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De Novo Charters: Reduced FDIC "Special Probation" Period

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After nearly a decade practically devoid of state or federal de novo charter activity nationwide, the FDIC has announced plans to return to its three-year post-approval oversight period for de novos that was in effect prior to the financial crisis. The reduced "special probation" period is down from the seven-year special oversight period which has been imposed by the FDIC since 2009 as a result of the relatively high percentage of troubled de novo institutions and de novo failures.

In an otherwise seemingly endless period of bleak regulatory news, the FDIC announcement is a small ray of sunshine intended to encourage new potential industry entrants. Unfortunately, there may be other forces at work that remain likely to continue to dampen the enthusiasm of potential investors in de novo institutions until these forces subside. Those forces include general ongoing economic factors, increased regulatory compliance expenses, increased funding costs if rates increase, reduced loan demand and significantly depressed margins generally.

Some might argue that the industry suffers from a "chicken and egg" scenario, where the FDIC may believe that the dearth of interest in de novos exists for reasons other than the current regulatory environment, and potential investors believe that the dearth of interest is in no small part a result of significantly heightened regulatory expense and exposure coupled with increased regulatory intervention, making a startup institution a much more risky, and less profitable, investment. Nevertheless, the FDIC initiative is an excellent start in the right direction and seems to reflect a recognition by that agency that things in the banking industry are in fact improving.

Of course, while the reduction of the de novo "special probation" period is good news, a practical matter the level of supervision and regulation already in place, coupled with strengthened enforcement authority, enables agencies to excise a level of ongoing oversight and correction that makes any "special" time period of heightened oversight somewhat irrelevant. This heightened regulatory environment is clearly viewed as a negative when it comes to investor consideration of de novo bank and thrift charters. In addition, the new regulatory risk-based capital requirements as well as the unknowns associated with the new FASB credit loss standards continue to adversely impact investor consideration.

In an interesting but separate twist, the FDIC has been imposing a similar three-year post-approval special oversight period for certain institutions that elect to convert from federal to state charters. This special oversight period is imposed irrespective of the fact that the converting institution may well have been in existence for decades, has been and continues to be insured by the FDIC, and is not in a “troubled” condition (which under Dodd-Frank would make approval of the conversion highly unlikely anyhow or otherwise subject to special regulatory concern. The concern seems to lie primarily with thrift conversions as opposed to conversions of commercial banks. In the context of thrift conversions, the FDIC seems, in essence, to be treating the converting institution much like a de novo irrespective of its length of existence and/or quality of ratings.

The FDIC move is a laudatory first step, and hopefully will serve to encourage private investors to look again to new entrants in the financial services industry as a viable place for capital. It is, however, likely to take much more in the way of economic certainty, regulatory reform and regulation “right sizing” to induce private investors to infuse capital in bank startups in a meaningful way.