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The Consequences of Fewer Banks in the U.S. Banking System

Remarks by

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at

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It is a pleasure to join you here today to discuss financial regulation. I thought this conference would be a good opportunity to share how I think about the evolution of the financial services landscape, in particular my views on de novo bank formation, or really the lack thereof. As a part of this discussion, I'll identify reasons why policymakers should take a careful look at the lack of de novo activity over the past decade, and the potential impacts on local and regional economies and the broader financial sector should this trend continue, before discussing the potential policy response.[1]

De novo bank formation has essentially stagnated for the past decade during a time when financial services have rapidly evolved. Banks continue to face increasing competition from credit unions and nonbank lenders, and significant consolidation over this time has resulted in a decline in the number of bank charters in the U.S. Many banks have focused more of their activities and services on technology and innovation, with a corresponding increase in risk, including cybersecurity and operational risk. These trends will likely have significant consequences. Some of these are predictable, like limiting the availability of banking services to underserved communities. Others are indirect, like encouraging acquisitions through charter strip applications and pushing activities outside of the federal and state bank supervisory and regulatory perimeter. These trends may signal dysfunction in the de novo formation process that needs to be addressed by policymakers, and highlight the need for consideration of de novo formation as we review the U.S. regulatory and supervisory framework.

Before turning to the main theme of my remarks, I would like to start by addressing the recent bank failures and subsequent stress in the U.S. banking system. Over the past several weeks some financial institutions have faced significant stress. We are still engaged in the

[1] The views expressed here are my own and are not necessarily those of my colleagues on the Board of Governors of the Federal Reserve System.

process of learning more about the failure of Silicon Valley Bank, including reviewing the regulatory framework that applied to the firm, the supervisory oversight by the Federal Reserve Board, the Federal Reserve Bank of San Francisco and California state regulators, and the role of the bank's management. The Board's Vice Chair for Supervision is also conducting an internal review of the Federal Reserve's oversight leading up to the failure of Silicon Valley Bank and will issue a report by May 1 that provides his conclusions. Of course, there are also a number of external reviews underway, which should contribute to a robust discussion about the root causes of the two bank failures.

I believe that the U.S. financial system and the U.S. banking system remain safe, sound, strong and resilient, and standing on a solid regulatory foundation. The review of the failure of Silicon Valley Bank—both the Vice Chair's review and the independent, third-party reviews—should provide useful insight into the lessons to be learned and help guide discussions among policymakers about the gaps in current bank supervision and regulation and the potential for effective improvements to both. We should not rush to judgment with respect to these ongoing reviews. We need a full, accurate, and thorough examination and diagnosis before we reach conclusions about solutions, to ensure that the prescribed remedy addresses the underlying symptoms. If we identify shortcomings in supervision and regulation, we should and will address those shortcomings. While this episode has demonstrated that some changes may be warranted, I do not believe the failure of these two institutions is an indictment of the broader regulatory landscape. The universe of financial institutions in the U.S. includes a wide variety of banks, with very different business models, risk profiles, funding structures, and asset sizes.

I'll now turn to the main theme of my speech, and to de novo bank formation.

Do We Need More Banks?

Should we be concerned about the decline in the number of banks in the U.S. banking system? In my view, we should.

Many factors have contributed to this decline in the number of banks. But a robust and diverse banking system ensures the wider access to and availability of credit, and that this credit reaches all levels of the income spectrum and supports a range of large and small businesses.

As we have seen over time, the smallest banks often outperform larger banks during periods of stress like the pandemic and during the 2008 financial crisis. Given the continued decline in the number of banks, preserving and enhancing the number of banks should be a regulatory and legislative imperative, including by encouraging new bank formation. Historically, during times of economic and financial stress, the smallest institutions have performed extremely well. For example, small banks demonstrated this strength during the pandemic through their outsized commitment to supporting small businesses through the Paycheck Protection Program.

From 2002 to 2022, the number of FDIC-insured banks declined by nearly half.[2] This reduction in the number of chartered financial institutions seems to have largely been driven by the consolidation and merger of existing financial institutions.[3] While there has been a slight uptick in de novo formation over the past few years, compared to the years immediately following the 2008 financial crisis,[4] de novo activity has been significantly outpaced by consolidation.

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[2] In 2002, there were 9,354 FDIC-insured banks. By year-end 2022, that number had dropped to 4,706. "FDIC Statistics at a Glance–Historical Trends as of December 31, 2022," Federal Deposit Insurance Corporation, https://www.fdic.gov/analysis/quarterly-banking-profile/statistics-at-a-glance/2022dec/fdic.pdf.

[3] Federal Deposit Insurance Corporation, "FDIC Statistics."

[4] Federal Deposit Insurance Corporation, "FDIC Statistics."

In my view, there are several features of the current U.S. banking system that suggest there is an unmet demand for de novo bank charters. I will briefly note three in particular: (1) the ongoing demand for “charter strip” acquisitions; (2) the shift of traditional banking activities out of the banking sector into non-bank financial entities, or the “shadow banking” sector; and (3) the rising demand for banking-as-a-service partnerships.

Charter Strip Acquisitions

A charter strip acquisition occurs when a purchaser wants to open a bank with a new business model, but instead of applying for a de novo bank charter, the purchaser simply acquires an existing bank. Once the acquirer is approved to take over the charter, the bank effectively starts over with a new business model, new banking products, and new management. The replacement business model often emphasizes novel technologies and rapid growth, and if the existing, legacy banking business of the target is retained, it is often operated separately from the new business.

What is the appeal of a charter strip? Simply put, it is often easier than chartering a new bank by side-stepping the de novo formation process. When evaluating a bank acquisition, regulators often rely on the legacy bank’s management performance and the existing supervisory and compliance record. The purchase of an existing charter can also bring efficiencies in terms of avoiding the restrictions that apply to de novo banks, which include higher capital requirements and business model limitations for the first several years of the new bank’s operation. Another benefit to a bank purchase over de novo, is that operating banks have existing core systems and other third-party relationships that can speed up the time to market for a new bank model. Therefore, a charter strip of a healthy target bank often results in a faster and cheaper approval than a de novo application.

While charter strips may provide exit opportunities for the bank's previous management and ownership, these transactions can have an adverse effect on local banking markets. The target institutions for charter strips are often the smallest banks. Acquired banks may provide services in small towns or rural communities, areas that may lack robust competition. Even when these legacy bank businesses continue to operate as an add-on to the new charter-strip business model, the institution as a whole tends to become riskier, jeopardizing the long-term viability of the legacy banking business and its ability to continue providing services to the local community.

Perhaps the fact that these transactions occur could signal dysfunction in the process of de novo chartering? A startup with a new business model should be agnostic between a charter strip and de novo and may actually prefer the "clean slate" of a new bank. It would then stand to reason that the applications process would be agnostic between these two transactions; both have the same result—the creation of a bank pursuing a new business model. The ongoing demand for charter strip formations, however, reveals a disparity in treatment between de novo formations and charter strips, a disparity attributable to the difference in expectations and regulatory burden between these two paths.

Of course, I am not suggesting that the solution is to make bank mergers and acquisitions more restrictive—these, too, are part of a healthy banking system. Instead, I would suggest that the regulatory framework should at least be more accommodative toward the de novo process.

The Shift of Traditional Banking Activities to Nonbank Financial Entities

Nonbank financial entities play a significant role in providing credit and other financial services in the U.S. economy. The role of nonbanks has been driven, at least in part, by regulatory preferences that have encouraged a shift in lending activities from the regulated banking system to nonbanks. For example, mortgage origination and servicing—both longstanding, traditional banking activities—shifted into nonbank entities following the 2008 financial crisis, with the volume of one-to-four family mortgages originated by nonbanks surpassing the volume originated by banks starting in 2016.[5] Nonbank lenders also play a significant role in leveraged lending and corporate lending, as well as in commercial real estate lending, agricultural lending, and consumer credit.[6]

The growth of lending in the shadow banking system can have significant consequences for the availability of credit over economic cycles, with losses eventually being transferred to regulated depository institutions, as appears to have occurred after the 2008 financial crisis.[7] While the disfavored activities may be pushed out of the regulated banking system, losses may be transmitted back into the banking system through related activities like the extension of credit by banks to those same nonbank lenders. Regulation can exacerbate and accelerate the shift of activities from insured depository institutions to nonbank financial entities. For example, research has shown that an increase in bank capital requirements for certain types of loans results in those loans simply being reallocated from banks to nonbanks.[8] The impact on bank activity can come about directly, for example, when risk weights are increased for certain asset classes, or indirectly, for example, when banks allocate capital internally across their various business

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[5] Federal Deposit Insurance Corporation, "Trends in Mortgage Origination and Servicing: Nonbanks in the Post-Crisis Period," *FDIC Quarterly* (2019): 51-69, https://www.fdic.gov/analysis/quarterly-banking-profile/fdic-quarterly/2019-vol13-4/fdic-v13n4-3q2019.pdf.

[6] Federal Deposit Insurance Corporation, "Trends in Mortgage Origination."

[7] See Joshua Gallin, "Shadow Banking and the Funding of the Nonfinancial Sector," Finance and Economics Discussion Series 2013-50 (Washington: Board of Governors of the Federal Reserve System, May 16, 2013), https://www.federalreserve.gov/pubs/feds/2013/201350/201350pap.pdf.

[8] See Rustom M. Irani, Raymakal Iyer, Ralf R. Meisenzahl, and José-Luis Peydró, "The Rise of Shadow Banking: Evidence from Capital Regulation," Finance and Economics Discussion Series 2018-039 (Washington: Board of Governors of the Federal Reserve System, April 24, 2018), https://www.federalreserve.gov/econres/feds/files/2018039pap.pdf.

activities. While banks are subject to significant reporting requirements, nonbanks are subject to fewer public reporting requirements, significantly limiting the transparency into the potential impact of these activities on U.S. financial stability.

While there is a broader debate over the appropriate roles for bank and nonbank credit, the tradeoffs are complicated. The rise of nonbank lending has provided two important lessons that can help inform policy around de novo bank formation in the United States.

First, the shift of lending activities outside the regulated banking sector suggests that there is disparate regulation for similar activities. Nonbank financial entities often operate with many fewer constraints, including a lack of capital requirements, activities restrictions, and a lesser degree of supervision and oversight. Nonbanks may also conduct less due diligence and have lower lending standards than banks. These regulatory burdens have real-world implications on where these traditional banking activities occur. The shift of activities to the shadow banking system can produce an unexpected and opaque buildup of risk, risk that can potentially destabilize the regulated banking system and the economy more broadly. For example, nonbanks may be more vulnerable to runs because they lack access to discount window lending.

Second, the rise of nonbank lending also implies that investors have weighed in on the business case for de novo bank formation. Regulatory burdens affect de novo formation and have contributed to the migration of lending from regulated institutions. Nonbank financial entities have a choice about how to operate, whether to seek a bank charter or not, and the regulatory burdens of de novo formation—putting aside the obligations of operating within the regulated banking system—can themselves contribute to this shift in activities.

Banking-as-a-Service

Another phenomenon that we have seen in the banking industry is the continued rise of "banking-as-a-service," in which banks enter into a partnership with a fintech company. In these relationships, the fintech provides customer-facing technology, while the bank provides some combination of ability to accept deposits, access to payments systems, extensions of credit, and issuance of debit and credit cards. These types of relationships can be valuable for community banks; they can help the bank provide new services or access new customers and can give the bank new business growth opportunities. This type of jump-start to innovation can make community banks more competitive with larger peers that may better be able to develop new technology and products in-house.

At the same time, could the rise of banking-as-a-service also be driven—at least in part—by the difficulty of de novo chartering? If a technology company has a new technology interface and product design that may better serve customer needs, it can be substantially faster to partner with an existing bank than to seek a standalone charter. This can raise challenging operational issues about who should "own" the customer relationship, but more importantly, about who is responsible for compliance obligations. From a policy perspective, there should be no net difference in the compliance expectations for banking-as-a-service and de novo banks that engage in the same underlying activity. The policy goals should be consistency in regulatory and supervisory approach.

The Consequences of Limited De Novo Formation

The continued interest in charter strip acquisitions, the shift of activities out of regulated banks into the shadow banking system, and the continued growth in banking-as-a-service partnerships all suggest that there may be some unmet demand for bank charters. As a practical matter, the consolidation of banks coupled with a deficit of new bank formations, if left unaddressed over time, could have several significant consequences.

When there is a decline in bank charters, and a reduction in bank branches, the net result in local banking markets is an increase in banking concentration—the percentage of deposits and loans controlled by a shrinking number of institutions—and a decrease in competition. Our traditional measures of assessing the concentration of markets, and the competitive effect of bank mergers, is to look at deposits as a proxy for the "bundle" of banking services. While one could reasonably question whether deposits are a reliable indicator of the competition for all banking products, I think it is safe to assume that a reduction in the number of in-market banks is often related to a reduction in competition, customer choice, and availability of credit.[9]

Reduced competition can harm local communities and economies. Banks play a significant role in providing banking services, including mortgage loans, small business loans, and core deposit products like savings and checking accounts. For example, within bank lending, community banks play a significant role in providing loans to consumers and small businesses, construction and land development loans, residential lending, agriculture lending, and land financing.

Banks with strong relationships to local communities also support those communities through the economic cycle. Banks located geographically close to businesses, like community banks, played an important role in providing credit during the pandemic, especially through the Paycheck Protection Program.[10] Community banks also tend to have lower loan delinquency

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[9] See Michelle W. Bowman, "The New Landscape for Banking Competition," (remarks at the 2022 Community Banking Research Conference, St. Louis, MO, September 28, 2022), https://www.federalreserve.gov/newsevents/speech/files/bowman20220928a.pdf.

[10] See David Glancy, "Bank Relationships and the Geography of PPP Lending," Finance and Economics Discussion Series 2023-014 (Washington: Board of Governors of the Federal Reserve System, January 19, 2023) https://www.federalreserve.gov/econres/feds/files/2023014pap.pdf.

and charge-off rates relative to larger banks, which may reflect local banks' willingness to work with borrowers during times of stress to restructure loans, in addition to these banks using their knowledge of local communities to improve loan application review and underwriting.[11]

It is likely that a more effective and efficient path to de novo bank formation would help support the U.S. banking system and the broader economy. Putting aside the broad range of legal, regulatory, and supervisory factors that may influence de novo bank formation, one of the key determinants in approval of a de novo application is the business case for forming a new bank in a particular target market. Does the target market have a strong economy and good growth prospects? Is there a lack of competition, for example, where mergers have reduced the number of banks in the market? Does existing competition leverage competitive pricing, or have in-market banks used their dominance to increase the cost of banking services?

Of course, we know that a business case for creating a bank would be incomplete if it focused only on market need and opportunity. The process of organizing a new bank, obtaining a charter, and living within the strict rules applicable to de novo banks is a significant and costly process.

Impediments to De Novo Formation and the Policy Response

Before policymakers can address the predictable and unintended consequences of a lack of de novo formations, it is helpful to consider the barriers to de novo formation. And, of those barriers, can they be addressed in a way that fosters prudent de novo activity?

Regulatory Barriers

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[11] See Federal Deposit Insurance Corporation, "FDIC Community Banking Study," (Washington: Federal Deposit Insurance Corporation, December 2020), https://www.fdic.gov/resources/community-banking/report/2020/2020-cbi-study-full.pdf.

Some of the barriers to entry for de novo banks fall outside the scope of bank regulation. For example, since the 2008 financial crisis, and until relatively recently, we have operated in a very low interest rate environment. Low interest rate environments lead to compression of interest rate spreads for taking deposits and making loans. Compressed margins, and the corresponding limits on bank profitability, present significant headwinds to de novo bank formation and returns for initial bank investors. Similarly, the demand for banking services tends to track broader economic conditions, independent from bank regulatory policy.

However, policymakers should carefully consider elements of the bank regulatory framework that adversely affect de novo formation. To be clear, many of these regulatory barriers are appropriate. Insured depository institutions benefit from the federal safety net of FDIC deposit insurance, and the ability to access liquidity from the Federal Reserve's discount window. These privileges carry with them substantial responsibilities, to comply with the law, to be responsive to regulators, and to conduct the business of banking in a safe and sound manner and in compliance with consumer protection laws. At the same time, barriers to entry into the banking system should not be so strict as to effectively prevent the formation of new banks. We should support regulatory and supervisory policies that encourage prudent and appropriate de novo bank formation.

Organizers of a de novo bank face a number of challenges, and the application process itself can be a significant impediment. The application process for a new bank charter often requires multiple applications to different regulators. For example, the formation of a national bank with a holding company requires the approval of the OCC, FDIC, and Federal Reserve.[12] While each regulator may have aspirational deadlines for processing de novo charter

[12] See 12 U.S.C. § 21-27; 12 U.S.C. § 1815(a)(1); and 12 U.S.C. § 1842(a)(1).

applications, the time actually needed can vary considerably, and is rarely quicker than anticipated. The uncertainties surrounding the application timeline may compound the difficulty of attracting capable board members, management, and employees. Even the demands of raising sufficient capital—a vital step in the de novo process—may pose challenges, as the total amount of capital is based on a forward-looking projection of the bank's expected future size. Investors could reasonably be reluctant to commit capital facing such uncertainty. Even after approval, de novo banks are subject to heightened standards and additional limits for at least three years after commencing operations.[13]

Policymakers have a responsibility to ensure that de novo bank formation continues to be viable, to preserve dynamism and competition in the U.S. banking system. The solution should not be to create roadblocks to bank mergers and acquisitions—which would lead to further migration of bank activities to the shadow banking system. Instead, we need to consider how regulatory burdens affect private behavior and have created impediments that discourage de novo bank formation.

Efficiency in Regulation and Supervision

In the context of de novo banks, efficiency in regulation and supervision can be thought of as an exercise in proportionality. In my mind, this is an extension of the risk-based approaches we use throughout supervision. It is certainly not a "light-touch" approach, but rather seeks to strike an appropriate balance based on the size, activities, business model, and risks of an institution. As with any new business, simply being a de novo can present additional

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[13] See "SR 20-16: Supervision of De Novo State Member Banks," Board of Governors of the Federal Reserve System, https://www.federalreserve.gov/supervisionreg/srletters/SR2016.pdf; Federal Deposit Insurance Corporation, "FDIC Rescinds De Novo Time Period Extension; Releases Supplemental Guidance on Business Planning," news release, April 6, 2016, https://archive.fdic.gov/view/fdic/5121.

risks, which justify heightened requirements and additional supervisory scrutiny as it grows into a viable banking operation.

At the same time, policymakers need to consider whether the tight framework of requirements that govern the operations of de novo banks are necessary and appropriate, and whether alternatives may be more efficient. For example, consider whether requiring an up-front capitalization of a de novo institution in an amount far in excess of standard capital requirements is necessary, or whether in some cases a phased approach that takes into account the early performance of the de novo bank may provide similar risk protection with a lower capital burden.[14, 15]

Regulatory obligations fall most heavily on small banks, including both community banks and de novos. While these burdens may evolve slowly over time for existing community banks—allowing banks time to adjust to heightened supervisory oversight—regulatory requirements can act as an additional barrier to entry for de novo banks.

Transparency in Expectations and Regulatory Support

The lack of de novo banks[16] and the trend toward bank consolidation has been a concern for some time, and I continue to see encouraging new bank formation as a priority. However, it is necessary to note that even if the regulatory message appears to support de novo activity, the regulatory tone in delivering this message matters. Investors and those seeking to organize a

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[14] "SR 20-16: Supervision of De Novo State Member Banks" suggests that de novo banks maintain a tier 1 leverage ratio of at least 8 percent for the first three years of its existence, and that de novo banks should receive at least two consecutive CAMELS composite ratings of "1" or "2" before making capital distributions.

[15] See, e.g., H.R. 758, 118th Congress, which proposes to establish a three-year phase-in period for de novo financial institutions to comply with capital requirements. Congress, "H.R.758 - Promoting Access to Capital in Underbanked Communities Act of 2023," https://www.congress.gov/bill/118th-congress/house-bill/758?s=1&r=30.

[16] See Michelle W. Bowman, "The Lack of New Bank Formations is a Significant Issue for the Banking Industry" (remarks at 2021 Community Bankers Symposium: Banking on the Future, Chicago, IL, October 22, 2021), https://www.federalreserve.gov/newsevents/speech/bowman20211022a.htm.

new bank notice when regulators encourage de novo formation. But almost more important than the words, the tone of that message must also be accompanied by actions that support, not inhibit, de novo bank formation. The banking agencies have made some progress by working to clarify regulatory expectations, giving potential applicants greater insight into the application process and by providing opportunities for feedback earlier in the process.[17] But I think we need to ask if these steps are sufficient, and whether they can be improved.

One model for greater transparency and coordination is the approach adopted by the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) in the United Kingdom. (U.K.)[18] The PRA and FCA both play a role in the review and chartering of depository institutions, and have jointly adopted the New Bank Start-up Unit initiative, which provides transparent, single-stop resources about the life cycle of de novo bank formation, including planning, applying, early-stage operation, and eventually moving into a mature, steady state as a viable banking operation.

In my view, the approach adopted by the New Bank Start-up Unit includes a number of features that could help inform process improvements in the United States. While adopting some would require statutory and regulatory changes, and others to some degree may already be a component of our existing practices, I see value in looking holistically at the lessons we can learn to improve transparency and encourage the formation of new banks.

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[17] "SR 20-16: Supervision of De Novo State Member Banks" sets key expectations for de novo banks during their early years of operation. See Jelena McWilliams, "Statement of FDIC Chairman Jelena McWilliams on the Oversight of Financial Regulators before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate," (December 5, 2019), https://www.fdic.gov/news/speeches/2019/spdec0519.html; "Licensing Manual: Charters," Office of the Comptroller of the Currency, https://www.occ.gov/publications-and-resources/publications/comptrollers-licensing-manual/files/licensing-booklet-charters.html.

[18] "New Bank Start-up Unit," Bank of England, last modified March 21, 2023, https://www.bankofengland.co.uk/prudential-regulation/new-bank-start-up-unit.

First, the New Bank Start-up Unit focuses on the broader timeline of de novo formation, rather than addressing only isolated elements like the filing of an application or the requirements for early-stage operation. The process of creating a de novo bank starts before an application is filed, and is a multiyear process, ideally ending after a brief period of early operations with the de novo transitioning into a mature, viable banking franchise. Organizers evaluate their business needs, and whether those needs are best served through the creation of a bank charter. They develop a business plan and raise capital. They develop the infrastructure to support the bank, both in terms of management and personnel, but also technology, policies, and procedures. Addressing the long life cycle of de novo formation, and committing to engage with proposed organizers, can lead to better de novo applications and ultimately, more de novo banks.

Second, the legal framework for de novo formation in the U.K. involves multiple regulators, but tasks those regulators with distinct, complementary assessment objectives. The PRA focuses on safety and soundness, and promoting competition between firms, while the FCA focuses on protecting consumers, enhancing the integrity of the U.K. financial system, and promoting competition in the interest of consumers. A legal framework that reduces overlapping and redundant evaluations can help facilitate efficiency in the application process and can promote greater consistency.

Third, the New Bank Start-up Unit provides resources clarifying not only the requirements that apply to de novo banks, but also espouses a philosophy that emphasizes proportionality in requirements, and a case-by-case assessment of firms. For the PRA and FCA, proportionality extends to the setting of capital requirements, capital management expectations, and the calibration of capital buffers.

Finally, the resources provided by the New Bank Start-up Unit emphasize the need for de novo institutions to contemplate and prepare for recovery, resolvability, and a solvent wind-down of operations. De novo banks often experience rapid growth, poor initial profitability, and loan quality issues that take time to emerge as the bank's portfolio matures. These factors can make de novo banks riskier than established banking franchises. The solution to potential weaknesses in de novo banks need not focus exclusively on increasing regulatory and supervisory requirements, particularly if there are lower cost alternatives like improved transparency, and better preparation for resolvability and solvent wind-down. While higher expectations and more capital can improve the resiliency of a de novo bank, those same expectations can contribute to a decline in the overall number of de novo charters.

Closing Thoughts

In my view, right-sizing regulatory requirements, improving transparency, and supporting regulatory approaches that support new banks are important tools to promote healthy competition and reduce unintended consequences. We need a viable pipeline for the creation of new banks in the United States, and there are troubling indications that we are falling short on this front, with a continued decline in the number of banks in the United States, the continued interest in charter strip applications, and the ongoing shift of traditional bank activities into shadow banks.

While de novo bank formation may not be a top-of-mind issue for policymakers as we continue to deal with the recent bank failures, it remains an important issue. As policymakers consider the regulatory and supervisory framework in the U.S. banking system and consider specific adjustments to address identified shortcomings, we should also take into account the impact of incremental additional regulatory changes not only on de novo bank formation, but also on credit availability, competition, and the financial system.