Part 1: Strategic Insights into Compliance Costs

By: Arthur Loomis, Boyang Zhou, and Victor Di Fede

It is evident that the new Dodd-Frank regulations and CFPB oversight are having major impacts on all banks, including community banks, but the extent of these impacts are still largely unknown. The 13th annual Loomis & Co. Community Bank Survey aimed to examine the effect of rising compliance costs on small banks and to offer insight into expected future trends. Over the last few years, a strict regulatory environment has pushed compliance expenditures to unprecedented levels, and this development seems likely to continue as 91% of institutions that responded to our survey agree that these expenses will grow.

To demonstrate the considerable impact regulatory and compliance costs represent, Mr. Robert Wilmers of M&T Bank, in his shareholder letter in 2013, noted that such costs were “$265 million or 10.3% of total operating expenses, well over double what we spent a year ago, and nearly four times the amount spent in 2007.” In addition, Doug Manditch of Empire Bancorp, Inc. in an interview with American Banker observed that 16% of his Bank’s revenue is allocated to compliance and governance, up from 13% in 2012. Manditch also voiced his frustrations that “the regulatory burden is just becoming impossible. The burden is extremely costly and it seems to be never-ending.” With only 53% of Dodd-Frank’s regulations having been implemented, these costs will continue to grow and threaten the survival of community banks.

In order to broaden the sample to derive more reliable findings than these two anecdotal sources, we distributed the survey to the chief executive officers of over 300 community banks, who are mostly in the Northeast region. The survey participants were asked to estimate annual costs for the last three years, expected future trends, how the bank expects to address compliance, and the quality of the compliance services.

Furthermore, Loomis & Co. also examined the impact of technology and security/fraud costs, and analyzed the greatest challenges facing banks over the next five years as part of the survey. These results are included in subsequent articles, “Strategic Insights into Technology Costs” and “Future Challenges Anticipated.”

We had a five percent response rate, with banks representing total assets between $56 million and $4.6 billion. Most institutions had less than $1 billion in assets. The respondents had median assets of $284 million, 72 employees and five branches at year end 2013. This is lower than the median assets of $416 million, 119 employees and nine branches in our 2012 survey. The middle 50% of the banks were between $155 million and $388 million in assets, with 34 to 165 employees, and 3 to 10 branches.

Survey respondents with more than $250 million in average assets witnessed fairly constant compliance expenditures over the last few years, while banks with over $500 million in average assets experienced a slight decrease in 2013. This experience, however, is in sharp contrast to the increase in compliance costs from 2010 to 2013 for respondents with under $250 million in assets. Their average costs soared to $148,750 per year, up from a fairly stable $84,400 per year in 2010.

Median Compliance Cost/ Assets (Basis Points)

	Number	2011	2012	2013	2013 Range
Banks Under $250 million	5	6.54	7.33	12.82	3.57-13.36
Banks $251 to $500 million	7	6.43	6.04	7.01	2.19-11.01
Banks $501 million plus	2	3.49	4.19	4.27	3.16-5.38
TOTALS	**14**	**4.33**	**6.81**	**7.01**	**2.19-13.36**

Note: Compliance costs are represented as a percentage of average assets

Based on the survey, compliance costs for larger institutions seem to behave more like a fixed cost. Smaller institutions on the other hand, appear to be experiencing almost a "catch-up" period, where expenses are practically spiraling. For the larger two asset size classes of banks, this cost has remained fairly constant, even decreasing at times. However, for banks under $250 million in assets, there has been a considerable increase in compliance expenditures over the last few years. These inexorable expenses may be the catalyst driving small banks to sell. In fact, 72.3% of all M&A deals in the last three years have involved targets of less than $50 million in purchase price, which is estimated to equate to roughly $400 million or less in total assets.

The median respondent had an increase in compliance costs to $205,000 in 2013 from $150,000 in 2011, an 11.0% increase. For the average respondent, compliance costs rose to $259,000 in 2013 from $173,000 in 2011, or a 14.4% increase.

Compounding this negative news from our survey, we are also disturbed by the significant disconnect between our respondents and the experience of Messrs. Wilmers' and Manditch's banks. Our results are approximately 10-12% of their levels, meaning that a broader sample size is necessary to demonstrate which entities are the outliers. As a result, if you are reading this and did not fill out our survey, please contact us at (518)-786-0100 so we can include your data in our on-line survey.

In addition, an overwhelming 92% of our respondents anticipate compliance costs will grow for the foreseeable future, with 75% of reporting institutions projecting at least $50,000 annual growth. This could potentially entail annual increases of 23% for the average institution in our survey and 25% for the median institution. Moreover, only 8% of participating institutions felt compliance costs would stabilize over the next few years.

To handle rising regulatory related expenses, 8% of the community bank respondents anticipate utilizing help from joint ventures, which is down from 24% of the community bank respondents who anticipated using joint ventures last year. 25% of community bank respondents plan to use only internal specialists and 25% of respondents expect to use only external specialists to deal with compliance issues. Over 41% of participating banks stated that they anticipate using both internal and external sources, which is up substantially from the 32% reported last year. This indicates that the increasing complexity and number of regulations is forcing community banks to incur increased expenses for both internal staff and external specialists.

Similar to last year, 83% of respondents felt that compliance costs will grow the most in dedicated personnel and not in front line or delivery of products and services. It seems community banks will have to face the unwanted financial burden of hiring or shifting personal to focus on compliance, much like JP Morgan who announced that they plan to hire approximately 17,000 new employees for compliance related tasks in 2015.

On a positive note, all of the participating community banks were generally satisfied with their external compliance providers as all three segments gave their providers an average grade of B.

This survey builds on previous years' results and indicates that increased regulation and growing compliance expenses are permanent. As previously noted, with only 53% of Dodd-Frank regulation having been implemented, compliance costs will increase even further. With a challenging regulatory environment reducing profit margins, many banks have opted to merge or be acquired. At the end of 2013, there were a total of 6,812 commercial banks and saving institutions, which is down from 9,181 a decade earlier. In order to offset these large and uncontrollable compliance expenses, the Loomis & Co team recommends community banks develop non-interest income sources and improve their efficiency levels elsewhere in the bank, at a minimum.