Scale Matters: Community Banks and Compliance Costs

By Drew Dahl, Andrew Meyer and Michelle Neely

Regulatory burden has long been a concern within the banking industry, and policymakers are taking notice—holding hearings, commissioning studies and proposing legislation to lessen the load. Recently, attention has been devoted to compliance costs that weigh more heavily on smaller banks than their larger counterparts in the community banking category. But how much more of a burden do the smaller banks bear?

Quite a bit, according to our analysis of data on compliance costs obtained in a recent survey conducted by state banking commissioners and the Conference of State Bank Supervisors (CSBS).[1] In order to identify the relative importance of these costs, we compared them with total noninterest expenses, which include these compliance expenses along with other expenses—like salaries—not directly related to the interest costs of extending loans and gathering deposits. We found that, in 2014, the ratio of compliance costs to total noninterest expense increased substantially as the size of the bank decreased. For example, banks with assets of $1 billion to $10 billion reported total compliance costs averaging 2.9 percent of their noninterest expenses, while banks with less than $100 million in assets reported costs averaging 8.7 percent of their noninterest expenses.

The observed tripling of costs across these size thresholds is consistent with the existence of economies of scale in achieving a given regulatory performance outcome. But that may not be the only explanation. What if lower costs are associated with worse outcomes?

Background

Past studies have uncovered evidence that compliance costs can be spread more efficiently across larger banks than smaller ones. But these studies are limited to examinations of costs that: 1) can be inferred from simulations; 2) are aggregated across compliance and noncompliance activities; 3) are unique to a particular regulation; or 4) are cumulative across all regulations but observed only in a small number of banks.[2] The CSBS survey addressed some of these limitations by acquiring dollar costs of compliance across a relatively large sample of banks.[3]

We began with the 974 respondents to the CSBS survey. From these respondents, institutions were eliminated if they did not meet the definition of a commercial bank, had more than $10 billion in assets (a common threshold for defining community banks is less than $10 billion in assets), could not be linked to sources of required supporting data or failed to report nonzero compliance expenses in at least one category. The final sample consisted of 469 banks.

The survey asked bankers to identify five categories of expenses incurred in 2014 in each of the following categories: 1) data processing; 2) accounting and auditing; 3) consulting and advising; 4) legal; and 5) personnel. Respondents were asked to specify the dollar amounts spent on compliance in these categories.

Analysis

Table 1 provides information on the five expense categories for banks in different size groups. It lists mean dollar amounts and mean dollar amounts as percentages of noninterest expenses.

Compliance expenses for personnel were, by far, the largest category in all size groups, representing more than 60 percent of total compliance expenses. These costs declined, as a percentage of noninterest expenses, from 5.3 percent for banks with less than $100 million in assets, to 1.8 percent for banks with assets of $1 billion to $10 billion. This result is consistent with a study that found that smaller banks have fewer staff members over which regulatory costs can be spread efficiently.[4]

Compliance expenses as percentages of noninterest expenses also decreased in the data processing, consulting and accounting categories as bank size increased. Compliance expenses for consulting and for legal fees were the lowest as a percentage of noninterest expenses among all five categories. (Comparisons can be seen by going down the columns.) Compliance expenses as a percentage of noninterest expenses in the legal category were relatively invariant across size cohorts (comparisons across rows).

Overall, these findings are consistent with the existence of economies of scale in satisfying regulatory requirements. For banks with assets of less than $100 million, total compliance expenses—across all categories—averaged $163,800 in 2014, or 8.7 percent of their noninterest expenses. Relative expenses declined systematically for banks in larger size groups. For banks with assets of $1 billion to $10 billion, total compliance costs averaged $1.8 million, or 2.9 percent of their noninterest expenses.

The differences in compliance cost expense ratios are qualitatively consistent with other estimates of relative regulatory burden. One recent study found that banks with assets of less than $1 billion had costs that represented as much as 6 percent of retail deposit operating expenses (a narrower basis of comparison than noninterest expenses), which was more than double the percentage for banks with assets of more than $1 billion.[5]

TABLE 1

2014 Mean Compliance Expenses

	Asset Size Categories				
	<$100M	$100M to $250M	$250M to $500M	$500M to $1B	$1B to $10B
Data Processing Expense	$27.6	$36.8	$82.0	$108.7	$188.3
	1.5%	0.9%	0.9%	0.6%	0.4%
Legal Expense	$4.6	$5.9	$20.0	$47.4	$134.9
	0.2%	0.1%	0.2%	0.2%	0.2%
Accounting Expense	$19.9	$31.6	$45.6	$57.7	$188.2
	1.1%	0.7%	0.5%	0.3%	0.3%
Consulting Expense	$11.7	$18.2	$24.0	$43.4	$129.1
	0.6%	0.4%	0.3%	0.2%	0.2%
Personnel Expense	$100	$176	$312	$507	$1,203
	5.3%	3.9%	3.4%	2.8%	1.8%
Total Expense	$163.8	$268.5	$483.6	$764.2	$1,843.5
	8.7%	5.9%	5.3%	4.2%	2.9%
Number of Banks	113	154	121	45	36

NOTES: The sample consists of 469 commercial banks with assets under $10 billion that responded to the Conference of State Bank Supervisors' survey in 2015 on operations in 2014 and for which complete data are available. Dollar amounts, expressed in thousands, represent means for banks in varying categories. Percentages are means within a category of the ratios of dollar amounts to overall noninterest expenses.

TABLE 2

2014 Compliance Expenses and Management Rating

	Asset Size Categories				
	<$100M	$100M to $250M	$250M to $500M	$500M to $1B	$1B to $10B
Number of Highest-Rated Banks	22	44	42	15	16
Compliance Expenses as % of Noninterest Expenses	6.8%	5.9%	5.1%	4.5%	3.0%
Number of Other Banks	91	110	79	30	20
Compliance Expenses as % of Noninterest Expenses	9.1%	5.9%	5.4%	4.0%	2.7%
Ratio	24%	40%	53%	50%	80%

NOTES: The sample consists of 469 commercial banks with assets under $10 billion that responded to the CSBS survey and for which complete data are available. The highest-rated banks are those assigned to the best category by regulators in the management component of their overall CAMELS rating; other banks are in lower categories. "Ratio" is the ratio of the number of banks in the highly rated category to the number of banks in the other category.

Comparing compliance costs across a sample of banks that vary by size suggests that economies of scale exist for banks in fulfilling their compliance obligations. Smaller banks incur higher costs than larger banks do in pursuit of the same performance standards.

A potential extenuating factor in our analysis of compliance costs is an implicit assumption of constant compliance performance across bank size categories, that is, our analysis assumes that banks spend different amounts to meet the same standard. It seems possible, alternatively, that lesser relative expenditures on compliance for bigger banks may be associated with worse performance outcomes and, therefore, the comparison would not be straightforward.

We addressed this question using confidential supervisory ratings. The rating we used assesses management's ability to "identify, measure, monitor and control the risks of an institution's activities and to ensure a financial institution's safe, sound and efficient operation in compliance with applicable laws and regulations." Results are shown in Table 2.

Comparing banks' management ratings across size categories provided no evidence that compliance performance decreased as bank size increased. In fact, ratios of the most highly rated banks to other banks in a given size category tended to increase in larger size categories. This suggests that governance practices across community banks may not be as critically dependent on direct expenditures as they are on the ability of management, boards, audit committees and internal auditors to work together to properly focus oversight attention, and that larger banks have an edge in focusing that attention more efficiently.[6]

Conclusion

Comparing compliance costs across a sample of banks that vary by size suggests that economies of scale exist for banks in fulfilling their compliance obligations. Smaller banks incur higher costs than larger banks do in pursuit of the same performance standards. Regulators, for their part, appear to be focusing greater attention on such apparent dilemmas and taking action. As Federal Reserve Board Gov. Jerome Powell noted in a recent speech, "The risks and vulnerabilities of community banks differ substantially from those of larger banks, and an explicit tailoring of regulation and supervision for community banks is appropriate."[7] Ω

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ENDNOTES

1. The survey analyzed ratios of compliance expenses to total expenses but did not isolate banks in different size categories. See Conference of State Bank Supervisors and the Federal Reserve System.
2. For an overview, see Hoskins and Labonte.
3. Our approach has its own limitations. Results will be biased if small banks have incentives to exaggerate reported regulatory burden or if respondent banks are not representative of the industry. Comparing means is a simplistic analytical approach without the structure imposed by a formal model. Conclusions must be qualified accordingly.
4. See Federal Reserve Bank of Kansas City.
5. See Consumer Financial Protection Bureau.
6. See Bies.
7. See Powell.

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