Appendix B - Regulatory Compliance Costs
A Summary of Interviews With Community Bankers

The cost of regulatory compliance and its effect on profitability and competitiveness is a frequent topic of discussion among community bankers.[1, 2] It was also a common topic for discussion at the six Roundtable discussions hosted by the FDIC in 2012 as part of the Community Banking Initiative. While regulatory compliance could affect the cost structure of community banks, particularly compared with noncommunity banks, Call Reports and other regulatory filings do not provide specific data regarding these costs.

Because of the limited data available to evaluate the cost of regulatory compliance, the FDIC's Division of Insurance and Research conducted interviews with nine community bankers to understand what drives the cost of regulatory compliance and, where possible, obtain actual financial data to better understand how regulation and supervision affects bank performance. The interviews were conducted throughout October and November 2012.[3]

Study Concentration: Regulatory Compliance Questions

The interviews focused on three main areas: (1) noteworthy events or financial trends that had an effect on the operations of community banks; (2) specific regulations or supervisory practices that have affected regulatory costs; and (3) cost of regulatory compliance. Questions were developed to address these main areas and each bank was interviewed with the same set of questions.

(1) The majority of the interview participants identified September 11, 2001, and the recent financial crisis and recession as the most significant events or financial trends affecting the operations of community banks within the past 20 years. Interview participants noted that after the events of September 11, 2001, the banking industry faced new regulations related to the Bank Secrecy Act and the USA Patriot Act. While the interview participants generally understood why these regulations were needed, many stated that a significant amount of resources are needed to adequately comply with them. Most interview participants also noted that the recent financial crisis and recession had affected their operation, but that the full impact of the Dodd-Frank Act and other significant regulatory changes in the consumer protection area was still uncertain.

(2) Interview participants were asked several questions to determine what drives regulatory compliance costs at their institution and, specifically, which rules, regulations, and supervisory practices had the greatest effect on their operations. Most interview participants stated that no one regulation or practice had a significant effect on their institution. Instead, most stated that the strain on their organization came from the cumulative effects of all the regulatory requirements that have built up over time. To support this statement, many of the interview participants indicated that they have increased staff over the past ten years to support the enhanced responsibility associated with regulatory compliance. In addition, at least one-half of the interview participants noted that because of the cumulative effects of regulations on their institution, the amount of time each employee, not just those focused solely on compliance, spent completing duties associated with regulatory compliance had increased over the past five years.

While the interview participants generally felt that the cumulative effects of regulations were driving their overall regulatory compliance costs, several bankers did identify specific regulations that require significant attention because of their business focus. These regulations included the Home Mortgage Disclosure Act, Unfair and Deceptive Acts and Practices, Fair Lending, Bank Secrecy Act, USA Patriot Act, Privacy Notices, and Electronic Funds Transfers Act.

[1] For purposes of these interviews, regulatory compliance costs are viewed as a decrease in income or an increase in expenses related to obtaining or maintaining compliance or conformance with banking rules and regulations and supervisory guidelines.

[2] See for example, Grant Thornton, "Bank Executive Survey: Bankers' Optimism Rebounds Amid Concerns Over Dodd-Frank," Third Quarter 2011. This survey indicated that compliance with regulatory reform was cited as a key concern by 91 percent of respondents. Respondents were not segregated according to community banker status, but were broken down by asset size, with 62 percent having more than $500 million in assets and 38 percent with less than $500 million.

[3] The selection criteria employed to determine the interview participants included a diverse set of factors, such as asset size, geographic location, business line, Minority Depository Institution status, and ownership structure, and participant banks met minimum supervisory ratings and other supervisory factors. All interview participants were state nonmember banks that had been informed that their responses would remain anonymous to promote candidness.

Interview participants were asked what steps the FDIC, as their primary federal regulator, could take to alleviate their concerns regarding regulatory compliance without affecting the FDIC's statutory role to ensure compliance with laws, rules, and regulations. The majority of interview participants indicated a desire for additional outreach by the FDIC to help them gain a better understanding of the proper ways to implement new or changing regulations and maintain compliance. The interview participants indicated that previous FDIC outreach events that were beneficial to their organizations included regional or nationwide conference calls, regional director's colleges, and contact with field office management, case managers, or review examiners.

(3) In an attempt to quantify the cost of regulatory compliance at their institution, interview participants were asked whether they tracked regulatory compliance costs within their internal cost structure. All the interview participants indicated that they did not actively track the various costs associated with regulatory compliance, because it is too time-consuming, costly, and is so interwoven into their operations that it would be difficult to break out these specific costs. Most of the interview participants indicated that they consider regulatory compliance as part of the normal cost of conducting business.

Consistent with the notion that these costs were a normal part of business, the interview participants noted that their overall business model and strategic direction had not changed or been affected by the regulatory compliance cost issues. In addition, the majority of interview participants stated that they had not discontinued offering products or services because of regulatory compliance, with the exception of overdraft protection and certain high-risk mortgage products.

Most interview participants indicated that while they do not specifically track and report on these costs to their board of directors, they can identify the direct costs associated with regulatory compliance from their general ledger. Direct costs are straightforward and easily identifiable to the extent that they can be separated from similar items not associated with compliance. Examples of direct costs include: compliance personnel salaries, employee training, consulting fees, external and internal audit fees, and specific software and hardware costs that are directly associated with compliance regulations.

Conversely, the interview participants noted that it is extremely difficult for them to identify indirect costs from their general ledger because they are not easily segregated between compliance and other areas. Examples of these costs include: noncompliance personnel time associated with regulatory compliance duties; software and hardware costs associated with responsibilities that might include compliance; and employee time associated with attending training that includes both compliance and noncompliance issues.

Common Themes Identified Across the Interviews

While the primary goal of the interviews was to identify what drives regulatory compliance costs at community banks, two related themes emerged. A majority of the interview participants discussed their increasing reliance on consultants and their dependence on service providers.[4]

The interview participants indicated that as the regulatory environment continues to change, they have become more reliant upon consultants to assist with interpreting and implementing new or changing rules and regulations. Many of the interview participants stated that their increasing reliance on consultants is driven by their inability to understand and implement regulatory changes within required timeframes and their concern that their method of compliance may not pass regulatory scrutiny. Several of the interview participants indicated that greater outreach or technical assistance from the regulatory agencies could alleviate some of their increased reliance on consultants.

With regard to dependence on service providers, each of the interview participants noted that they had contracted with at least one firm to provide products and automated processes that provide a cost-effective means of complying with certain regulations. While these service providers are considered beneficial to their bank's operations, interview participants noted that these firms have few incentives to make timely changes to their software to meet new regulatory requirements. These time delays could affect their bank's ability to comply with new or changed rules. The interview participants expressed a strong desire to comply with outstanding rules and regulations; however, they feel dependent on service providers to provide the means for

[4] Service providers assist community banks with processing financial transactions, automating business processes, managing mission-critical information, implementing regulatory requirements, and other essential business processes.

compliance. To potentially alleviate some of the effects of this dependency, the interview participants recommended that regulators communicate with service providers prior to the issuance of new regulation to ensure that these firms can provide the necessary products and services to institutions in a timely manner.

Conclusion

The goal of these interviews was to obtain specific information about what drives the cost of regulatory compliance and, where possible, actual financial data to begin to understand how regulation may affect bank performance. These interviews revealed that it is the cumulative effect of regulations and not one specific regulation that has had the greatest impact on the operations of the interview participants. Interview participants do not specifically track or report on the cost of regulatory compliance for their boards of directors. The majority of interview participants indicated that while direct costs can be more easily identified, it would be very costly to separate indirect costs from normal operational costs.

Every interview participant indicated that they understand the importance of being in full compliance with outstanding regulations and that they each spend considerable resources to achieve this. However, the interview participants felt that they would benefit from additional outreach and technical assistance from the regulatory agencies to assist them in their efforts to reduce their growing reliance on consultants and dependence on third-party service providers.