likely to survive an economic downturn in their region or their area of concentration.

Thus far, the Third District has been fortunate in that no de novo in the group chartered since 1985 has failed. This fine record owes not just to the nation's long economic expansion, but to the strength of the regional economy. However, signs of a national economic slowdown are clearly on the horizon. Already there have been impacts on reported earnings at regional banks throughout the country, as well as on money-center institutions. It will inevitably have a greater impact on new entrants here and elsewhere.

At least partially because of the change in economic environment, de novo activity in the Third District has declined substantially over the last calendar year. Regulators granted only four new charters for full-service commercial banks within the Third District over the first three quarters of 1990. This decline in the trend may signal an end to the recent wave of new entrants into the banking market as prospective entrants await calmer waters to launch their new institutions.

SUMMARY

De novo banks are an important force in American banking. In many respects, they differentiate the American system from its more concentrated counterparts worldwide. Entry, even if regulated, adds an entrepreneurial spirit to any industry and allows the industry to serve its market more efficiently.

Within the Third District, fully 13.4 percent of operating institutions are less than five years old. These new entrants have entered a mature market and have performed well. On average, they break even in approximately two years and maintain a positive, if low, return on assets in the subsequent period. The secret to their

[1] Douglas V. Austin and Christopher C. Binkert, "A Performance Analysis of Newly Chartered Commercial Banks," *The Magazine of Bank Administration* (January 1975) pp. 34-35.

[2] William C. Hunter and Aruna Srinivasan, "Determinants of De Novo Bank Performance," Federal Reserve Bank of Atlanta *Economic Review* (March/April 1990) pp. 14-25.

performance is substantial growth of high-quality assets in the first few years, coupled with the development of a strong core deposit base. In addition, successful banks exhibit a competitive strategy that exploits market niches left open in a consolidating industry. These institutions should be encouraged to continue serving their market.

Yet, the prospects for de novo banks are not all rosy. By their nature these institutions cannot be broadly diversified and they face an uncertain future. Previous studies have shown that nearly half disappear, usually through consolidation, within the first decade. Whether this will be the fate of the Third District de novos is an open question. For the present, however, the customers and stockholders of these banks appear to find value to their presence in the Third District market.

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