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U P D A T E

News of Developments in the Financial Sector and Related Areas

* *IN THIS ISSUE* *

Drought in Bank Formations

Earlier this year the Federal Reserve of Bank of Richmond published a study entitled "Who Wants to Start a Bank?" which addresses the scarcity in the formation of new banks in the United States. The study notes that in late 2013, the Bank of Bird-in-hand obtained regulatory approval and opened its doors in an Amish community in Lancaster County, Pennsylvania. Bird-in-Hand was the first newly chartered bank anywhere in the United States in three years. Organizers of the Bird-in-Hand reported a longer and more difficult application process than in years past.

According to the study, the FDIC reported only seven new bank charters since 2010. For the period 1997 to 2007, the United States averaged 159 new banks a year. The study notes that 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. As noted in the study, the total number of banks has fallen by about 9,000 since the mid-1980s, as weaker banks merged with stronger ones. There was always a steady influx of new banks to replace some of those lost which is no longer the case.

The study reflected that 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 Federal Reserve Bank of Dallas 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 2015 article 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. Dedicated human resources for compliance-related issues creates higher fixed cost for newly chartered banks.

The study noted that 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 according to the study, the FDIC returned the enhanced supervisory period back to three years.

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. The study noted that net interest income has been similarly low in previous recessions without a complete collapse in new bank entry.

The study also addressed the question, "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. Small 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. The study noted that small banks are organizationally better equipped to engage in this sort of relationship lending than large banks. If small businesses are primarily reliant on banks for funding, they may face troubling effects from the dearth of de novos.

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.

Our firm is experienced and available to answer questions regarding new bank formations and the consolidation of banks.