



FINANCIAL INDUSTRY

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Issues

New Banks: Why Enter When Others Exit?

When most ducks are flying south for the winter, seeing others headed north might seem strange. Similarly, if many businesses were leaving an industry, seeing others entering it also might seem strange. The U.S. banking industry has followed that seemingly curious pattern. The number of banks nationwide has declined over the past 18 years, but the number of new, or *de novo*, banks began a resurgence in 1995. This article explores this apparent paradox of new banks forming while the total number of banking organizations continues to fall.

We unravel the paradox by showing that *de novo* banks are springing up to take advantage of local conditions that favor entry. By capitalizing on such conditions, *de novos* are providing the additional banking services called for by the market. These new banks have increased competition in markets where it was initially sparse. Also, *de novo* entry has worked to increase the number of banks in states with relatively strong economies and has helped fill the associated increase in demand for banking services there. Thus, *de novo* banks are not going the wrong way like contrary ducks but instead are seeking their place in a financial services marketplace that offers opportunities to newcomers even while others are leaving the industry.

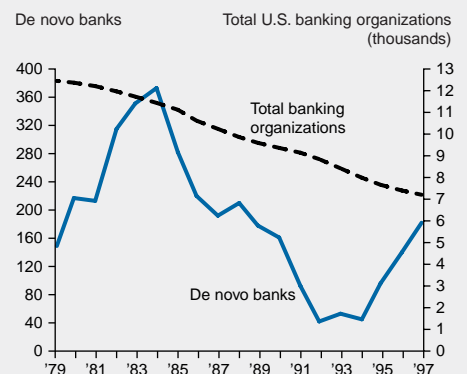
De novo banks are springing up to take advantage of local conditions that favor entry.

The Paradox

Chart 1 shows the features of the banking market that make up the paradox. First, the number of banking organizations in the

United States has been declining for the past 18 years. To explain this trend, analysts have pointed to the growth in nonbank competitors and to changes in technology and in banking legislation and regulation, among other factors. The chart also indicates that despite the factors working to reduce the number of banking organizations, financial entrepreneurs continued to start new ones. And while the number of such new banks had been declining from 1984 to 1994, the number of *de novos* has since begun a resurgence. This resurgence raises the question of what these new banks look like and why they are emerging while others are leaving the industry.

Chart 1
**Total Banking Organizations
Versus De Novo Banks***



* Adjusted for de novos that acquired existing offices.
DATA SOURCES: Report of Condition and Income; NIC (the Federal Reserve's National Information Center for Systemwide Structure and Financial Information).

Table 1
Characteristics of De Novo and Small Banks, 1997

Balance sheet items	1997 De Novo Banks		1997 Banks Under \$100 Million in Assets			
	Average per bank (thousands of dollars)	Assets (percent)	Average per bank (thousands of dollars)	Assets (percent)		
Cash	4,028	6.19	2,365	5.17		
Securities	5,852	9.00	12,608	27.56		
Loans	45,213	69.51	26,515	57.96		
Other assets	9,954	15.30	4,257	9.31		
Total assets	65,047	100.00	45,744	100.00		
Deposits	19,627	30.17	39,342	86.00		
Other borrowed funds	27,170	41.77	534	1.17		
Fed funds purchased	974	1.50	428	.94		
Other liabilities	2,619	4.03	485	1.06		
Total liabilities	50,390	77.47	40,789	89.17		
Equity	14,657	22.53	4,955	10.83		
		Average assets (percent)	Average equity (percent)	Average assets (percent)	Average equity (percent)	
Income statement items						
Interest income	3,994	7.70	30.93	3,354	7.72	70.14
Interest expense	1,214	2.34	9.40	1,483	3.41	31.02
Net interest income	2,780	5.36	21.53	1,871	4.31	39.13
Noninterest income	1,376	2.65	10.65	561	1.29	11.74
Noninterest expense	1,651	3.18	12.78	1,596	3.67	33.37
Net income	-132	-.25	-1.02	522	1.20	10.92
Number of banks	179			5,853		

NOTE: In 1997, three de novo banks did not last the year. The numbers for the 1997 de novos exclude any de novo banks that purchased an existing branch or bank.

DATA SOURCES: Report of Condition and Income; NIC.

De novos held more of their assets in loans and less in cash and securities than did their older counterparts.

Characteristics of De Novo Banks

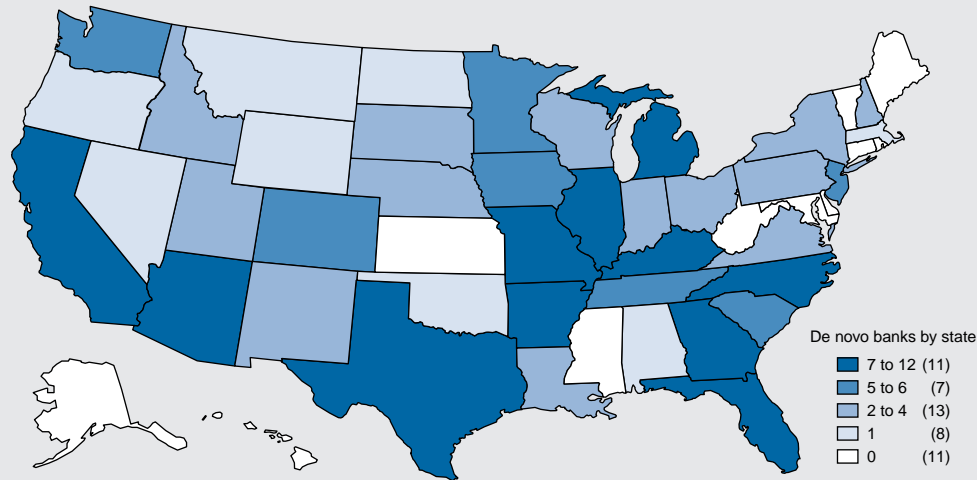
A new bank that is formed by obtaining a new charter is called a de novo bank.¹ Chart 2 shows that the de novos opened in 1997 were widely dispersed across the country. Table 1 compares the characteristics of the 179 de novos started in 1997 that survived the year with those of all small banks in 1997. At the end of their start-up year, the de novos held an average of \$65 million in assets. Given their relatively small size, de novos can reasonably be compared with other banks with under \$100 million in assets. Like small banks in general, de novos held the bulk of their assets as loans, with securities and cash accounting for smaller percentages. However, the de novos held more of their assets in loans and less in cash and securities than did their older counterparts. On the liability side, the 1997 de novos funded themselves with deposits to a much smaller degree than did small banks in general and relied far more heavily on other borrowed funds. Finally, they had a higher

equity-to-asset ratio than did other small banks. Thus, de novos' intensive lending leaves them in what appears to be a risky position—typical for start-up businesses—although their strong capital position ameliorates that risk.

De novos in 1997 were unprofitable as a group in their start-up year, as Table 1 shows. It is not surprising for a business—including a de novo bank—to be unprofitable in its initial year of operation. However, the sooner a new business could be expected to become profitable, the more attractive it would be to start the business.

Table 2 shows the financial performance of de novos started in 1992–95 and tracks their performance during their start-up, second, and third years. For all years, the median de novo bank was unprofitable in its start-up year but was profitable by its third year. The percent of all de novos that were profitable in their first year ranged between 13.7 and 30.6 percent; on average, one of every five banks posted positive profits during its first year of operation. By

Chart 2
1997 De Novo U.S.-Insured Commercial Banks



DATA SOURCE: NIC.

The median de novo bank was unprofitable in its start-up year but was profitable by its third year.

their third year, however, three out of four de novos were profitable. For 1992–95, the median bank posted a return on average assets (ROAA) of –2.71 percent during its first year, narrowed losses to an ROAA of –0.24 percent during the second year, and had a respectable return of 0.7 percent during the third year of operation. The trend in the return on average equity (ROE) is similar.

What Type of Market Attracts De Novo Banks?

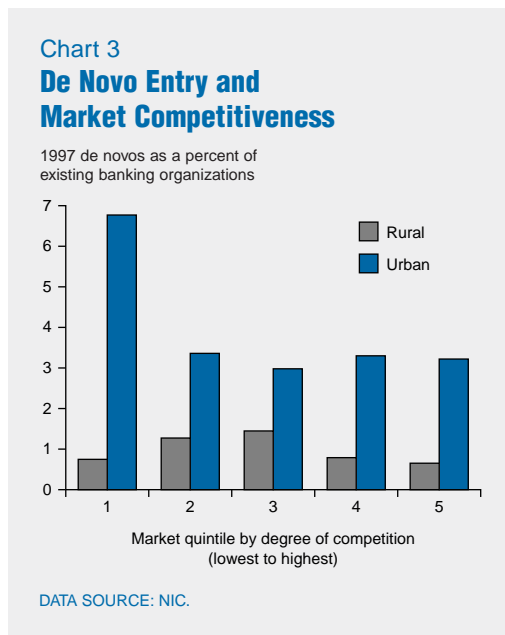
A market’s attractiveness for de novo entry would depend on the profitability that a de novo could expect from entering that market. Profitability, in turn, could be influenced by a number of factors, including the degree of competition, the share of the market held by small banks, small-business lending activity, the profitability of banks in

Table 2
Profitability of De Novos Started in 1992–95

	Year 1	Year 2	Year 3
1995 de novos	1995	1996	1997
Median ROAA	–2.95	–.41	.63
Median ROE	–5.84	–2.21	5.17
Percent profitable	13.7	39.8	79.1
1994 de novos	1994	1995	1996
Median ROAA	–2.09	–.02	.57
Median ROE	–5.15	–.13	5.87
Percent profitable	19.1	48.8	81.0
1993 de novos	1993	1994	1995
Median ROAA	–2.48	.33	.83
Median ROE	–4.56	2.25	6.03
Percent profitable	30.6	55.1	78.7
1992 de novos	1992	1993	1994
Median ROAA	–3.73	–.34	.79
Median ROE	–10.6	–2.13	7.09
Percent profitable	20.5	42.1	74.3
Overall Median Numbers for 1992–95 De Novos			
	Year 1	Year 2	Year 3
ROAA	–2.71	–.24	.70
ROE	–5.57	–1.36	5.85
Percent profitable	20.0	44.4	75.1

DATA SOURCES: Report of Condition and Income; NIC.

De novo banks aim at a market niche associated with their small size.



the market, population growth and general economic conditions. These characteristics are examined to determine whether they can help explain the paradox of new banks being formed while the total number of banking organizations is declining.

Market competitiveness. One factor that could influence the profitability a potential de novo bank might expect from a particular market is the degree of competition. Markets with relatively few competitors may be more attractive for de novo entry because such markets would be more likely to have unmet financial needs. An entrant could thus profit by providing services to meet those needs.

Chart 3 shows that for urban markets, there tend to be more de novos in markets with less competition—specifically, the least competitive markets have noticeably more de novo entry than do the other markets.² Rural markets, in contrast, have fewer de novos relative to existing banking organizations than do urban markets. Also, rural markets do not display a noticeable pattern between market competitiveness and de novo entry. Rural markets appearing uncompetitive may not exhibit high de novo entry because counties with low populations can support only a small number of banking organizations. In the least competitive rural quintile, there are only 1.4 banking organizations per market on average, compared with 4.8 banking organizations per market on average in the least competitive urban quintile.

Presence of small banks. As mentioned above, de novo banks are small. Therefore, the attractiveness of a market to a potential

de novo bank could be influenced by how prevalent small banks are in that market. To the extent that small banks provide banking services that differ from those offered by larger banks, they would operate within a market niche somewhat insulated from larger banks. Thus, a market with few small banks could represent an attractive opportunity for a de novo because there would be few competitors within that niche.

Chart 4 shows the relationship between de novo entry and existing small bank presence, in which small bank presence is measured by the percent of banking assets in the market held by banks with less than \$100 million in assets. Entry is greater in the lower quintiles, implying that de novo entry tends to occur where small banks are relatively scarce. Thus, the evidence supports the notion that de novo banks aim at a market niche associated with their small size.

Lending to small businesses. One part of small banks' market niche may lie in small-business lending.³ Small banks have a larger fraction of their loan portfolios directed to small-business lending than do larger banks. In 1997, small business loans accounted for 18.3 percent of the loan portfolios of banks with less than \$100 million in assets, compared with 11.1 percent for banks with assets above this level.⁴ Given that de novos are small, it would be reasonable to expect that they might target small-business lending. If so, then de novos might be attracted to areas where this type of lending is most promising.

Chart 5 shows the relationship between de novo entry and the intensity of small

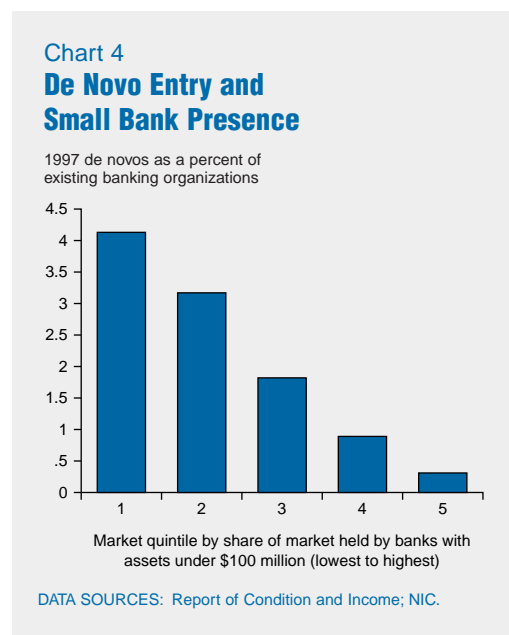
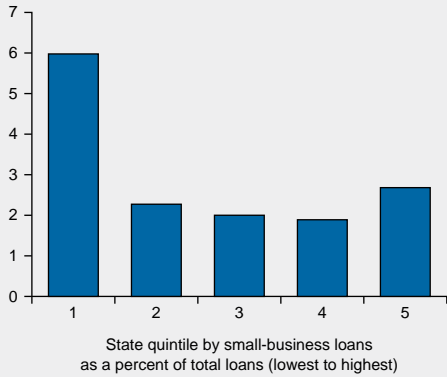


Chart 5
De Novo Entry and Small-Business Lending

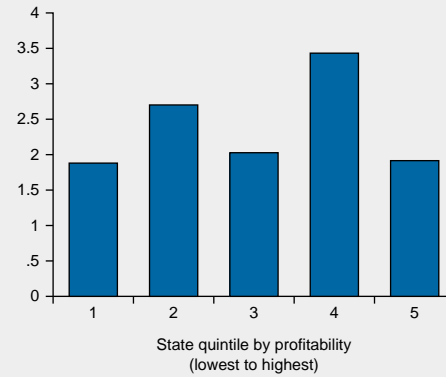
1997 de novos as a percent of existing banking organizations



DATA SOURCES: Report of Condition and Income; NIC.

Chart 6
De Novo Entry and Market Profitability

1997 de novos as a percent of existing banking organizations



DATA SOURCES: Report of Condition and Income; NIC.

business lending in a market—specifically, the fraction of bank loans devoted to such lending. The chart indicates that markets with the smallest fraction of bank loans devoted to small business lending had the greatest de novo entry. This suggests that de novos were attracted to markets where opportunities to lend to small businesses had not been pursued extensively.

Profitability of existing banks. Another variable that would seem likely to influence de novo entry is the profitability of existing banks in a market. However, such influence on the expected profitability of entering a market is not straightforward. On the one hand, high profitability among existing banks in a market could reflect market conditions that would favor all banks in that market, including de novos. On the other hand, high profitability in a market could reflect the presence of strong competitors that would make it difficult for a de novo bank to be profitable. Reflecting these opposing forces, Chart 6 does not show any consistent relationship between the profitability of banking markets and de novo entry.

Population growth. Beyond characteristics of the banks themselves, what can help explain the state-to-state variation in the number of de novo banks? One possible factor is population growth. States with rapid population growth would be likely to have a heightened demand for banking services, which, in turn, could encourage de novo entry. Chart 7 illustrates the relationship between the growth in population and de novo entry by state. The chart shows that more rapid population growth is

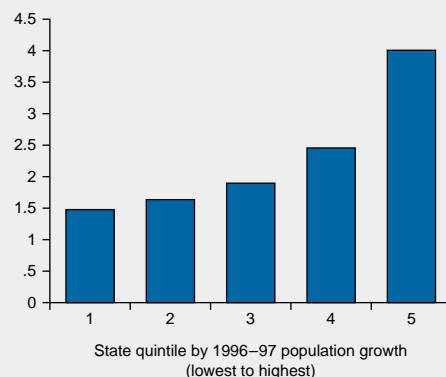
associated with greater de novo entry. Thus, the pattern of de novo entry is consistent with de novos emerging in response to differences in the demand for banking services across states.

Change in unemployment rate. The strength of a state's economy is another factor that will also influence the profitability of starting a de novo. As economic conditions in a state improve, the demand for financial services will also increase, thereby creating better opportunities for de novos. Using the change in the unemployment rate as a measure of economic conditions, Chart 8 shows that the quintile of states with the most improved economies had the most de novo entry. Hence, improvements in a state's economy tend to attract de novos. These de novos, in turn,

The pattern of de novo entry is consistent with de novos emerging in response to differences in the demand for banking services across states.

Chart 7
De Novo Entry and Population Growth

1997 de novos as a percent of existing banking organizations

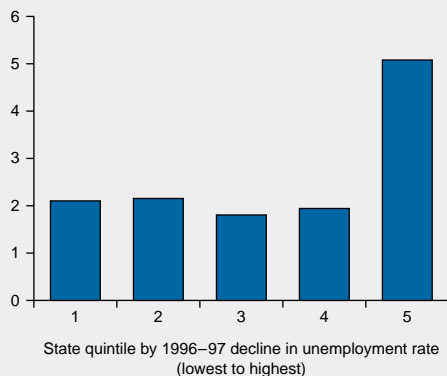


DATA SOURCES: U.S. Census Bureau; NIC.

Entrepreneurs' freedom to find and respond to market opportunities is one of the strengths of our free enterprise system.

Chart 8 De Novo Entry and Change in Unemployment Rate

1997 de novos as a percent of existing banking organizations



DATA SOURCES: Bureau of Labor Statistics; NIC.

provide financial services that help sustain the improved economic conditions.

Conclusion

The recent resurgence in the number of de novo banks might appear puzzling in light of the ongoing decline in the number of banking organizations nationwide. The key to this puzzle, however, lies in the diversity of the banking market: de novo banks are finding local conditions that offer promising opportunities, despite factors that are causing the total number of banking organizations to decline. As de novos respond to these opportunities, they are providing desired financial services to their customers and are establishing their place in the financial services marketplace. Similarly, small banks—de novo or not—can prosper in their own niches, despite trends that might appear to be working against their success. More generally, entrepreneurs' freedom to find and respond to market opportunities is one of the strengths of our free enterprise system: even as some firms find their services no longer needed, the evolutionary dynamics of the market can spur the creation of new firms more closely aligned with consumers' needs and desires.

—Robert R. Moore
Edward C. Skelton

Notes

¹ The analysis here excludes de novos that were formed by purchase of an existing bank or branch. Also, the time at which a de novo is no longer referred to as such and is simply called a bank is arbitrary. Here, a 1997 de novo refers to one that opened in 1997.

- ² Here we define banking markets as standard metropolitan statistical areas for urban markets and as counties for rural markets. We compute competition in the market using the Herfindahl-Hirschman index, calculated by summing the squares of each firm's share of the market's deposits.
- ³ In this and subsequent sections, we define banking markets as states because the relevant data are unavailable for individual counties and standard metropolitan statistical areas.
- ⁴ We measure small-business lending using data from the Report of Condition and Income. Those data define small-business loans as loans with original amounts of \$1 million or less that are either commercial and industrial loans or loans secured by nonfarm nonresidential real estate.

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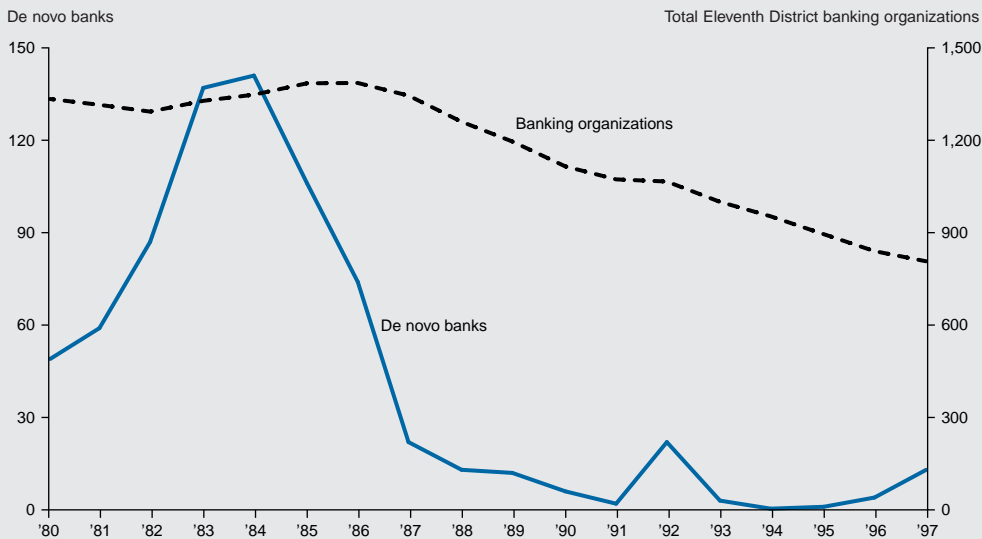
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11K Bank Notes

New bank charters in the Eleventh District have followed a pattern similar to that of new bank charters for the nation as a whole. From 1984 until 1994, the number of de novo banks chartered in the Eleventh District declined each year, except for 1992, with no new banks chartered during 1994. Although only 13 de novos were chartered during 1997, this number has risen steadily over the past three years. Of these 13 de novos, eight were chartered in urban areas and five were chartered in rural areas. The banks chartered in rural markets tended to be larger than those in urban markets. By year-end 1997, the average rural de novo had assets of \$31 million, while the average urban de novo had assets of about \$20 million. The rural de novos also tended to carry more loans than their urban counterparts. On average, newly chartered urban banks reported a loan-to-deposit ratio of 47.7 percent, whereas newly chartered rural banks reported a 61.1 percent loan-to-deposit ratio. Furthermore, de novos in urban markets tended to have more equity, as evidenced by an equity-to-assets ratio of 21.3 percent—almost 10 percentage points higher than the equity-to-assets ratio at rural de novo banks.

Eleventh District: Banking Organizations Versus De Novo Banks



Eleventh District De Novos in 1997

	Number	Average assets (thousands of dollars)	Loans/deposits (percent)	Equity/assets (percent)
Urban markets	8	20,192	47.7	21.3
Rural markets	5	31,302	61.1	11.7

DATA SOURCES: Report of Condition and Income; NIC.

Insights in a New Banking World

New banks today are emerging into a whole new world. Traditional banking activities are giving way to more and more off-balance-sheet activity; recent financial crises have focused attention on the role of government in the banking sector. The latest *Financial Industry Studies*, a semiannual Dallas Fed publication devoted to scholarly research into the forces shaping banking and finance, takes an in-depth look at these issues.

Rethinking Bank Efficiency and Regulation: How Off-Balance-Sheet Activities Make a Difference

Getting an accurate picture of a bank's financial condition is becoming more difficult as banks embrace more nontraditional activities. Authors Thomas F. Siems and Jeffrey A. Clark demonstrate that failure to include a measure for these off-balance-sheet activities in the traditional bank efficiency models can have important statistical and economic effects on derived efficiency estimates by seriously understating actual bank output.

Government Guarantees and Banking: Evidence from the Mexican Peso Crisis

What can an examination of Mexico and Argentina during the 1994 peso crisis reveal about the effects of bank supervisory policies? In this article, Robert R. Moore explores the crisis and the relationship between deposit growth and financial strength in these countries to determine the cost of government guarantees.



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