

Study: Bay State Ripe for Startup Banks

By Jennifer Jope

Reporter

New England, and particularly the Boston area, will be next to experience the de novo bank explosion, according to a recent study by FinPro, an investment banking and management consulting firm specializing in advisory services to the financial institutions industry.

A phenomenon that has occurred with regularity in Florida, Georgia and California in recent times, new startup banks may soon begin to appear more frequently in the Northeast. De novo banks tend to form in areas with high business growth, wealthy residents and bank consolidation activity, according to Don Musso, president of New Jersey-based FinPro.

The study compares the de novo banks started in 1999 through 2004. Since New Year's Day in 1999, 846 de novo institutions that remain active today were formed throughout the country. Approximately one out of 11 banks is currently a de novo bank formed in the last five years.

Musso said New England, which has experienced consolidation in the last two years, could see a de novo explosion of up to 30 new banks in the next few years. Pat Rohan, managing director for FinPro's Boston office, said he monitored similar growth in the South after a wave of consolidation.

In Massachusetts, some suburbs around Boston are prime markets for de novo banks, Musso said.

"Boston proper is where we will see the first explosion," Musso said.

When bank consolidation occurs, small businesses tend to be heavily affected. Nick Ketcha, managing director at FinPro, said people running small businesses tend to be entrepreneurs and want to deal with a decision maker, like a small bank executive. The study found that there is an 87 percent correlation between the number of businesses and the number of de novo bank openings by region in 2003. In New England, approximately 701,000 businesses existed, the lowest amount compared with other regions of the country. The area had 19 total de novo banks, the lowest ranking in the country.

The Midwest ranked highest with almost 3 million businesses in 2003 and 210 de novo banks.

Ketcha said many de novo banks that open are "niche players" that will specialize in small-business lending.

History shows that de novo banks in Massachusetts form in areas where there have been multiple mergers and where demand exists for certain products. De novo banks that have emerged within the past few years in the Bay State include Leader Bank in Arlington; Horizon Bank & Trust Co. in Braintree, which was recently acquired by South Shore Savings Bank; and Commonwealth National Bank in Worcester.

“There was a real demand for small-business lending,” Daniel J. Forte, president of the Massachusetts Bankers Association, said of those startups.

The study found that household growth and de novo bank openings also are connected. There is an 89 percent correlation between household growth by region and the number of de novo bank openings by region. Musso said banks are formed in areas where there are enough people to support it.

These banks also look for wealthy counties. According to the study, there is a strong correlation between de novo bank openings and average household income.

“People with wealth tend to be investors in these organizations,” Musso said. Wealthy markets also tend to attract a lot of business growth, Musso said. In addition to compiling data, FinPro also asked why some de novo banks are more successful than others. Musso said he thought there would be one specific business model that proved successful, but he found otherwise.

“There is no correlation between the business model you select and the success of a de novo,” Musso said.

FinPro came to the conclusion that the marketplace, management team and board of directors were the determining factors of a successful bank.

“There has to be a correlation between those,” Ketcha said. “The management has to know the market.”

A startup bank also needs to focus on its demographics and have a board and management team that can “work” the market.

“The board is integral in referring loans, referring deposits,” Ketcha said.

Right Environment

Sushil Tuli, president of a de novo institution, Leader Bank in Arlington, agrees that the board of directors is a crucial ingredient to the success of a de novo bank.

“The role of board of directors has changed so much,” Tuli said.

Banks used to bring in local people to serve on the board, which played a lesser role. Today, Tuli said, a bank’s board of directors plays a larger role and requires more professionals.

Leader Bank’s board of directors includes a professor from Harvard Business School, a graduate of the Massachusetts Institute of Technology Sloan School of Management, a local businessman, as well as two attorneys.

Tuli said Leader Bank is proof that finding the right location is also essential. He said placing a branch in an area with high foot traffic is important for business. Leader Bank’s Arlington Center branch is growing faster than the bank’s other branch, located in a slightly more residential area.

Tuli encourages more de novo bank openings, saying customers feel they “get lost in the shuffle in big banks.”

“There is an opportunity for community banks,” Tuli said. “The environment is right to open a bank.”

Rohan said there is an interest in forming de novo banks in Massachusetts and FinPro is currently working with two clients interested in opening banks in the state. While there are a fair number of de novos that choose the subchapter S election in other areas of the country, Musso said it is unlikely to happen in Massachusetts because it often involves too many shareholders.

According to the Internal Revenue Service, an S corporation can avoid double taxation – once to the shareholders and again to the corporation. The corporation is exempt from federal income tax other than tax on certain capital gains and passive income. On their tax returns, the S corporation's shareholders include their share of the corporation's separately stated items of income, deduction, loss and credit and their share of non-separately stated income or loss.

In order to get a Massachusetts charter, a bank must have \$8 million in capital. Musso said New England states tend to require more capital than other areas of the country.

Forte said he doesn't expect de novo growth to be as quick as other parts of the country because Massachusetts had a loss of population last year – the only state in the nation to experience such a decline – and bank consolidation has been slower.

“We won't see the pace of de novo banks, here in Massachusetts, developed as quickly as other parts of the country,” Forte said.

Forte also cites the \$8 million startup capital requirement as a reason for slower de novo growth.

“We've had pretty strict capital requirements in Massachusetts,” Forte said.

Forte said some states have a two- or three-step process where a bank might not need to start with as much capital, but will be required to grow over time.

But Forte said he is curious to see how the de novo landscape turns out.

“It will be fascinating to watch the developments.”

Ultimately, Forte said, the market will determine if there is a need for de novo banks, especially if there is a niche to be filled and a bank finds the right spot to do business.