COMMUNITY BANK COMPLIANCE COSTS

William Dunkelberg and Jonathan Scott
Temple University[1]

Introduction

The cost of compliance is well-studied area of concern for policy makers, especially since the passage of Dodd-Frank. Over the past few years, the cost of complying with financial regulation, preparing for examinations and new reporting requirements is probably the fastest growing category of expenses in the banking industry.[2] These costs are especially burdensome on smaller financial institutions because the regulations were mostly designed for systemically important financial institutions and the assets needed for compliance have large fixed costs for small banks. Most banks are relatively small and pose no systemic threat to financial markets, which diminishes the value of increased compliance costs for this reason.

The cost of compliance with bank regulations is a regressive tax on small banks. Compliance at large banks can be more easily managed because they have established departments that specialize in the legal and technological activities required for compliance and can spread this cost across many activities. However, few small banks have their own legal or compliance departments. Compliance often requires incurring additional fixed costs larger than needed (hiring an additional accountant or computer programmer for example), which impairs the bottom line to a larger degree than at larger banks. More importantly, this burden creates a competitive advantage for larger banks that can more easily absorb (utilize) these fixed costs. Both the regulators and Congress have recognized the importance of compliance costs on small bank viability resulting in numerous proposals to roll back these costs.[3]

In this report, we use the Conference of State Bank Supervisor's 2018 National Survey of Community Banks to more closely examine the association of bank size with regulatory compliance costs. The Survey asks each respondent to report the amount of expenses directly associated with regulatory compliance for each of five categories from Schedule RI-E, including

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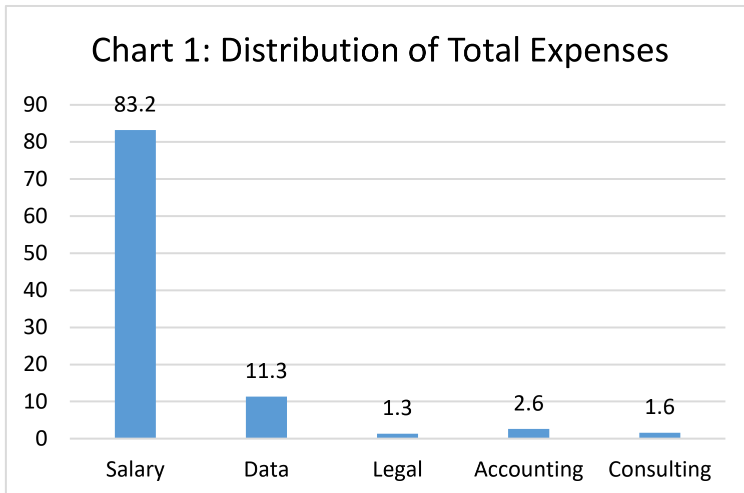
[2] For examples, see https://www.csbs.org/smaller-banks-have-greater-compliance-burden-according-st-louis-fed-report.

[3] See Federal Financial Institutions Examination Council. 2017. Economic Growth and Regulatory Paperwork Reduction Act (Federal Register, March 30); U.S. Department of the Treasury. 2017. A Financial System That Creates Economic Opportunities (June); U.S. Senate Committee on Banking, Housing and Urban Affairs. 2017. Economic Growth, Regulatory Relief and Consumer Protection Act (November 16).

personnel, data processing, legal fees, accounting/auditing, and consulting/advisory expenses. The sum of these compliance costs divided by total non-interest expense is nine percent for all banks in the study. This compliance burden falls more heavily on smaller banks across all categories except for legal fees. While we do not have access to exam report ratings, it appears that this burden is independent of bank financial strength. Not surprisingly, over 70 percent of community banks in the 2018 National Survey reported the costs of dealing with regulations as important in considering an offer to be acquired.

Compliance Cost Overview

Personnel expenses (salary in Chart 1) comprised 83 percent of total expenses reported for the 407 respondents who responded to question 19 to provide data from the call report Schedule RI-E. The next largest category was data processing at 11.3 percent.



The estimated costs associated with regulatory compliance for each category for the 386 firms that responded is shown in Chart 2. Given the high cost of adding personnel to meet compliance requirements, it is not surprising that compliance costs are highest for personnel at 8.5 percent of the total. New regulations often require significant system changes that increase data processing expenses. However, the regulatory compliance proportion of total data processing costs was only 1.9 percent. At the 75th percentile, the compliance burden for salary was 10.9 percent and 2.3 percent for data processing costs.

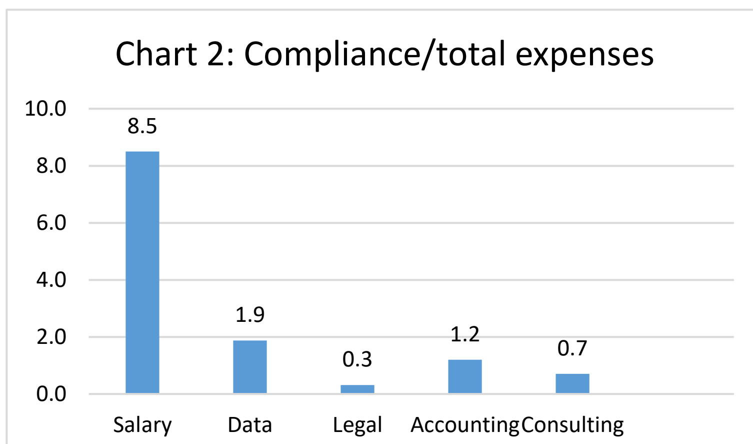
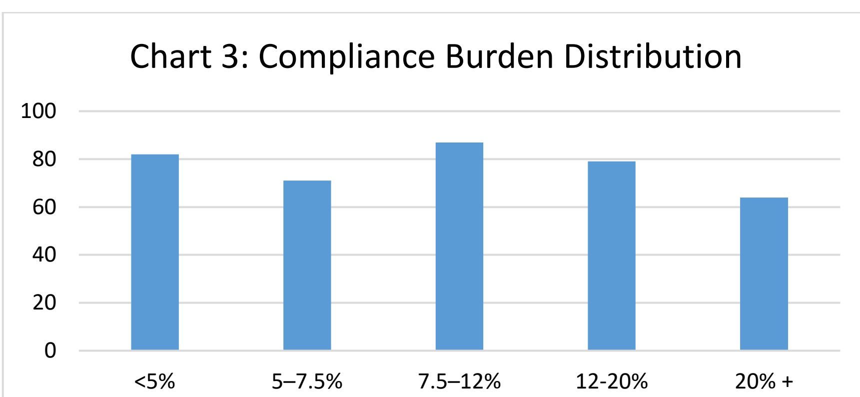


Table 1 reports the distribution of the total compliance expenses. Almost 79 percent of the 512 respondents (or 407 respondents) reported total expenses, while 95 percent (or 386 respondents) of those respondents reported the corresponding regulatory expenses for the five categories. The mean compliance burden, defined as total regulatory expenses divided total expenses for the five categories, is 12.6 percent, with a median burden of 9.5 percent.

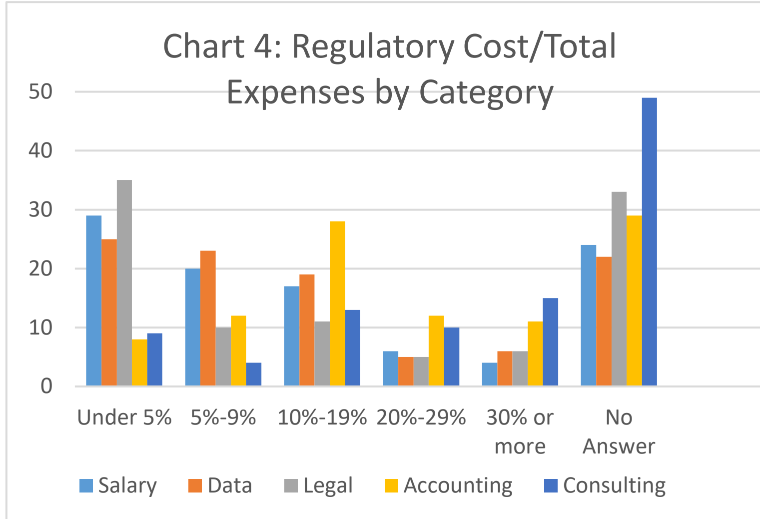
Table 1: Survey Response Distribution for Question 19 of 2018 National Survey					
	Total Expenses	Total Regulatory Expenses	Regulatory/ Total Expenses	Truncated Total Expenses	Truncated Regulatory/ Total Expenses
Observations	407	386	383	387	364
Missing	118	139	142	138	161
Mean	$268,728	$15,174	12.6%	$8,116	12.8%
Percentiles 25	$2,117	$218	5.4%	$2,062	5.5%
50	$4,887	$433	9.5%	$4,401	9.6%
75	$10,851	$908	16.7%	$9,282	16.7%

Elimination of the top five percent of reported expenses to eliminate possible impacts of extreme cases resulted in 387 respondents with a mean total expenses equal to $8.1 million compared to $286 million for the full set of respondents. The overall compliance burden for the truncated sample is 12.8 percent, the same as the 12.8 percent burden for the full sample. A similar result is seen for the median response: 9.5 percent for the full sample and 9.6 percent for the truncated sample.

Because the full and truncated compliance burden ratios are so close, for the remainder of this analysis, we will use the full sample, i.e. the 386 banks that reported regulatory costs. The compliance burden distribution is broken into approximate quintiles with the distribution shown below in Chart 3. The distributions are modified slightly by category of expense to provide approximate quintiles for the number of respondents.

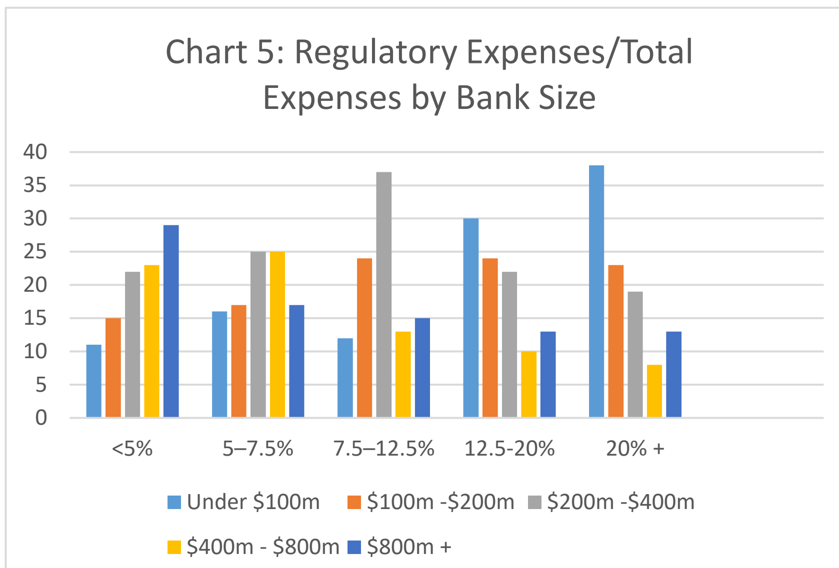


For many banks, compliance costs account for a significant percent of their operating costs as shown in Chart 4. Ten percent reported that compliance accounts for over 20 percent of their total salary (and benefits) cost. Nearly a quarter of the banks reported that over 20 percent of their accounting costs were compliance related. Over 10 percent reported that compliance accounted for over 20 percent of their data processing and legal costs. And 25 percent spent 20 percent or more of their consulting budget on compliance.



Bank Size and Compliance Costs

The regressive nature of compliance costs becomes clear when examining the distributions of expense percentages by bank size. Chart 5 shows all regulatory expenses divided by total expenses (salary, data, legal, accounting and consulting), the "compliance burden." Only 11 percent of those banks reporting compliance burdens under 5 percent of total expenses are small banks (under $100 million), but these same banks constitute 38 percent of the banks reporting compliance burdens over 20 percent. The pattern is reversed for large banks, where 29 percent report compliance burden of 5 percent or less but only 13 percent report a burden greater than 20 percent.



Tables 2 to 6 show a detailed breakdown of the compliance burden by expense category. The percent of banks reporting compliance burdens equal to 15 percent or more of total salaries and benefits declines sharply with increasing bank asset size from 34 percent of banks under $100 million to only 14 percent for banks over $800 million.

Table 2: COMPLIANCE SALARY as a % of TOTAL SALARY						
BANK SIZE>	Under $100m	$100m - $200m	$200m - $400m	$400m - $800m	$800m +	All Banks No Data 21%
<2.5%	21	10	18	19	32	29%
2.5–5%	3	26	28	26	17	30%
5–10%	16	27	30	13	14	20%
10-15%	25	27	27	10	10	6%
15% +	34	21	18	11	14	4%
All Banks	20%	22%	25%	16%	17%	100%

Data processing and accounting compliance costs behave similarly (Tables 3 and 4). Larger banks less frequently report a data processing compliance burden that is greater than 25 percent of total data processing expenses (11 percent) and more frequently report a burden of less than 5 percent (24 percent). The opposite is true for banks under $200 million. Accounting costs and the compliance burden show a similar pattern. Banks under $200 million in assets more frequently report a compliance burden in excess of 25 percent of total accounting and audit costs (35 percent) compared to large banks (15 percent). Similarly, large banks more frequently report an accounting and audit compliance burden of less than five percent (27 percent) compared to small banks (eight percent).

Table 3: COMPLIANCE DATA PROCESSING % of TOTAL DATA PROCESSING						
BANK SIZE>	Under $100m	$100m - $200m	$200m - $400m	$400m - $800m	$800m +	All Banks No Data 23%
<5%	14	15	23	24	24	30%
5–10%	17	18	29	17	18	23%
10–15%	18	25	20	18	18	19%
15-25%	22	19	27	14	19	5%
25% +	31	29	22	6	11	1%
All Banks	20%	22%	24%	16%	18%	100%

Table 4: COMPLIANCE ACCOUNTING/AUDIT as % of TOTAL ACCOUNTING/AUDIT						
BANK SIZE>	Under $100m	$100m - $200m	$200m - $400m	$400m - $800m	$800m +	All Banks No Data 30%
<15%	8	21	27	12	27	8%
15–25%	22	13	23	17	20	12%
25–50%	8	22	26	22	14	28%
50-60%	24	29	24	19	15	12%
60% +	35	15	27	9	15	11%
All Banks	20%	21%	24%	16%	18%	100%

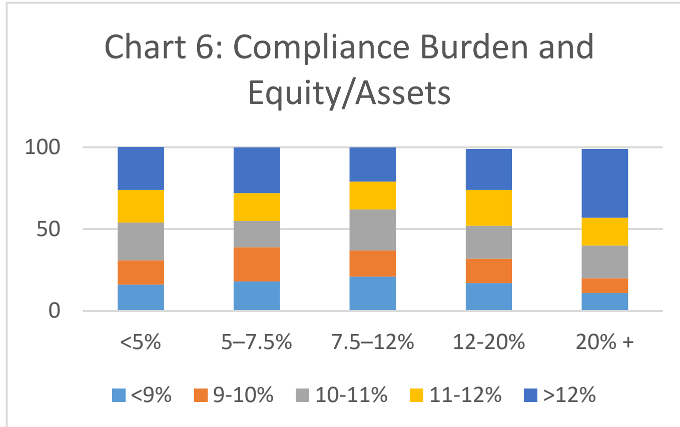
The regressive incidence of the compliance burden is not seen in legal fees (Table 5). While it appears that the compliance burden for consulting falls disproportionately on small banks (Table 6), a high proportion of banks did not report any consulting expenses.

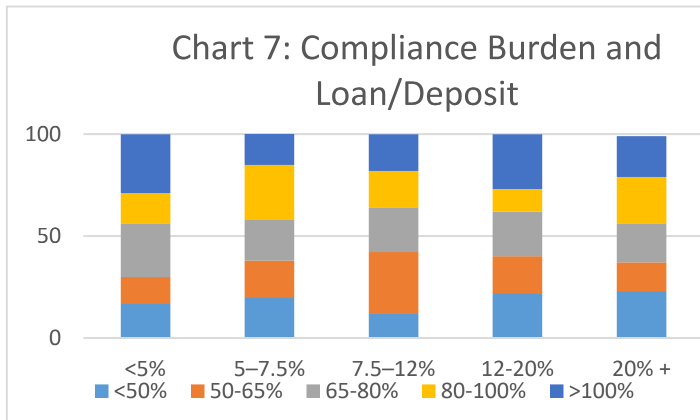
Table 5: COMPLIANCE LEGAL FEES as a % of TOTAL LEGAL FEES						
BANK SIZE>	Under $100m	$100m - $200m	$200m - $400m	$400m - $800m	$800m +	All Banks No Data 34%
0%	30	29	16	12	12	43%
0–10%	22	16	24	19	19	11%
10–25%	10	26	34	18	13	5%
20-30%	17	19	24	19	20	6%
30% +	21	22	25	11	21	3%
All Banks	20%	21%	25%	17%	18%	100%

Table 6: COMPLIANCE CONSULTING as a % of TOTAL CONSULTING and ADVISORY FEES						
BANK SIZE>	Under $100m	$100m - $200m	$200m - $400m	$400m - $800m	$800m +	All Banks No Data 49%
<15%	12	10	26	23	30	9%
15–25%	10	13	23	23	30	3%
25–50%	14	25	31	15	14	14%
50-60%	23	23	23	17	15	10%
60% +	29	29	29	6	8	15%
All Banks	20%	21%	25%	16%	18%	100%

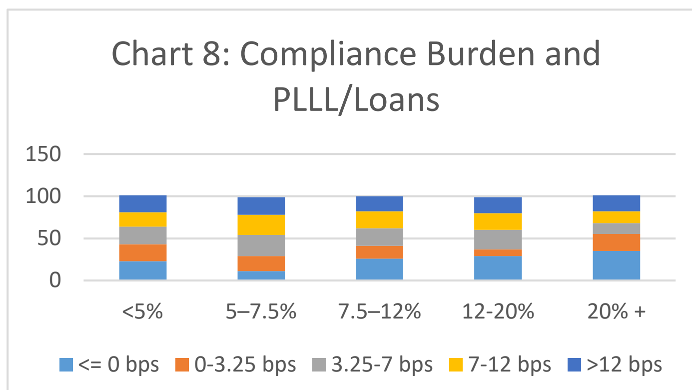
Compliance Burden and Bank Financial Strength

An argument could be made that the compliance costs are making the banking system safer and that weaker banks should be committing more resources to risk management. Charts 6 to 8 provide some evidence to reject that hypothesis. Banks with equity/assets ratios greater than 12 percent more frequently report a compliance burden in excess of 20 percent (Chart 6). Banks with the lowest loan/deposits ratio more frequently report a higher compliance burden, while banks with the highest loan/deposit ratios more frequently report the lowest compliance burden (Chart 7).





And finally, Chart 8 shows that banks with the lowest ratio of PLLL (provision for loan and lease losses)/Loans more frequently report ratios above 12 percent, the highest compliance burden.



These results are generally in conformance with the findings of the Federal Reserve Bank of St. Louis report on the 2017 National Survey, where the authors found that the amount spent on compliance showed no association with regulatory performance.[4]

Another view of the compliance burden looks at its effect on decisions to consider an offer to sell the bank. Mergers for good economic reasons such as taking advantage of scale economies or new market opportunities are healthy. Mergers and sales due to the heavy burden of regulatory compliance are not. Of the 56 small banks reporting a decision to seriously consider an offer, 73 percent reported that the costs of dealing with regulations was “important” or

[4] Compliance Costs, Economies of Scale and Compliance Performance. 2018. Federal Reserve Bank of St. Louis.

“very important” part of the decisions. The inability to achieve economies of scale and excessive costs of doing business – both related to the compliance burden – were reported as “important” or “very important” by 63 percent and 72 percent, respectively, in the consideration of a merger offer.

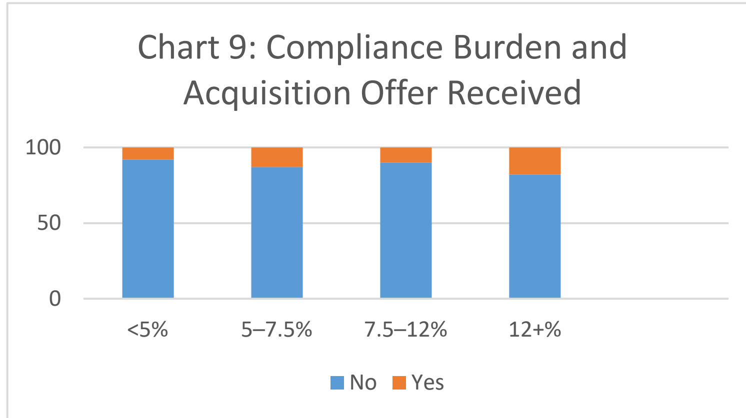


Chart 9 provides some evidence that a high compliance burden (12.5 percent or higher) is associated with more frequent reports of receiving and seriously considering an acquisition or merger offer (18 percent versus eight percent for a compliance burden under five percent).

Compliance and Bank Outlook for the Future

And finally, the impact of committing a relatively larger share of all expenses to compliance is obvious in the Index of Community Bank Sentiment (ICBS) shown in Table 7. A lower compliance burden (under 12.5 percent) is more frequently reported for scores over 110. Banks with a compliance burden in excess of 20 percent more frequently report scores under 100.

Table 7: ICBS and COMPLIANCE BURDEN

SENTIMENT INDEX>	Under 95	95-99	100-104	105-109	110+	All Banks No Data 25%
<5%	2	10	46	26	26	15%
5-7.5%	0	11	35	53	22	14%
7.5-12.5%	2	10	46	39	24	17%
12.5-20%	1	9	37	55	9	15%
20%+	5	15	36	36	8	13%
All Banks	2%	11%	41%	35%	12%	100%

Table 8 shows the ratio of reported total compliance costs to reported net income from the Call Report. The computation could be made for only 75 percent of the respondents because not all banks reported fully on all the categories of expenses. About a third of the banks reported compliance costs that were in excess of 50 percent of net income. Forty percent reported cost to income ratios under 25 percent.

Table 8: ICBS and TOTAL COMPLIANCE COSTS/NET INCOME						
SENTIMENT INDEX	Under 10%	10%-25%	25%-50%	50%-75%	75% or more	All Banks
<95	14	14	45	14	14	3%
95-99	14	22	22	15	27	11%
100-104	14	27	31	12	16	39%
105-109	12	26	23	14	15	34%
110 +	24	28	17	11	20	13%
All Banks	15%	25%	27%	13%	20%	100%

Conclusion

Compliance costs continue to have a disproportionate impact on small banks. Banks under $100 million report a higher compliance burden across all categories of expenses except for legal fees. There is no evidence that financial strength is associated with compliance burden. Compliance uses up valuable and scarce capital and hours of expensive human capital. Even if the bank continues to operate, it is less effective and weaker when carrying a large burden that is of questionable value on a cost/benefit basis. Compliance should not be a force that reduces the number of community banks by forcing a consideration of an acquisition and merger offer.