

## CASE 15

# OKLAHOMA NATIONAL BANK

"The bank that makes dreams come true."

### INTRO

It's January 1, 2002, and the momentum is high among the top executive leaders of Oklahoma National Bank. The bank has just been named the fastest growing new bank in its economic region of the country and the future is looking very bright. After opening its doors in January of 2000 with \$11 million in capital, the bank has grown to over \$127 million in assets. The major growth over the past two years has been fueled by the strong organizational culture and the bank's ability to maintain high asset quality. To look ahead, the major concern is finding other sources of income and building and managing a sustainable growth strategy for the future.

### THE U.S. BANKING INDUSTRY

There were 9,613 FDIC-insured banking institutions at the end of 2001. Of these, 8,080 were commercial banks; 1,533 were savings institutions. Total assets at FDIC-insured commercial banks are \$6.569 trillion; savings institutions hold \$1.299 trillion. Out of 9,613 banks, 5,062 hold less than \$100 million in assets. Thus, the majority of banks are small, community banks that hold just 3 percent of the industry's total assets.

In the last decade, the world of commercial banking has undergone significant changes, but the pace of consolidation and mergers has finally slowed. In 2001, mergers absorbed 422 banks and savings institutions. This contrasts with 2000, when 499 institutions merged. In 1999, there were 513 mergers and in 1998, there were 680 mergers. Also in 2001, 146 new banks and/or savings institutions had been chartered, while 208 new banks and savings institutions were chartered during 2000.

Compared to 2000, 56.7 percent of all U.S. commercial banks reported higher annual earnings in 2001. Full year 2001 earnings of \$74.3 billion outperformed the previous record of \$71.7 billion set in 1999. Key factors in the improvement in industry earnings included sharply lowering funding costs (Federal Reserve's cut in interest rates) and higher gains on sales of securities and other assets. Through much of 2001, lower interest rates

## 564 PART 6 CASES

continued to boost the values of banks' fixed-rate securities. Rising provisions for loan losses and a lack of growth in noninterest revenues limited this increase in profits. Noninterest income was only \$368 million (0.9 percent) higher than the fourth quarter of 2000.

For the year, asset growth slowed to 5.2 percent, the lowest annual rate since 1992. Loans increased by only 2.0 percent in 2001, after growing by 9.4 percent in 2000. Most major banks have been experiencing trouble maintaining the quality of their assets. Declining asset quality has been a trend over the past two years and the level of problems and the pace of deterioration continue to be significantly greater at large banks. Increases in charge-offs were reported on commercial and industrial loans, credit card loans, commercial real estate loans, home equity loans, and residential mortgage loans.

## ISSUES AFFECTING THE BANKING INDUSTRY

The first trend, an area of concern, is household and business debt levels. Spending by households and businesses is growing faster than cash income, resulting in debt rapidly increasing. Further, recent growth in business indebtedness raises concerns about commercial credit quality. After expanding at the fastest growth rate in more than a decade during 1998, the commercial and industrial (C&I) loan portfolios at insured depository institutions continued to grow rapidly in 1999. Evidence of weakening corporate credit quality began to appear during 1999, and the federal banking regulators have publicly expressed their concerns about the quantity and quality of commercial credit risk in the system. Despite starting from very low levels, net C&I loan charge-offs for all insured institutions totaled \$3.6 billion during 1999—a 51 percent increase over 1998. Moreover, results from the annual interagency review of large commercial credits—the Shared National Credit (SNC) Program—noted a sharp rise in criticized loans. At the same time, corporate bond defaults and negative credit rating revisions during 1999 reached levels not seen since the early 1990s. This deterioration in commercial credit quality occurred during a particularly strong economic environment, leading to questions about how much further credit quality might deteriorate in the event of a moderate to severe recession.

Second, intense competition in banking is driving business strategies. Evidence also suggests that, to maintain loan growth and meet funding needs, institutions are pursuing asset-liability structures with higher levels

of interest rate risk. Innovations and cost-cutting initiatives used by insured institutions to counter competitive pressures may introduce new risks associated with complex accounting valuations, weakening internal controls, and the need for more intensive loan servicing.

Third, the economy and the banking system are vulnerable to sudden shocks from financial market instability. The 1990s were marked by recurring, and perhaps more frequent, episodes of financial market turbulence, and the banking industry asset growth has outstripped growth in deposits, creating greater reliance on more expensive and less stable market-based sources of funding. These funding trends present challenges for community institutions.

## TRENDS SHAPING THE FUTURE OF THE INDUSTRY

### Consolidation

While most financial services companies spent most of the past five years scrambling to become bigger so that they could be all things to all people, community banks emerged to fill the gap left by the ongoing consolidation in the banking industry. Many consumers and businesses were left with fewer choices among financial institutions. This created an opportunity for community banks such as Oklahoma National Bank to develop a profitable niche by providing personalized service to local residents and businesses in their communities.

### Slow Economic Growth

Rising problem loans and compressed profit margins, combined with slow economic growth over the past two years, have created a much more challenging environment for banks and securities firms. This has caused management teams to focus on nurturing high performing units, cutting costs, and eliminating nonperforming units.

### Falling Low Cost Consumer Deposits

Profits derived from the net interest margin achieved by making business and consumer loans funded by relatively low cost consumer deposits make up the bulk of traditional bank earnings. As competition from investment banks and mutual fund companies gets more intense, consumers are leaving less and less low cost money in their checking and savings accounts. Banks

have had to bid up their pricing on certificates of deposit in order to attract adequate funding for their loans. As a result, net interest margins have declined.

## Noninterest Income

Noninterest refers to income that is derived from activity other than the interest spread received from loans: service charges, overdraft fees, trust fees, servicing fees on sold loans, and selling insurance and brokerage services. In recent years, banks have increased their focus on noninterest income as a way to increase their profitability. Noninterest income can be more stable than traditional lending, and this revenue does not adhere to the typical loan growth cycle. This income also provides an offset to declining net interest margins.

## THE OKLAHOMA BANKING INDUSTRY

Despite a nationwide earnings decline in 2001, the Oklahoma banking industry is growing faster than the national industry. In its Quarterly Banking Profile, the Federal Deposit Insurance Corporation reported that Oklahoma banks posted a net income of \$487 million as of December 31, 2001.

Following are details from the FDIC report for Oklahoma:

- Total loans and leases outstanding from Oklahoma banks stood at \$27.5 billion as of December 31, 2001, compared to \$26.0 billion a year earlier; a 5.8 percent increase.
- Oklahoma bank assets totaled \$45.9 billion at the end of the year, up 6.2 percent from the same point in 2000.
- The average return on assets for the state industry was 1.09 percent, up from 1.07 percent a year earlier. Return on equity averaged 11.77 percent across the state.
- Total Oklahoma bank deposits grew by 5.1 percent, from \$33.4 billion in 2000 to \$35.1 billion in 2001.
- The net interest margin for Oklahoma banks averaged 4.11 percent, compared to 4.18 percent in the same period of 2000.
- The ratio of noninterest income to average earning assets grew from 1.40 percent in 2000 to 1.46 percent in 2001.
- The ratio of net loans and leases to total bank assets was 59.13 percent, down slightly from 59.43 in 2000.
- The percent of unprofitable banks decreased from 5.94 percent in 2000 to 3.55 percent in 2001. However, the number of banks with earning gains decreased from 62.24 percent to 58.16 percent.
- The ratio of noncurrent loans and leases to total loans and leases remained steady at 1.1 percent while the ratio of nonperforming assets to total assets increased slightly.
- The ratio of net loan charge-offs (losses) to total loans increased in 2001 to 0.44 percent from 0.32 percent in 2000 and 2001.
- The FDIC reported that Oklahoma had 282 commercial banks as of December 31, 2001, down from 286 in 2000. The number of bank employees in the state grew by more than 400, to 17,701.

## HISTORY OF OKLAHOMA NATIONAL BANK

After retiring from 26 years in the banking business and serving as president of Stillwater National Bank in Tulsa, Tom Bennett, Jr., Oklahoma National Bank (ONB) Chairman and Chief Executive Officer, got the idea for a start-up bank from his son, Tom III, during a family ski trip. His first call was to an old friend from college, Garry Groom, who had been CFO at two other Oklahoma banks. In response to Bennett's invitation to create a new bank in a way they had always dreamed that a bank should be run, he became ONB's CFO. A short time later, Bennett was introduced to Michael Bezanson through one of his potential investors. Bezanson had been president and CEO of Security National Bank of Sapulpa and had also been thinking about starting a bank. Bezanson quickly became Oklahoma National Bank's president, and the process of creating a dream to turn into reality began around the Bennetts' kitchen table with three banking veterans (Bennett, Bezanson, & Groom) and one rookie (Tom Bennett III).

Bennett pulled together a group of investors and board members that reflected the bank's interests in small businesses, entrepreneurs, and local professionals. Among the board members are B. J. Dumond, chairman and chief executive officer of Simple Simon's Pizza; Dr. Ben Johnson, president of Tulsa Dental Products; and home builder Stephen Murphy of Murphy Resources Inc. It has been said that the bank's investors and board members read like the *Who's Who of Business in Tulsa*.

The bank's employees include a mix of veteran bankers and industry newcomers. Among them are

Bennett's wife, Sue, who serves as director of marketing and investor relations, and their son, Tom, who is currently a vice president with the bank. The average banking experience of the 12 senior officers is 22 years, and the average banking experience of the 33-person staff is 15 years.

## OKLAHOMA NATIONAL BANK OPERATIONS

### Products

Oklahoma National Bank offers a variety of deposit products including regular checking, business checking, savings accounts, and tiered rate money market accounts and CDs with the most competitive rates in Tulsa. One depositary product that is unique is their personal checking account that pays a CD rate of interest as long as the customer maintains a minimum balance of \$5,000. They've developed the NetTeller online banking system to offer customers the opportunity to visit their Oklahoma National Bank account from any Internet connection, and they offer to reimburse their customers for ATM access fees charged by other banks when ONB customers use other banks' ATMs to access ONB accounts.

Oklahoma National Bank also makes mortgage loans and consumer loans and specializes in small- to medium-sized business loans, SBA loans, and loans to professionals. They believe that their success at growing a high

volume of high quality, well-priced loans has been their ability to understand their customers' financial needs and their willingness to propose creative loan solutions that tailor repayment programs to each customer's unique ability to repay, and to make prompt commitments followed by fast loan closings.

### Financial Performance

Like most other start-ups, Oklahoma National Bank was expected to lose money during early operations and not to turn a profit until [its] third year of operations. However, in 2001 Oklahoma National Bank made a net profit of \$65,237 for the year; \$359,237 ahead of the original plan given to investors. The net profit of \$65,237 was after allocating \$708,000 to the reserve for loan losses. This represented \$809,676 in pre-reserve earnings for 2001, a figure that also outperformed the 2001 budget.

Loan performance also fueled the growth of Oklahoma National Bank during the 2001 operating year as the loan portfolio grew from \$42.1 million to \$110.8 million. More importantly, even during slow economic growth, Oklahoma National Bank was able to maintain stellar asset quality. As of September of 2001, the bank had no loans that were over 30 days past due and no net charge-offs for the year. The performance of ONB is indicated in Exhibits 1 through 4.

#### EXHIBIT 1 State of the Bank Report, April 19, 2002

##### I Introduction

I am pleased to report that the state of your banking company, both Twenty First Century Financial Services Company and Oklahoma National Bank & Trust Company, is excellent! No, now that I think about it, it's better than excellent, it's amazing! I have been an optimist all of my life, and even I am surprised at our extraordinary growth, more rapid than expected profitability, and excellent asset quality. I am also very pleased with the high quality staff that we have continued to assemble and the continued growth in our many wonderful relationships with customers and friends. For ONB, these are the best of times.

##### II Perspective

Last year our big announcements were:

1. Our first month of profitability in March 2001, our 14th full month of doing business.
2. That in our first 15 months we had exceeded all of our 24 month goals.
3. That we had successfully recruited Oklahoma's #1 radio personality, John Erling, to be our spokesman.
4. That we were the fastest growing new bank in the region.
5. That we were about to finish our drive-in at 91st & Yale.
6. That we had just finished our first Habitat for Humanity House.
7. That we had moved from the 17th largest bank in Tulsa to #12, and we rightfully celebrated these achievements!

**EXHIBIT 1 State of the Bank Report, April 19, 2002 (continued)****III The Last 12 Months & Where We Stand Today**

Let me tell you now about the road we have traveled in the last 12 months and where we stand today.

1. Last year we went from being profitable in March, to being profitable for the entire year. In 2001, the Bank earned a net profit of \$65,000, which was \$241,000 ahead of the original pro forma loss of \$176,000 for the year 2001 in your initial private placement memorandum. This resulted in the Holding Company having a net profit of \$37,000 for the year, with the major difference being the interest paid by the Holding Company on a bank stock loan that was used to inject capital into the Bank. Overall, our company is \$602,000 ahead of our original pro forma losses in our first two years, which I think is pretty amazing!
2. This week, our bank exceeded \$155 million in total assets, which is a \$5 million increase over our 3/31/02 quarter end. In reaching \$155 million in assets, we are two and one-half times the size that we thought we would be at year end 2002 and nearly twice the size that we thought we would be at year end 2003. Now, some of you might think we were bragging in our initial pro formas. The fact is that out of the 22 new banks that were started in 2000 in our region of the country, including banks in Dallas, Houston, Kansas City, and St. Louis, the average size at year end 2001 was \$44 million. Our original pro forma showed us at \$44 million at year end 2001. So, achieving our pro forma growth would have made us average. While we thought we might be a little better than the average, we never imagined we would be nearly 300 percent of the average, which is what we have in fact achieved. To me, this too is amazing!
3. We will never top the [coup] of recruiting John Erling as our spokesman; but we have pulled an equally great, different kind of [coup] in the new Advisory Board members we have recruited from Sapulpa. I will let Mike introduce them all later. But, I have to say that I never believed we could open our first branch in a new town and get the Mayor, the President of the Rotary Club, and a Who's Who of Local Business People to join our cause. Those of you who are members of our Sapulpa Advisory Board—you are amazing!
4. We are still the fastest growing new bank in this region of the country. In addition, we are in the top 10 percent in the country of new banks in growth, earnings, and asset quality! We are in the top 10 in all three categories all at the same time.
 

Comparing ONB to the average start-up bank in our region from the year 2000, at year end 2001:

  - They reached \$44 million in assets; we reached \$124.7 [million].
  - They had experienced an average loss of 5.7 percent on equity; we had a 0.7 percent profit.
  - They had loan losses of 0.11 percent of their loans; we had 0.00 percent loan losses.
  - They had 0.21 percent of their loans over 30 days past due; we had 0.01 percent.

To me, all of this is amazing!
5. Last year, we finished our drive-in at 91st & Yale; this year we opened our first full-service branch in Sapulpa on April 10, 2002 (and it has a drive-in), we opened a Loan Production Office in Owasso in February; and we have just been approved by our bank regulators to open our new branch at 21st & Lewis this fall. At our last Board meeting, we approved a budget of \$1.5 million to renovate the first floor, build a four-lane drive-in, and provide bank only parking on the north side of the building at 21st Street. I've heard that all the other Banks in town think that is amazing!
6. Last year we finished our first Habitat for Humanity House. This year we have asked our Sapulpa Advisory Board to help us identify a similar type of project to do in Sapulpa . . . it too may be a Habitat for Humanity House, but I'm not sure. I know many members of our staff, and many of you as investors, have been involved in a wide range of philanthropic projects in this last year. It's hard to put it all in perspective following the events of September 11th. However, it is clear that we have much to do in our community, our state, our nation, and throughout the world. My prayer for all of us is that we will find God's activity and listen to His calling, and go to join Him wherever that might be. For some, it will be our local Red Cross or the local bowl-a-thon for Big Brothers & Sisters in which ONB Club is sponsoring eight teams this weekend, for others it will be serving the orphans of Russia or Vietnam. One thing I am sure about is that the challenge for all of us is almost overwhelming. However, I believe that as we follow God's leadership, somehow it will all work out for good, and the fact that we may be a part of that goodness . . . that is amazing!
7. Last year we had moved from the 17th largest bank headquartered in Tulsa when we started #12 on 3/31/01. This year we became the 7th largest bank headquartered in Tulsa on 3-31-02 . . . and I believe in the last three weeks, we are now actually #6. At year end 2001, we became the 64th largest bank in Oklahoma. Probably we are now about 50th out of 290 . . . in two years, two months, and twelve days. Now that's amazing!

(Continued)