Part 1: Strategic Insights into Compliance Costs

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In recent years, many community banks have cited rising uncontrollable compliance costs as a reason for selling or merging with another bank. While compliance costs have continually risen over the past ten years, we sought to establish whether their inexorable rise was really critical to the long term viability of a community bank. To begin to get a sense of the issue's magnitude, we sought to obtain direct information from community banks. We distributed a survey to over 300 community banks, predominately in New York or New England. Among the questions asked included the estimated annual cost for the last three years, expected future trends, where these costs are expected to grow most, how the bank expects to address compliance (whether by building its internal capacity or outsourcing), and what the quality of the compliance service was.

We also inquired as to their data processing and security/fraud cost trends; the quality of the service provided by these outsourced entities, as well as the prioritization of challenges to their bank over the next five years. These results will be the topics of future articles.

We had an approximate ten percent response rate, with those banks representing total assets between $50 million and $15 billion. A complete list of the questions asked is provided in Appendix A.

The responding banks had median total assets of $416 million, 119 employees and nine branches at year end 2012. This compares similarly to the $470 million, 102 employees and 8 branches in our 2011 survey. The middle 50% of the banks were between $241 million and $806 million in total assets, with 63 to 174 employees, and 4 to 13 branches.

Compliance costs, as a percentage of average assets (in basis points), remained fairly constant for banks with more than $400 million in total assets, with slight decreases in 2012. That is in contrast to the increase for banks under $400 million in total assets between 2010 and 2012 as shown below:

Median Compliance Cost/Assets (Basis Points)

	Number	2010	2011	2012	2012 Range
Banks Under $400 million	12	5.29	5.57	6.27	1.61-15.73
Banks $401 million to $750 million	7	4.03	4.09	3.56	1.72-9.71
Banks $751 million plus	7	2.67	2.94	2.58	0.82-9.54
TOTALS	26	4.26	4.99	5.66	0.82-15.73

These results corroborate the belief that compliance costs are not terribly variable. Rather, they tend to represent more of a fixed cost. For the larger two asset size banks this cost has decreased, but for banks under $400 million there has been a considerable increase. This substantial increase may be the catalyst driving small banks to sell, as nearly 80% of all M&A deals in the last three years have involved targets less than $50 million in purchase price (which is perhaps $300-400 million in total assets). The good news is that compliance costs remained fairly modest in magnitude, as 2-5 basis points is far from the 50-100 basis points in after tax ROA most banks generate.

For the median respondent with assets of $416 million, its compliance costs rose to $221,455 in 2012 from $204,841 in 2010, nearly a 4% compounded annual increase. For the average respondent which had assets of $1.105 billion, compliance costs rose to $306,000 in 2012 from $235,000 in 2010, or nearly a 14% annual increase.

Looking forward, over 88% of these community banks anticipate compliance costs will grow $50,000 per year, at least. This is up from 70% last year. That means annual increases of perhaps 16% for the average institution in our survey and 23% for the median institution! Just 12% felt compliance costs would stabilize in the coming years.

In terms of dealing with compliance issues and its related expense, 24% of the community banks anticipate help from their state associations or joint ventures, while 28% expect to use internal resources. Over 32% believe they will use a combination of internal and other external resources (not state associations or joint ventures), whereas only 16% expect to solely rely upon external service providers.

Somewhat surprisingly, respondents also felt by an overwhelming majority (80%), that compliance costs will grow the most in dedicated personnel and not in front line or delivery of products and services. We wonder if this opinion is just the tip of the iceberg, as we are concerned that the front line compliance costs will mushroom in the years ahead.

Another piece of good news was that all the community banks were generally pleased with their external compliance providers; all three segments reported that they were satisfied (B average).

This survey reaffirms last year's survey, indicating the norm for community banks. As most of Dodd-Frank regulation has not been implemented, perhaps this consensus may evolve, however. Equally certain, many small community banks are not waiting for the final chapter in compliance expense, rather they are voting with their feet and selling. At a minimum, we recommend community banks develop non-interest income sources and operating plans in order to offset these large, uncontrollable and insidious expenses.