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Too Small To Succeed: Size Matters

Size in banking matters more than ever… Increasingly heightened regulatory requirements over the past 15 years have mandated increased compliance costs, which take a disproportionate toll on the profits of smaller banks that lack economies of scale. Smaller bank are becoming too small to succeed. BayBoston Capital believes that their response will be to seek consolidation.

As the FDIC noted in a 2012 community banking study, following the events of September 11, 2001, the banking industry faced new regulations under the USA Patriot Act and enhanced supervisory attention and enforcement under the Bank Secrecy Act. Then followed the financial crisis of 2008 which was responded to by the Dodd Frank Act, the development of the Consumer Financial Protection Bureau and heightened supervisory attention and enforcement of many existing federal, state and municipal laws and regulations, in particular, the Home Mortgage Disclosure Act, Truth In Lending Act, Servicemembers Civil Relief Act, fair lending laws and unfair and deceptive practices laws. And the latest challenge is the need to institute robust data security, as attacks on financial institutions have become almost an epidemic.

This new emphasis has resulted in ever increasing costs, the direct costs are:

- new compliance personnel,
- consultants to help develop appropriate policies and procedures, which require constant updating as the requirements and interpretations expand,
- lawyers to interpret the regulations,
- technology service providers to implement regulatory requirements and provide the deeper information technology and data security the new environment demands,
- data collection, maintenance and storage costs,
- new hardware and software, and
- greater external and internal audit costs.

And there are the indirect costs, including:

- greater proportion of C-suite focus shifted to regulatory issues and managing such relationship,
- non compliance employees' time devoted to compliance activities, and
- employee time devoted to compliance training.

The cumulative effect of these requirements falls disproportionately and most heavily on smaller banks.

The Federal Reserve Bank of Minneapolis, in a study published in 2013 of the costs of additional regulation on community banks concluded that the community bank's response to increased regulation "will manifest itself in lower profits, as if the bank altered its headcount." And the study also noted an additional cost to community banks – the potential for "dynamic changes in the risk-taking of banks (e.g. the bank takes on more risk in response to higher fixed costs)".

The study sought to quantify the cost of additional regulation. It found that the smaller the bank the more unbearable the cost. For instance, they found that if banks with less than $50 million in assets had to increase staff by one person, return on assets (ROA) falls by 28 basis points and if they had to increase staff by two persons, ROA falls by 45 basis points and, at that rate, 33% of the banks with assets under $50 million become unprofitable. A modest one person increase in staffing for banks with $50 to $100 million in assets leads to a fall in ROA of 11 basis points; and a one person increase in banks with $100 to $250 million in assets results in a 10.5 basis points of ROA decline.

The requirements are mounting and the costs will only increase. To preserve profitability and avoid undue risks, BayBoston believes that many community banks will seek consolidation.

References:

FDIC, "Community Banking Study", Appendix B – "Regulatory Compliance Costs. A Summary of Interviews With Community Bankers", December 2012.

Federal Reserve Bank of Minneapolis, "Quantifying the Costs of Additional Regulation on Community Banks", an Economic Policy Paper, May 30, 2013.

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