

M A G A Z I N E A R C H I V E S

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Secrets of De Novo Success

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Ever thought you'd like to start a bank? Lots of people have, and they say while the experience can be very rewarding, it requires time, money and a lot of smart planning.

A few years ago, Frank Sorrentino, a real estate developer in northern New Jersey, was having a hard time finding the kind of customer service he was used to. His local community bank had been acquired by a larger institution—then bought again by an even bigger organization. Gone was the local touch and feel of a bank where he once knew everyone. Gone also was the local decision-making ability he valued, which meant large loans applications were shipped out of state for approval.

But instead of getting mad, Sorrentino got even—he formed his own financial institution. Sorrentino recruited an organizing group, raised capital, and received a state charter in just five months—an unusually short time period for a de novo. North Jersey Community Bank, based in Englewood Cliffs, New Jersey, opened its doors in February 2005 and Sorrentino hasn't looked back.

By the end of last year, the bank had amassed \$180 million in assets and become profitable; in early 2007 it opened its fourth location. Although Sorrentino's experience makes starting a new bank look easy, he warns otherwise. It's one thing to open a de novo, Sorrentino cautions, and quite another to build one that will ramp up quickly and provide a high likelihood of decent returns for shareholders.

"If you are not hitting on all cylinders, you are not going to be successful," Sorrentino says. "It's a process. There are a lot of moving parts."

While few de novo banks fail, many do not achieve the kind of success that North Jersey Community has enjoyed. As a group, start-ups aren't a sure thing. Banks created in 1998 had a return on average equity of 9.05% in 2005, according to FinPro Inc., a consulting firm in Liberty Corner, New Jersey. By comparison, the top 100 bank holding companies' banks had a minimum ROAE of more than 20% that year.

And yet many people still see the formation of a new bank as one of the industry's great growth opportunities. Some 190 new banks were approved for deposit insurance last year by the Federal Deposit Insurance Corp., up from 179 in 2005—and the most since 2000. Plenty of forces are behind the surge. Big bank mergers have left behind many disgruntled customers, particularly small business owners like Frank Sorrentino. Mergers also leave behind ex-bank presidents, many of whom are smitten by the dream of becoming an entrepreneur. Even some larger banks have taken it upon themselves to form their own de novos, providing start-up capital and recruiting local investors and talent.

Changing demographics are also playing a part in the spike of activity. Just like in past immigration waves in American history, banks are being formed to cater to immigrant needs. Mexican, Asian, Indian, and Eastern-European banks are forming fast, says Donald Musso, president and chief executive officer of FinPro. Musso likens the trend to that of the 1920s, when German, Polish, and Italian banks sought to meet the needs of their markets.

Bank executives and consultants who have successfully played the de novo game stress over and over that organizing groups must be intimately involved in the start-up process and that the best guarantee of success is to have a solid business plan in a market with excellent growth opportunities. Starting a new bank is also an intensely detailed undertaking in which a number of key decisions must be made and important issues addressed. What follows is a comprehensive outline for starting a new community bank.

CHOOSING ADVISERS

Advisers play a key role in getting a new institution up and running. "The important thing is to find advisers that have recent experience in chartering de novos," says Chet Fenimore, a partner in the financial institutions group at the Austin, Texas-based law firm of Jenkins & Gilchrist. "That experience translates into saving time and money and avoiding the missteps that will ultimately slow you down." Fenimore also notes that a good lawyer will prepare bylaws and corporate documents, in addition to offering counseling and consulting. "You can't separate the business decision from the legal decision," he says.

Given that obtaining a charter can take as long as a year for approval, advisers can help organizing groups speed up the process. They can also provide advice on what the hot topics are these days for regulators, such as the Bank Secrecy Act and technology. "When you file for a de novo, time is money," Musso says. "You need to go through your approvals quickly. If we can get it done in six months, we save a ton of time and money."

Earlier this year, Tom Hassey, a former radio station owner, was in the process of organizing three banks in California, Texas,

and Arizona that will operate under one holding company and use the name "Interstate Commerce Bank." Given the relatively high degree of regulation, he has found his adviser—Dallas-based BankMark—essential to the process. "Advisers are the ones that can put the whole deal together," Hassey says. "If you don't know how to form a bank, advisers know the steps and have the people in place."

THE BUSINESS PLAN

The business plan is a critical step in a de novo bank's applications for a charter and deposit insurance. Regulators want to see a three-year plan, with a projected asset size for the end of that period and the required capital to support it.

"We allow the market to dictate if there's a need for another bank," says Lawrence Beard, deputy comptroller for licensing at the Office of the Comptroller of the Currency, which regulates national banks. "We just need to make sure they have at least thought about it as they look to compete head-on with other banks in that market and to address how they are going to offer products," he says.

Musso says he frequently sees fledgling institutions coming to FinPro for help about 15 months after they have opened for business. The problem: the bank is failing to grow at the right pace and is far from achieving profitability. The culprit: lack of differentiation from the rest of the market, says Musso. "All too often they [take] a cookie cutter [approach]," he explains. "[They focus on] a combination of commercial real estate, residential one to four, and construction lending. They say they're going to be retail funded but don't say how they are going to do it. There is no target [customer] group. They don't say how they are going to differentiate themselves from the [competition]."

"If you were to pick up that plan from 20 others," Musso concludes, "there is nothing to distinguish it." To differentiate itself in the marketplace, North Jersey Community focuses on business customers. But it also has spent the money on making sure its customers are well taken care of. It uses Metavante, a Milwaukee-based data processor, for its technology platform to make sure it can offer the same bells and whistles as the big banks. But differentiation also means attention to detail. That means calling customers by their name when they walk into the branch. And to Sorrentino, it means going out of one's way to provide superior customer service. Recently Sorrentino met with a new customer for dinner, and the customer said he needed to write checks the next day. Sorrentino immediately called one of his branch managers, who met them at the restaurant with a starter kit. "We said, 'Here you go, you're all set, tomorrow you can write checks,'" Sorrentino recalls.

Banks should also have an idea how much brick and mortar they want to create. Commonwealth National Bank, a \$281 million institution in Worcester, Massachusetts, opened its doors five years ago. The bank-reinvested income into branch expansion, opening three branches in its first 13 months, and now has seven locations. "It sent a message to the marketplace that it must be doing something right," says Charles Valade, the bank's president and chief executive officer. "We were able to turn a profit in 22 months, which is actually pretty quick and faster than what the regulators tend to be happy with. A lot of it had to do with our ability to generate loans, and that goes back to the way we treat our customers and the fact that the word spread."

Others have taken a slower approach. Virginia National Bank, headquartered in Charlottesville, Virginia, is nine years old and has seven locations with \$303 million in assets. "We chose to go very limited brick and mortar and to try to have larger offices that served the larger area and left more capacity for technology," says Mark Giles, president and chief executive officer. Either way, Giles notes that it's important to have a strategy in place. "I would have hated to have visited that conversation every couple of months," he adds.

Start-up banks also need to have a solid strategy to garner core deposits, says Jay Brew, chief executive officer of BNK Advisory Group, a consulting firm in Bethlehem, Pennsylvania. Brew is a strong proponent of branch banking because it brings in deposits. "[Deposits] have to be the cornerstone of any strategic plan," Brew says. "It's cheap funding and tends to be sticky." But all too often, start-up banks miss this key point, spending most of their energy chasing loans and worrying about funding later. "That's the name of the game that most de novos fail to see," Brew says. "You have to develop deposits. It's not just about writing loans. Deposits are a value driver in community banking. De novos must do this."

To be sure, all the components of a business plan ultimately affect profitability. North Jersey Community Bank faced the challenge of attracting customers over a large footprint in Bergen County. So it embarked on an ambitious branching strategy. It also spent money to get the word out to build the brand. "These were all questions we had at the start," Sorrentino says. "The answer to all of them was 'Yes,' but all of them impacted profitability."

RAISING CAPITAL

Organizing groups also need members with the kind of connections that will bring in the necessary capital that a fledgling bank will need to survive (see accompanying story on bank board selection, p. 39). They should be professionals with solid backgrounds and separate circles of contact in order to maximize fund-raising capabilities. Most groups vary in size, typically anywhere from seven to 20 or more. BankMark counsels its clients to aim for a group of 19-21 people, with individuals capable of contributing \$30,000 to \$45,000 for start-up fees and \$75,000 to \$125,000 total when all is said and done. In some de novos, individual members of the organizing group have ended up contributing even more money to the venture.

Nevertheless, raising capital is the hardest part of starting a bank, executives and consultants say. There are two phases. One is the pre-charter phase, where organizers must raise enough among the founders to pay the expenses of getting a business plan written and preparing the charter application. Once they've been approved for a charter, the bank can sell stock

to raise enough capital to last three years, a requirement by regulators. "You need strong horses in the race to raise the money," says Tim Telman, president and CEO at \$23 million Bank of Cape Cod, which opened last year in Hyannis, Massachusetts. "If you don't raise the money, you will not open."

"Capital raising reflects on the board and management," adds Lee Bradley, managing director at the Atlanta office of Samco Capital Market Inc., a Dallas-based investment bank. "If you have a strong organization and management—and good contacts—that is the meat of your capital raising."

Bradley points out that organizers don't have a performance track record when it comes to banking. Instead, investors are betting on the reputation of the directors and management. He advises each board member of an organizing group to come up with 100 prospect names to call on. Bradley also urges clients to host breakfasts, lunches, dinners, and other events to get out in front of the community, which often is more effective than trying to make a pitch over the telephone.

Organizers need to assemble a diverse group in order to cast as wide a net as possible. Founders will play a big role because they put up the initial seed money. But they will also prove critical in helping the bank sell stock to a wider audience. "You try to pick several disciplines that you see in the area for business," Telman says. "Then you pick prominent people out of those areas and hopefully you can convince them that there is a need for what you're doing in the area." Focusing on local investors will preserve a desire to serve the community. Bank of Cape Cod's investors included town selectmen, town counselors, real estate professionals, former bankers, and other local entrepreneurs. Industries represented included trucking, technology, tourism, advertising, and medicine. All told, 27 of the 29 founders were local residents or business owners.

Once a bank receives its charter, it can then sell stock to the public. Advisers also advocate keeping the investor base local, because the investors will end up being the bank's first customers. "The key with the shareholders is you want to sell as much stock locally as you can, because if all the local businesses on Main Street become stockholders, they are going to become customers," Telman says.

Another issue is determining the size of the investor base. Keeping the number of investors below 500 will allow a bank to avoid having to file proxy statements, 10-Qs, and 10-Ks with the Securities and Exchange Commission. Bank of Cape Cod has just over 300 shareholders, helping it avoid the added expense for now. But other startups have gone well over 500, with the goal of gaining the loyalty of as many prominent people in the community as possible. Virginia National Bank went well over the limit, but not for a lack of ability to raise money with a smaller group. "We were confident we could raise the money, but long term, wanted people to feel like this is their bank and that they own this bank," says Giles. "If your goal really is to be local and independent for the long term, the more owners who really love that bank and champion it around town, the better." This not only brings more referrals at the start, a larger base creates a barrier to entry to another group that comes along to start a bank. Adds Giles: "More people can say, 'I've already invested in a bank.'"

How much capital a bank should raise depends in part on its business strategy. Commonwealth National raised \$14 million in 2001 for its opening, about twice what regulators were looking for. That's because the bank wanted to pursue an aggressive growth strategy, starting out with five lenders with an average of 30 years' experience each. It also wanted to start with a complete management team: an operations person, retail person, a chief financial officer, and credit officer.

Although it may seem counterintuitive, de novo organizers also need to watch out for raising too much capital. Roughly speaking, experts say that a bank should reach in three years an asset level 10 times the size of its initial capital. So a bank raising \$10 million should be at \$100 million in three years. Banks need to realistically assess what they can achieve in that period. If a bank raises \$40 million, it looks impressive, but then it must deploy it—a tough task—says FinPro's Musso. Instead, a bank could give investors a better return by raising \$10 million at \$10 a share—a standard stock price used with de novo offerings—than raising subsequent rounds at a higher stock price.

Virginia National Bank faced the possibility of having too much capital at the start, with requests to invest \$34 million during a 21-day offering period. So it went to work whittling down the number. It went back to its investors and told them it would only accept \$18.7 million. The offering was still heavily oversubscribed and brought in \$24 million, so the organizers eliminated out-of-town investors and used a sliding scale to return some money to investors in order to get to \$18.7 million.

Organizers also have to be up front with their investors on expectations. Organizers of Virginia Business Bank, which formed last year in Richmond, told investors they were making a minimum of a seven-year investment. "We told our early investors that they needed to be patient," says Merlin Henkel, chief executive of the \$23 million bank. Once it reached the seven-year point, the bank could pay dividends, create a more liquid stock, and build on its position—or look for a buyer to pay a premium in a takeover.

REGULATORY CONSIDERATIONS

Organizers must make time to gather all the necessary information for the applications to the FDIC and the state or national agency they select as a regulator. Applicants need to have a chief executive officer, a potential list of directors, and a site chosen for the bank.

In short, regulators want to see that a bank has the ingredients to get moving, says Beard of the OCC. "We are not looking for anything unusual," he says. "Just solid basics: a sound business plan that has a reasonable chance of success."

Often the strategy of an organizing group will help determine what type of charter it wants to pursue. Choosing either a

national bank charter with the OCC or a federal thrift charter with the Office of Thrift Supervision affords the bank the opportunity to use the same interagency application it already completed when applying to the FDIC for deposit insurance. Groups interested in branching across state lines will also benefit from federal preemption by choosing either a national bank charter or a federal thrift charter. States sometimes have lower legal lending limits as well as their own specific applications, although the application process at some states may be simpler. "There is no right or wrong when choosing a regulatory authority," says Dan Hudson, president and CEO of Bankmark, a Dallas-based consulting firm. "Your business plan will play a large role in the decision—in some cases, it may dictate what type of charter you choose."

For instance, Virginia National Bank chose a national bank charter to streamline its reporting. While the bank works only in one state, Giles likes dealing with the OCC, citing its convenience and continuity in its examining ranks. "The biggest reason was to have a single regulator," he says. "If you are a state bank, you have both the FDIC and the state. We like the cleanliness of just dealing with the OCC."

For North Jersey Community Bank, Sorrentino's group went with state regulators since they had no desire to branch out of state and preferred the New Jersey Department of Banking and Insurance's familiarity with the market. "The charter should be based on what your need is and what your plan is," Musso says.

Bankers and consultants also stress the need to have open lines of communication with agencies and the use of regulators as a guidepost. "Having a good relationship with regulators is extremely important," Sorrentino says, who attributes the fact that the bank's charter application was approved in five months to the good relationships he and his group fostered with the regulators.

TECHNOLOGY CHOICES

Another key decision to make in the early stages relates to the bank's data service provider. "That is the guts of the operation," Musso says. "If you get that right, you are heavily automated from day one, which means you can be lean on people. That is a huge decision. It deserves a lot of time and attention."

It's also important because regulators have little else to go on in. Since there is no loan portfolio to review, regulators will want to know what the technology platform looks like. From the get-go, cautions Fenimore, "it's important for them to know you got it right."

Most start-up banks go with outside data processors that work with community banks, such as Metavante, Brookfield-Wisconsin-based Fiserv, and Monett-Missouri-based Jack Henry & Associates. These types of providers provide one-stop solutions that are competitive with services of larger banks. Commonwealth National, for example, went with Fiserv for its strength on the commercial side, Valade says. "As a commercial bank, we had to have product offerings that were very competitive." These national providers can update and offer new products often because costs are spread out over a large number of clients.

Some banks choose to go it alone and have processing done in-house. Often this is not an option for de novos, since it means an initial investment of \$1 million or more, consultants say. But with \$18.7 million in start-up capital, Virginia National went with a system from Open Solutions Inc., a vendor based in Glastonbury, Connecticut. "If you are a tiny bank on a very big bureau, you're going to be the tail of the dog," Giles says. "My feeling was that if we were really going to provide service excellence with the ability to do things with some flexibility, we had to be able to do our own processing." Giles also noted that he didn't want the bank to be faced with the prospect years down the road of having to do a data processing conversion from a bureau to its own system, especially if the bank was in a period of high growth.

DEFINING A DE NOVO'S SUCCESS

Ultimately, all of a start-up group's work will be judged by the market in terms of return on average equity and return on average assets. Recruiting a board, raising capital, hiring management, executing a sound business plan, working with regulators, and choosing a good technology platform will all play their part in a de novo bank's performance. "What is going to define our success are the metrics that are used to gauge all banks," Sorrentino says.

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