For release on delivery
10:00 a.m. EDT (9:00 a.m. CDT)
October 22, 2021

# The Lack of New Bank Formations is a Significant Issue for the Banking Industry


Remarks by Michelle W. Bowman

Member

Board of Governors of the Federal Reserve System


at

2021 Community Bankers Symposium: Banking on the Future

Federal Reserve Bank of Chicago

Chicago, Illinois

October 22, 2021

Good morning. I appreciate the opportunity to be part of this symposium on "Banking on the Future," especially since the future of banking is one of the highest priorities in my work at the Board. Today, I will focus my remarks on the importance of community banks to our financial system and the challenges they face. In particular, I will focus on the formation of new banks and pose two key questions concerning the recent scarcity of these "de novo" banks.[1]

The first question: Why have there been so few de novo bank formations over the last decade? And second, what can be done to encourage more de novo banks? I will begin with some background on community banks and bank formations.

**The Importance of Community Banks**

By serving communities, households, and businesses that may be underserved by larger institutions, community banks play a key role in advancing diversification in the U.S. banking system. First and foremost, community banks provide critical financial services to their communities and to many customers who might have limited geographic access to banking services. Because community bankers are active participants and leaders in their communities, they typically know their customers and their needs better than a banker at a branch of a larger institution. Community banks draw upon this knowledge and conduct "relationship" lending versus relying on automated underwriting models that are typical in larger institutions. Therefore, community banks are more willing to underwrite loans to creditworthy customers based on an assessment of qualitative factors that automated models do not consider. Since community bankers are part of the fabric of their communities, they better understand the local market and economic conditions in the area compared to larger institutions that are not resident within the community.

[1] In general, an insured depository institution is in the de novo phase if it has been operating for three years or less.

Collectively, community banks are critical in advancing the health and stability of the U.S. economy as evidenced by their participation in the Small Business Administration's Paycheck Protection Program (PPP). Community banks made 4.7 million PPP loans, totaling $429 billion, which accounted for nearly 60 percent of the program's total loan amount.[2] In comparison with the banking industry as a whole, these banks provided more loans to traditionally underserved communities and population segments: community banks provided 87 percent of total PPP loans to minority-owned businesses, 81 percent to women-owned businesses, and 69 percent to veteran-owned businesses.[3]

**Trends in Community Banking**

Despite the local and national significance of community banks, their numbers, as well as the number of insured banks in general, have been declining for several years.[4] This erosion of community bank charters is not just an issue in our rural communities. In urban areas, these banks, including minority-owned banks, serve businesses and households that may also be overlooked by larger institutions. I am concerned that the contraction of community banks could lead to an unhealthy level of similarity in the banking system. As a result, this could limit the ability of households and small businesses to access credit and other types of financial products and services. The beauty of community banks is in their differences—whether in their personality or business model. Each is unique in its mission, service delivery, and profile.

While I am troubled by the declining community bank footprint, I am not surprised that banks are choosing to merge or to be acquired. I am well aware of the significant challenges that

[2] See the Independent Community Bankers of America (ICBA), "Community Banks Made 60 Percent of PPP Loans to Small Businesses," news release, September 1, 2021, https://www.icba.org/newsroom/news-and-articles/2021/09/01/icba-to-congress-ppp-forgiveness-should-be-straightforward.

[3] ICBA, "Community Banks."

[4] From 2011 to 2019, there has been a 30 percent decline in the number of community banks, whereas the number of larger banks has declined by more than 36 percent. See the *FDIC Community Banking Study* (December 2020) at https://www.fdic.gov/resources/community-banking/report/2020/2020-cbi-study-full.pdf.

smaller banks face. Since joining the Board, and increasingly over the past year, I have met with many state member bank CEOs who share these challenges with me. These CEOs have expressed frustrations with ever-increasing compliance burden, which distracts their attention from prudent revenue generating activities.

As I discussed in recent remarks at the community bank research conference in late September, public policymakers must avoid adding regulatory burden on the smallest banks, particularly on those that maintain a more traditional business model.[5] Therefore, policymakers need to achieve a meaningful balance in our supervisory approach for community banks. Otherwise, community banks will continue to face a regulatory and supervisory framework that is ill-suited for a lower-risk profile and activities that are less complex than those of larger institutions.

**Why Have There Been So Few De Novo Bank Formations over the Last Decade?**

The underlying question remains: why have there been so few de novo bank formations over the last decade?

There have been only a handful of new bank charter applications over the past decade. In fact, only 44 de novo banks have been established, which include both state and national charters. A 2014 study by Federal Reserve Board economists noted that from 1990 to 2008, over 2,000 new banks were formed, which on average is more than 100 per year.[6] In contrast, the study noted that only seven new banks were formed from 2009 to 2013. The 2014 Board study

[5] Michelle W. Bowman, "Creating a New Model for the Future of Supervision" (speech at the Community Banking in the 21st Century Research and Policy Conference, Federal Reserve Bank of St. Louis, September 28, 2021), https://www.federalreserve.gov/newsevents/speech/bowman20210928a.htm.

[6] Robert M. Adams and Jacob P. Gramlich, "Where Are All the New Banks? The Role of Regulatory Burden in New Charter Creation," Finance and Economics Discussion Series 2014-113 (Washington: Board of Governors of the Federal Reserve System, December 2014 (revised July 2016)), http://www.federalreserve.gov/econresdata/feds/2014/files/2014113pap.pdf.

suggests that “low interest rates and depressed demand for banking services—both of which depress profit for banks, and particularly new banks—may also have discouraged entry.”[7]

The conclusions from a Federal Reserve Bank of Kansas City study completed this year align with observations from the 2014 Board study. In this more recent study, the authors noted that new bank formations tend to be cyclical, accelerating during periods of economic expansion and slowing during recessions.[8] While regulatory burden has also contributed to depressed de novo formations, the authors pointed to the weak economy following the 2007-2009 financial crisis and low profitability for banking as overriding factors.

A recurring theme that has surfaced through my discussions with bankers and other industry stakeholders is the regulatory burden imposed upon de novo banks. In particular, community bankers noted the challenges in raising the capital required to establish a new bank. The 2014 Board study noted that the states’ statutory capital requirements for a new state-chartered bank could be as low as $10 million, but in practice could be as high as $30 million.[9] Given the high initial capital requirement, a de novo bank has a small margin of error in implementing its business strategy and meeting profit projections.

In establishing a new bank, bank executives explained the challenges in developing a business plan and risk-management framework that addresses how the bank can generate a sufficient profit to provide an adequate return to shareholders. For a de novo bank, the cost and burden of starting from ground zero in establishing their risk-management and internal controls are high. De novo banks make strategic decisions in establishing risk-management processes

[7] Adams and Gramlich, “Where Are All the New Banks?”
[8] Matt Hanauer, Brent Lytle, Chris Summers, and Stephanie Ziadeh. “Community Banks’ Ongoing Role in the U.S. Economy,” Federal Reserve Bank of Kansas City, *Economic Review* 106, no. 2 (June 24, 2021), https://www.kansascityfed.org/research/economic-review/community-banks-ongoing-role-in-the-us-economy/.
[9] Adams and Gramlich, “Where Are All the New Banks?”

and controls that may delay the launch of revenue-generating products and services. Further, a de novo bank faces the pressure to grow quickly, which in turn, may lead to riskier lending and other activities. Indeed, experience has shown that pronounced problems often surface in the early years of a de novo bank's operations, which explains the elevated capital and supervisory expectations for these banks. The Federal Reserve and the other banking agencies generally expect a de novo bank to maintain a Tier 1 leverage ratio of at least 8 percent for the first three years of its existence and they examine the bank on a more frequent schedule.[10]

For a de novo bank, there is a heightened need to hire experienced staff who are quickly able to establish the bank and show progress in meeting the operating goals and profit projections in the business plan. As we all know, difficulty in finding skilled workers is an issue more broadly in the economy, but community bankers frequently tell me of their ongoing challenges in attracting and retaining experienced staff. These challenges are even more acute for de novo banks who require staff with experience in regulatory compliance and internal controls.

A Kansas City Reserve Banks study echoes these anecdotes, which indicate that the volume and complexity of regulations require specialized expertise that can be costly and difficult to find.[11]

The competitive landscape for financial services and products is also a key consideration in developing and executing a de novo bank's business plan. I often hear the perspective from bankers that non-regulated financial entities have a competitive advantage over regulated

[10] See Supervision and Regulation (SR) letter 20-16, "Supervision of De Novo State Member Banks," at https://www.federalreserve.gov/supervisionreg/srletters/SR2016.htm. This guidance on the supervision of de novo banks aimed to promote transparency and timeliness in the supervision of these banks. Further, SR-20-16 aligned the Federal Reserve's definition of a de novo bank with that of the other agencies. All agencies now consider a bank to be in the de novo phase if it has been operating for three years or less.

[11] Hanauer, Lytle, Summers, and Ziadeh. "Community Banks' Ongoing Role in the U.S. Economy."

financial institutions in providing financial services and products. It would be helpful to appropriately acknowledge this competitive disadvantage for banks and tailor the regulatory framework based on the risks and complexity of their activities.

As a result, the economic, regulatory, and market realities discourage the formation of de novo banks, as investors have many other options for entry into the financial services market. For example, they may choose to acquire an existing bank charter and subsequently establish branches in new markets. Further, they can acquire a branch office from an existing bank. And finally, they may choose to establish or acquire a nonbank financial firm that is subject to less regulation than a chartered and insured financial institution.

**What Can Be Done to Encourage More De Novo Banks?**

So, let's address the second question: what can be done to encourage more de novo banks?

Simply the fact that I am speaking about this topic today should give you the sense that I am concerned about the impact of the declining number of community banks. While the loss of a single community bank may be inconsequential to U.S. financial stability, that loss may have profound consequences to households and businesses in that community. This is particularly true in rural communities and remote areas and in certain urban areas when the loss of the local bank may leave customers in a banking desert, void of tangible, relationship-based financial services.

But we should also be concerned about how a continued decline in the number of community banks, in part due to the lack of de novo formations, will affect the banking and financial services system more broadly. When banking services are limited, it is much more difficult for people to fully participate in the economy, or to manage their finances when times

are tough. A shrinking community bank sector may lead to a weaker banking system and weaker economy.

It is crucial to provide a balanced, transparent, and effective regulatory framework that promotes a vibrant community bank sector. Public policymakers need to ensure that the regulatory and supervisory framework promotes safety and soundness, while recognizing the reduced risk of these banks' noncomplex services and activities. As large institutions and nonregulated financial companies expand their reach into markets traditionally served by community banks, policymakers need to ensure that the regulatory and supervisory framework does not exacerbate this competitive disadvantage.

If we are not able to achieve an appropriate balance, I am concerned that there will continue to be fewer de novo banks as well as a decline in the overall population of community banks. These banks are a key segment of the industry in that they provide financial services and products to a wide range of consumers and businesses. Looking to the future, policymakers need to appropriately refine the regulatory and supervisory framework to minimize unnecessary compliance costs for smaller banks and address impediments to bank formations.

**Closing**

In conclusion, I have raised two important questions about why there so few de novo banks and what can be done to encourage new bank formations. It is important for us to fully understand why we have seen the steady decline in bank formations, and to continue to explore ways to encourage community banks in such a competitive environment. Identifying answers to these questions should enable the federal banking agencies to identify potential regulatory and policy constraints on the formation of new banks. To further this effort, I have asked Federal Reserve staff to continue to study trends in community banking so that we can fully understand

the economic and regulatory factors that constrain the ability of community banks to form, compete, and thrive.

I appreciate the opportunity to raise these questions with you. And I look forward to further discussions about tailoring our regulatory and supervisory framework to ensure that community banks remain an essential part of the future of the U.S. financial system.