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# U P D A T E

## News of Developments in the Financial Sector and Related Areas

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### *The Failure in New Bank Formations*

A number of articles has been written in recent years regarding the scarcity in the formation of new banks in the United States. A study by the Federal Reserve Bank of Richmond published in 2015 noted that the financial crisis that began in 2007 significantly altered the banking land scape. The study found that from 2007 through 2013 that the number of commercial banks in the United States fell by more than 800 representing a 14 percent decline. The drop was highly concentrated among small community banks with less than $50 million in assets representing a 41% decline.

The study noted that although many banks failed during the financial crisis beginning in 2007 that this decline was driven largely by the lack of new bank formations. The study found that the formation of new banks has fallen sharply since 2010. For instance, in 2012, there were no new banks formed in the United States, and in 2013 there was only one bank formation which was formed to serve the Amish community in Lancaster County, Pennsylvania. From 2011 through 2013, there were only four new banks formed in the United States compared to a yearly average of more than 100 from 2002 through 2008.

Some commentators take the position that the decline in the formation of new banks is due in large part to low bank profitability. An important factor in bank profitability is the net interest margin meaning the spread between deposit rates and lending rates. The Federal Reserve Board's policy of keeping the federal funds rate near zero since 2008 has pushed lending rates down resulting in the net interest margin being relatively low.

Other commentators are of the position that the following the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, compliance costs are a driving force for the lack of new bank formations. Among other factors in the lack of new bank formations in the United States include, but are limited to, higher capital requirements, more frequent examinations by bank regulatory agencies and the lengthy application process to form a new bank.

In the fall of 2014, the FDIC updated its Statement of Policy on applications for new bank formations. It was the hope of the FDIC that more organizing groups would apply for a new bank charter based on the updated policy. However, the updated policy has had little or no effect on new bank applications.

The FDIC reports that there were more than 18,000 insured institutions in the 1980s compared to 6,122 in the first quarter of 2016 representing a decline of over 66%. In its research study in April 2014 on long-term bank consolidation, the FDIC

concluded that the rate of consolidation is attributable to factors that are likely to subside once the effects of the financial crisis is behind, and that consolidation has had much less impact on the community banking sector than is commonly believed. The FDIC research study also concluded that based on prior experience that chartering activity in the form of new bank formations can be expected to recover over the next few years as the effects of the financial crisis recedes. One might wonder if these conclusions in the in the 2014 research study are viable today.

The FDIC published an article in August 2016 entitled De Novo Banks: Economic Trends and Supervisory Framework. The article provides an overview of trends in de novo formation, the process by which the FDIC reviews applications for deposit insurance, the supervisory process for de novo institutions, and steps the FDIC is taking to support de novo formations. The information provided in the article reflects the FDIC's ongoing efforts to work with, and provide support to, groups interested in organizing a de novo institution. The article points out that of the more than 1,000 new banks formed between 2000 and 2008, there were 634 were still operating as of September 2015, but also noted that the failure rate of banks established between 2000 and 2008 was more than twice that of small established banks, this being consistent with previous research that found de novo banks to be susceptible to failure under adverse economic conditions. The article concluded by noting that the current economic environment with narrow net interest rate margins and modest overall economic growth remains challenging for the establishment of de novo institutions.

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

### *Noncumulative Perpetual Preferred Stock*

During the foreseeable future, capital may be the biggest issue facing community banks. Noncumulative perpetual preferred stock ("Noncumulative Preferred") is an excellent alternative for bank holding companies that need capital. Although common stock should generally be the dominate form of capital for a bank holding company, Noncumulative Preferred qualifies as capital.

Noncumulative Preferred may be issued at both the bank holding company level and the bank level in order to increase capital. Because Noncumulative Preferred is considered a separate class of stock, Subchapter S corporations are not eligible since they can only have one class of stock. A coupon payment on Noncumulative Preferred is similar to trust preferred, and the issuer has the option to call the securities after five (5) years.

Any redemption of Noncumulative Preferred is subject to regulatory approval. Noncumulative Preferred has no voting rights and is perpetual, meaning that it has no final maturity date.

Quarterly dividends are subject to board approval and are noncumulative if not paid. Unlike dividends paid on trust preferred securities, dividends paid on Noncumulative Preferred are not a tax deductible interest expense.

Noncumulative Preferred is an excellent vehicle for increasing capital, maintaining shareholder ownership, funding acquisitions, stock repurchases and providing funds for internal growth. Our firm is available to answer questions on the benefits of issuing Noncumulative Preferred and the placement of these securities with third parties.

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