

Part 2: Strategic Insights into Technology Costs

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In addition to compliance costs, Loomis & Co. also examined operating costs of community banks, including technology, security and fraud related expenses. This article will assess the challenges that small banks face as data processing and security/fraud costs continue to grow. This is meant as a supplement to our separate compliance cost article, which examined rising regulatory costs and their impact on the operations of community banks.

The survey was distributed to just over 300 community banks, with approximately a 5.0% response rate. The questions asked were aimed at gauging the increase in technology and security/fraud costs and to analyze the impact of this trend.

The survey was sent to community banks that have assets between \$56 million and \$4.6 billion, although most have less than \$1 billion, and respondents were asked to provide data from the past three years (2011, 2012, and 2013).

The responding banks had median total assets of \$284 million, 72 employees and five branches at year end 2013. The middle 50% of the banks were between \$155 million and \$388 million in average assets, with 34 to 165 employees, and 3 to 10 branches.

As the table below indicates, large banks with over \$500 million in average assets have substantially lower processing and technology costs as a percentage of average assets (in basis points), when compared with banks with less than \$500 million in assets.

Technology is no longer a luxury in the community banking industry. To stay competitive, banks must invest in online banking platforms, ATM's, and other technological advancements. While large banks may spend more to update their technology, small banks must spend a significantly larger percentage of assets, putting intense financial pressure on smaller institutions that are choosing to sell amid these high operational expenses.

Median Processing & Tech Costs/ Assets (Basis Points)

	Number	2011	2012	2013	2013 Range
Banks Under \$250 million	5	29.79	29.79	29.77	14.24-72.95
Banks \$251 to \$500 million	7	15.46	32.98	32.61	0.27-34.06
Banks \$501 million plus	3	13.13	12.11	12.27	9.24-22.20
TOTALS	15	21.93	25.16	22.20	0.27-72.95

Note: Technology costs are represented as a percentage of total assets (in basis points)

Between 2012 and 2013, security and fraud costs as a percentage of assets remained fairly constant, with a slight jump from 2011 to 2012. As shown in the table below, small banks with less than \$250 million in assets experienced the highest security and fraud costs as a percentage of average assets in 2013. Interestingly, medium sized banks (\$251-\$500 million), reported the lowest security and fraud detection expenses as a percentage of assets. One possible explanation is that large banks have come under scrutiny in recent years for widespread fraud and unlawful practices. This would lead large institutions to spend more on security services to protect against these illegalities.

Median Security & Fraud Costs/ Assets (Basis Points)

	Number	2011	2012	2013	2013 Range
Banks Under \$250 million	5	1.31	1.20	1.78	0.42-18.24
Banks \$251 to \$500 million	7	1.82	1.07	1.09	0.93-3.60
Banks \$501 million plus	3	0.81	2.02	1.66	0.14-2.95
TOTALS	15	1.15	1.42	1.43	0.14-18.24

Note: Security/Fraud costs are represented as a percentage of total assets (in basis points)

Giving their outsourced technology providers an overall grade of B, banks were seemingly satisfied with the services they received. Only two institutions reported a grade of C level of satisfaction, while three of the responding community banks rated their technology providers with a grade of A.

Satisfaction with Technology Provider

	Number	2013
Banks Under \$250 million	5	B
Banks \$251 million to \$500 million	7	B
Banks \$501 million plus	3	B
TOTALS	15	B

The results for security and fraud providers are similar in that reporting banks gave an overall satisfaction rating of B. These results were less variable, with 90% of community banks giving their security providers the grade of B.

Satisfaction with Security and Fraud Provider

	Number	2013
Banks Under \$250 million	5	B
Banks \$251 million to \$500 million	7	B+
Banks \$501 million plus	3	B
TOTALS	15	B

When we asked CEO's to rank the biggest expected challenges for their banks in the next few years, technology and security and fraud costs both fall within the top five. Rising technology costs is actually the third biggest challenge, while security and fraud costs was deemed fifth in importance. Only regulatory oversight and expenses and NIM deterioration were more concerning than increased technology costs.

As technology continues to advance, small banks may find it financially difficult to keep pace with larger institutions. As a result, we foresee an increase in acquisitions as small community banks decide to sell.