De novo banks: A failure of youth?

District's young banks share unique features

By DANIEL ROZYCKI
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Dedicated industry watchers may have noticed something oddly similar about three Twin Cities area banks that failed in the past year. Riverview Community Bank in Otsego, Brickwell Community Bank in Woodbury and Pinehurst Bank in St. Paul were all shuttered before reaching their seventh birthdays. (The average bank in the district has been operating for seven decades.) In fact, it might not be just a quirky coincidence. Last year, the Federal Deposit Insurance Corp. released a letter voicing its concerns that depository institutions less than seven years old were apparently failing with greater frequency than others.

In banking, as in other business sectors, youth can be both a buoy and an anchor. Newly chartered banks—also called *de novo* banks—typically begin life with significant, uninvested capital to put to use in underserved markets and financial niches. But they can struggle to gain the necessary market depth, traction and consumer loyalty to survive tough economic times. As bankers nationwide have learned, operating losses can outlast investor funds, and young banks can be especially vulnerable.

Is this true for Ninth District banks? A *fedgazette* data review found support for the phenomenon and some unique features of the district's de novo banks.

The failure of youth

To begin with, the district has a smaller portion of young banks than the nation as a whole. The exception is in the Twin Cities, the district hatchery for young banks (see Chart 1) and where banks skew younger than the national total. Past *fedgazette* research found that the Twin Cities ranked highly among all metro areas in the country for the number of new banks chartered during the opening years of the decade (see Charts 2 and 3).

As it turns out, those newly minted banks ended up failing more frequently than other, older banks. Almost half of all the banks that failed since the beginning of 2008 through the second quarter of 2010 in the Twin Cities, accounting for 21 percent of failed banks in the Ninth District, were less than seven years old. That compares with 17 percent of failed banks nationwide. But before you panic about the prospects of your local young bank, it pays to know that that there were only six bank failures in the Twin Cities and 14 failures in the district.

What makes young banks more likely to fail? Research generally points to three major issues that take time to resolve as de novo banks establish their business: an inability to generate earnings, excessive risk in lending and volatile funding prior to the buildup of stable deposits.

And, in fact, all of these factors are present among the failed de novo banks in the Ninth District. Other young banks in the district look fairly similar to the mature population in terms of their capital and the rate of noncurrent loans (loans that are past due by 90 days or more) (see Chart 4).

However, they differ in the composition of their loan portfolios; district

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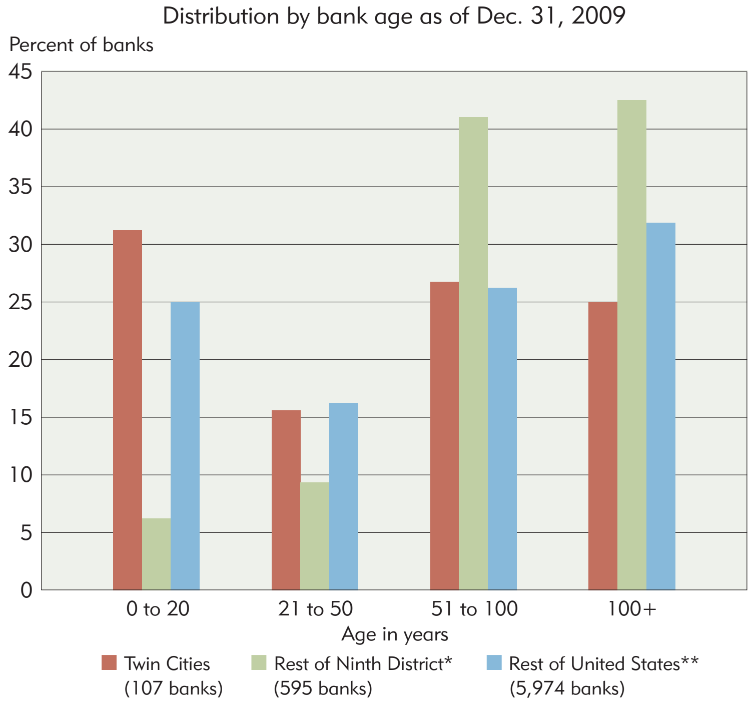
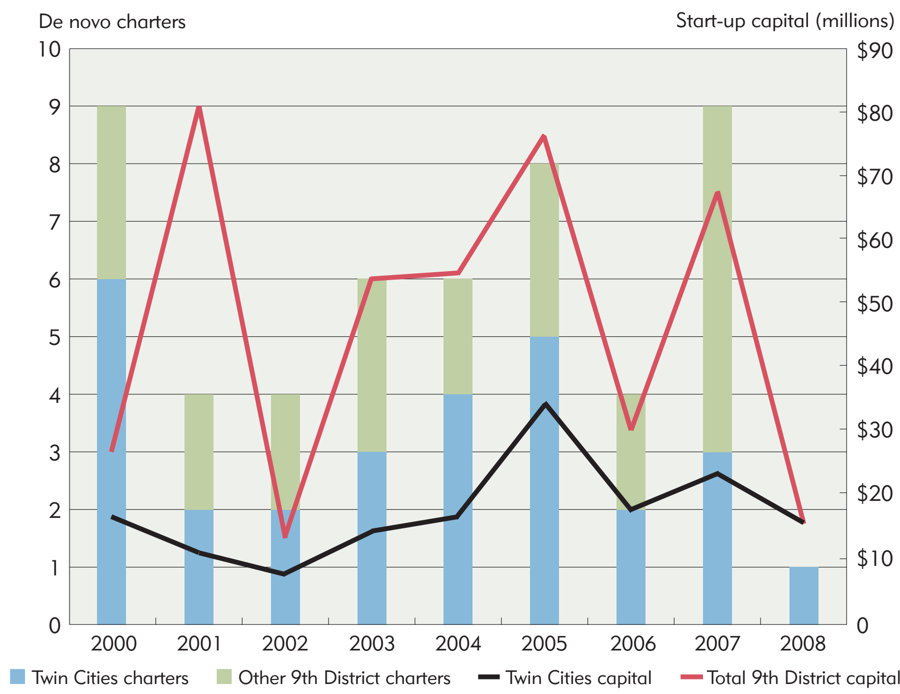
CHART 1 **Bank age skews young in the Twin Cities**
Distribution by bank age as of Dec. 31, 2009



*Excludes Twin Cities
**Excludes Ninth District
Source: Federal Reserve

CHART 2 **Twin Cities area comprises large share of district de novo banks**
New bank charters and investment



Source: Federal Reserve

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Taking root

Organic farming continues to grow in the Ninth District

By ALISON SEXTON
Research Assistant

When you think of organic agriculture, you probably imagine yourself eating leafy greens and other vegetables you buy for a salad. For that reason, you might not think that Ninth District states, which specialize in major commodity crops and livestock, have a large role in organic production.

But, in fact, the Ninth District is a major organic producer, and its organic footprint continues to expand as more farms undergo the certification process that ensures that their practices exclude or strictly limit the use of synthetic fertilizers and pesticides, plant growth regulators, livestock antibiotics, food additives and genetically modified organisms.

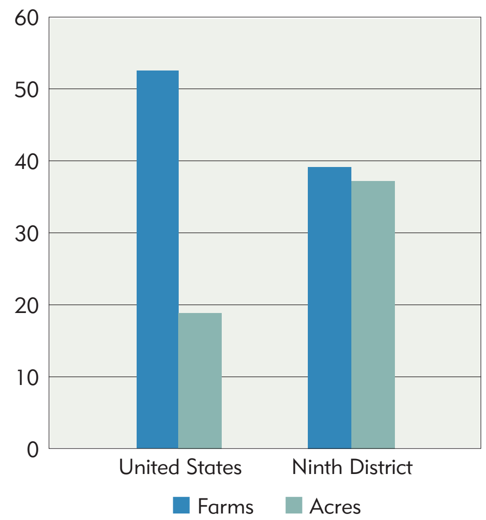
Although it remains a small component of total U.S. agriculture (0.6 percent in 2008), organic farming has been expanding both nationwide and in Ninth District states. For example, the number of organic farms in district states increased by almost 40 percent from 2005 to 2008, slightly lower than the 52 percent growth across the country, according to the most recent data from the U.S. Department of Agriculture (USDA) (see Chart 1).

Wisconsin was the only district state to see higher growth (75 percent, or 436 farms) than the national average (see Chart 2). In fact, Wisconsin ranks in the top five states for the number of farms producing organic dairy, beef, poultry, other livestock, crops, vegetables and melons. Wisconsin's organic farms are diverse in both size and crop, but they are on average smaller than similar farms in other states, which likely contributes to its larger numbers.

Conversely, the rate of acreage certified as organic grew faster in district states during this period—37 percent compared with 19 percent nationwide (see Chart 3). In terms of total organic acreage, all five district states ranked in the top 11 states in 2008. Growth was stronger in pastureland and rangeland (63 percent) than in cropland (28 percent), but all district states rank high in both categories.

CHART 1 **Organic growth**

Percentage change in organic farms and acreage, 2005 to 2008



Source: U.S. Department of Agriculture

Districtwide acreage growth was largely driven by two states. Total organic acreage in South Dakota almost tripled, and roughly doubled in Wisconsin. South Dakota also saw organic pastureland and rangeland increase ninefold, or 100,000 acres, during this three-year period. This growth is perhaps due in part to the addition of about 3,300 organic beef cows (a 500 percent increase) over the same period.

Montana is the district outlier, having negative growth both in the number of certified organic farms and in acres. These data are based on information from USDA-accredited state and private organic certifiers. But certifications by the Montana Department of Agriculture—the state certifier—actually increased by 44 farms (67 percent) between 2005 and 2008.

The Montana department also suggested that the decrease in certified acres may have resulted from a number of farms dropping certified acres never

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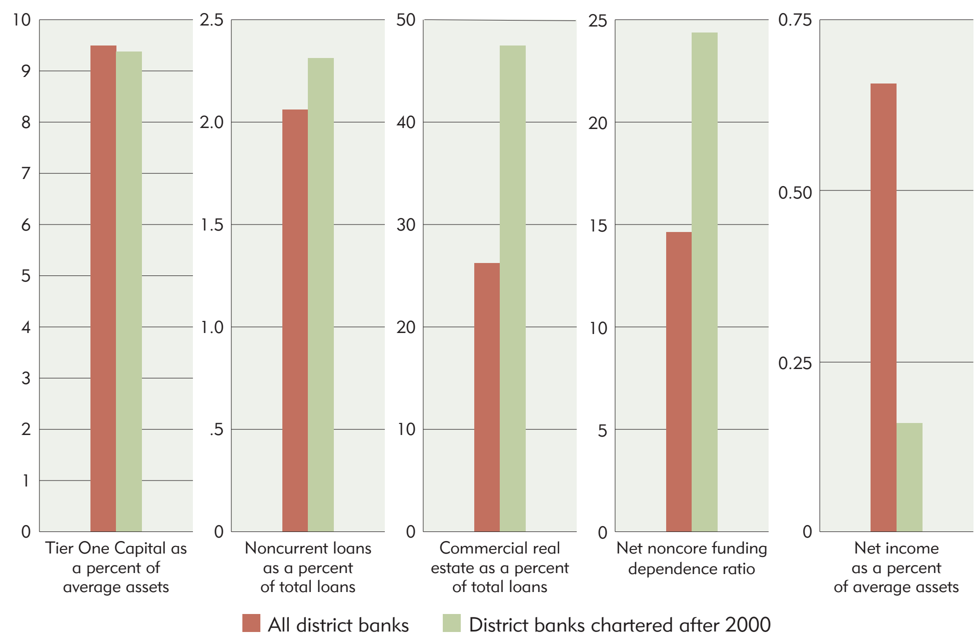
CHART 3 **Twin Cities area ranks high, but falling**

National rank, annual bank charters and new investment*

*There were no new bank charters in the Twin Cities during 2009.
Source: Federal Reserve

CHART 4 **De novo banks have more CRE loans and lower net income**

Financial comparisons of de novo banks and all district banks
Median ratios as of June 30, 2010



Source: Federal Reserve

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concentration in comparatively risky commercial real estate. Moreover, de novo banks rely to a greater extent on more volatile sources of funding (so-called noncore funds like jumbo certificates of deposit and brokered deposits rather than traditional savings). And unlike the mature banks, the average de novo bank earns a very small profit.

As long as capital remains strong and loans continue to perform, young banks can remain stable and healthy. But these basic measures reveal that riskier loans, less reliable funding and lower income continue to challenge de novo banks. f