“Deposit Rate Advantages as the Largest Banks”

Stefan Jacewitz and Jonathan Pogach

Discussion by Donald P. Morgan*
Federal Reserve Bank of New York

November 2013

*My views do not necessarily represent the views of the Federal Reserve Bank of New York or the Federal Reserve System

Contribution

- First to rigorously investigate funding cost advantage for large (TBTF) banks in deposit market
  - Virtually all of literature looks at bond or equity markets.
  - Important to consider deposits as they are primary source of funds
  - Baker and McArthur (2009) did simple unconditional comparison that wasn't persuasive
- Main findings:
  - Deposit risk premium 36 bp lower at banks at $200 billion banks
    - $7.3 billion annual saving
    - 30% of 2006 pre-tax profits
  - Funding advantage disappears after deposit insurance limit lifted to $250 k in 2008:Q4.
- Convincing, though some minor concerns

Rates on insured and uninsured deposits at large banks and other banks

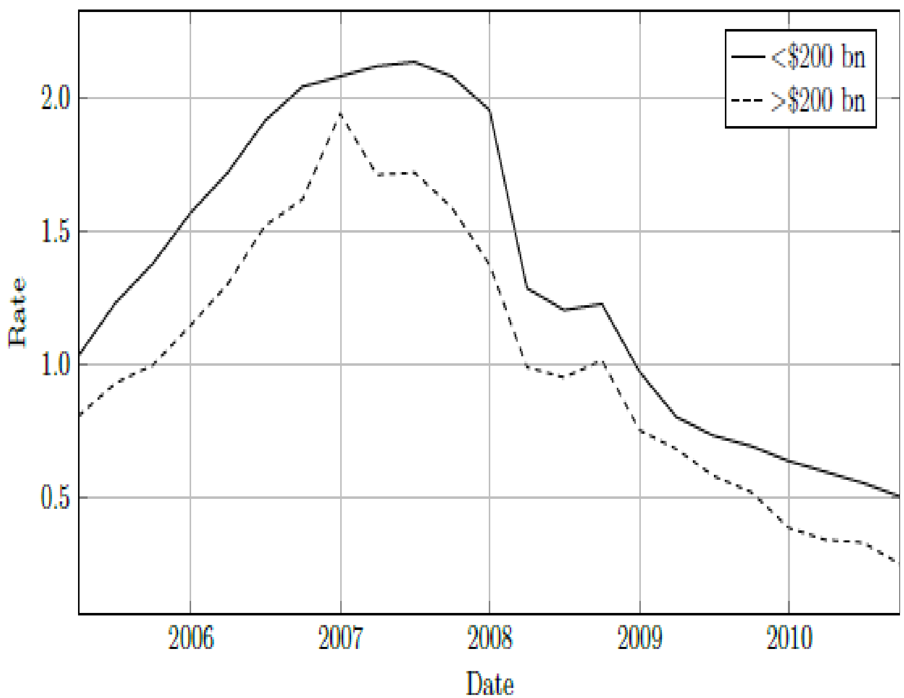

Figure 3: Mean interest rates on 25K MMDAs for Large and Other banks.

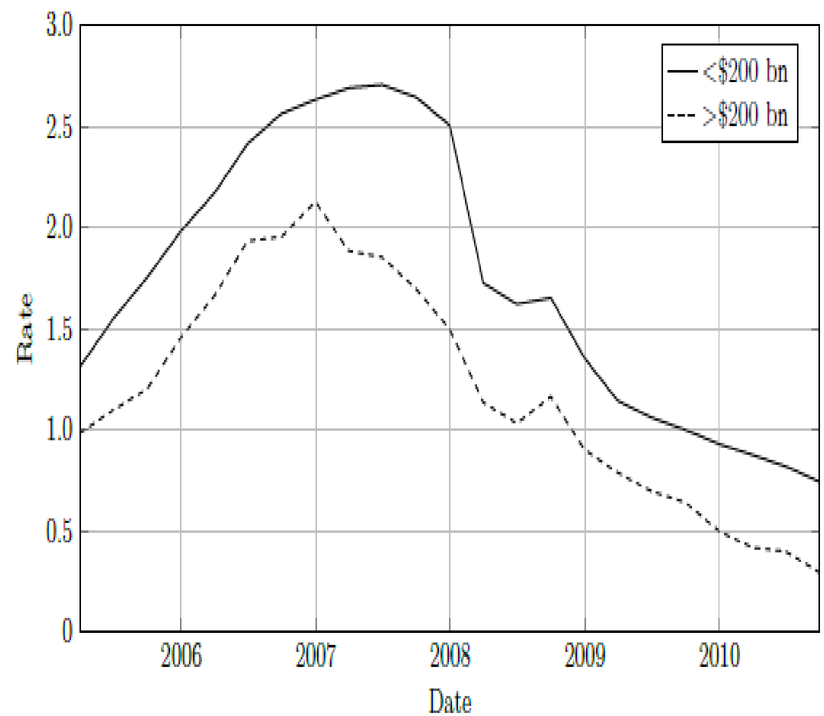

Figure 4: Mean interest rates on 100K MMDAs.

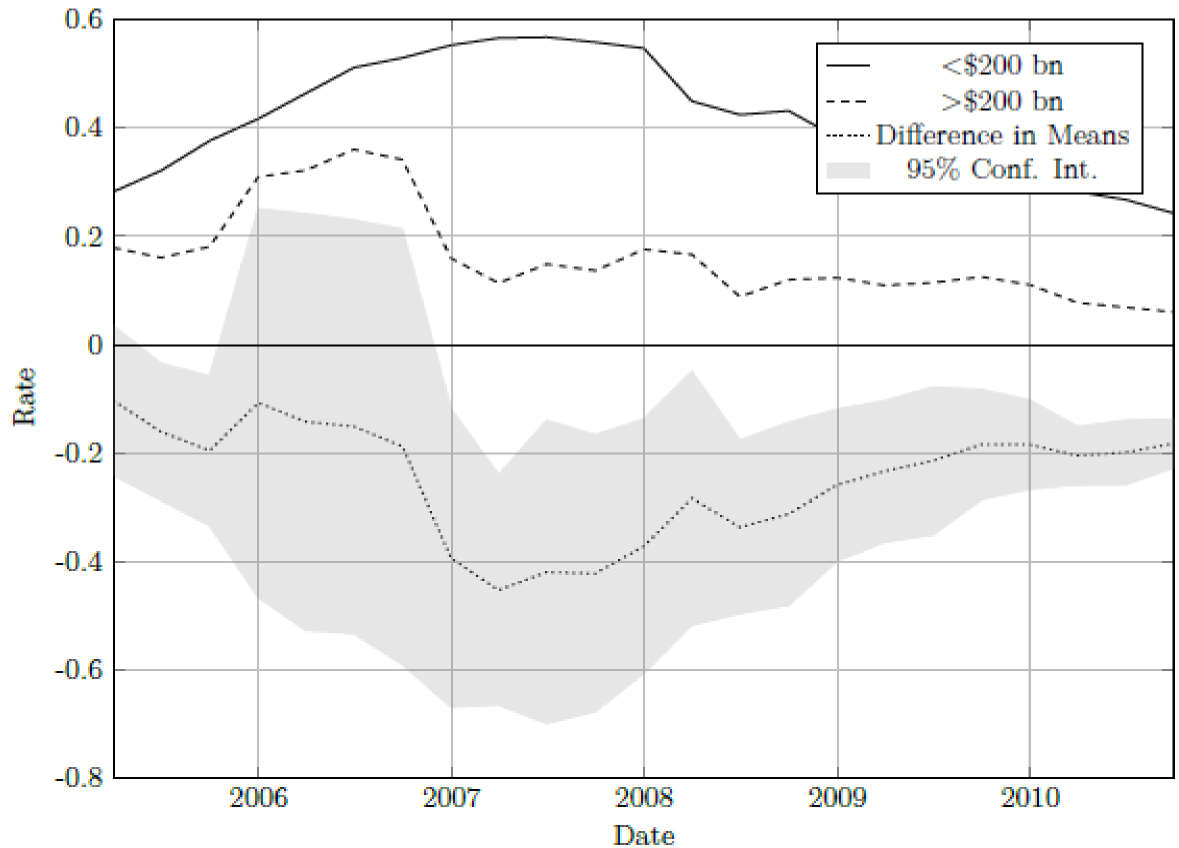

Figure 5: Mean premium on $100K MMDAs for Large and Other banks, as well as the difference. That is, the difference between the riskless $25K MMDAs and the risky $100K MMDAs. The shaded region represents the 95% confidence interval around the difference in means.

Identification

- Essentially diff-in-diff:

$$p_{small} - p_{large} = (R_{small} - r_{small}) - (R_{large} - r_{large})$$

- Identifying assumptions

  1. Error in measure of risk premium using difference between products does not differ systematically by size, *or*

  2. non-risk components of price related to being large do not differ systematically across products

- Weak assumptions

Estimate of funding advantage for banks of various size

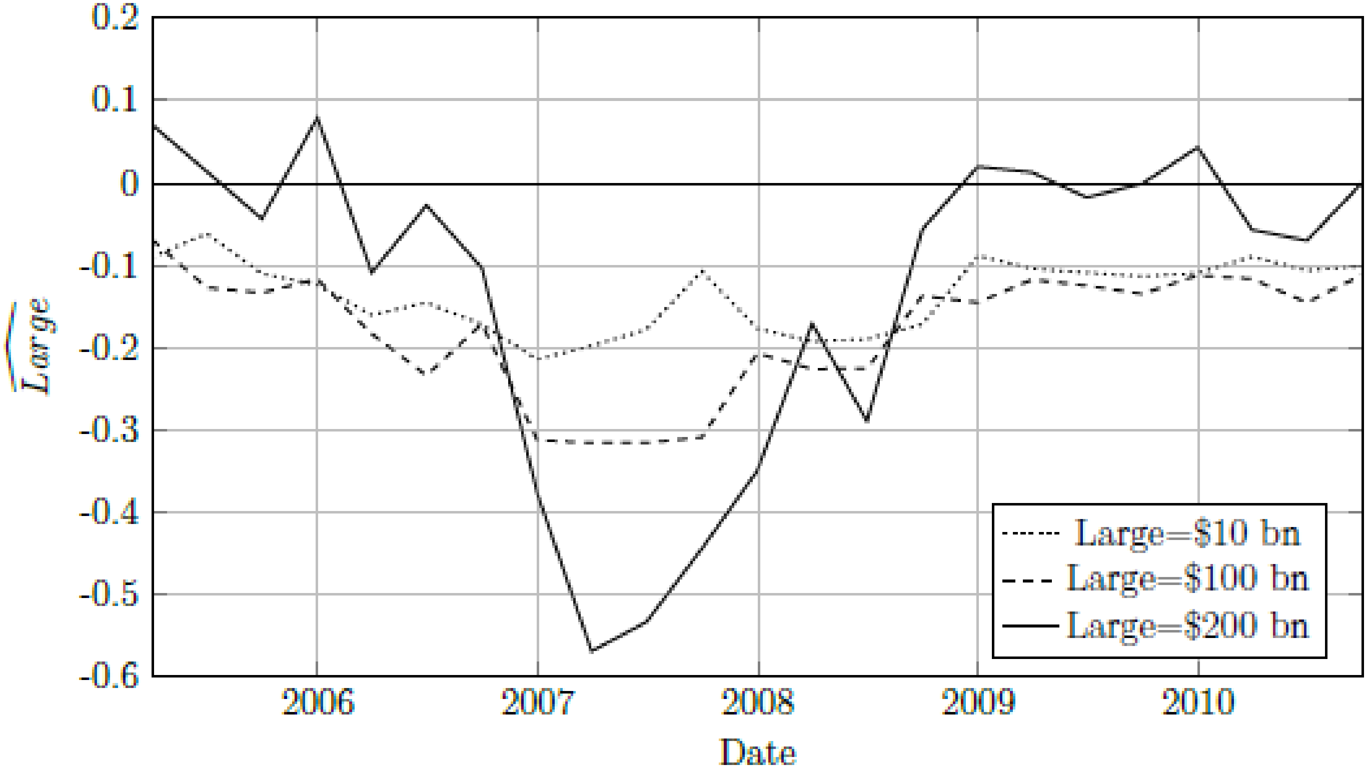

Figure 6: Cross-sectional estimated *Large* dummy parameter under different thresholds.

Omitted variable bias?

- Include long list of risk proxies:

  Equity, asset growth, NPL, loan loss reserves, non-brokered insured deposits, liquid assets, trading assets, income, growth volatility

- Few, except trading, significant
  - Suggestions: include st. dev. of income, report F test
  - May make sense: unlike bond holders, MMDA holders may not know anything about risk profile of their bank *except* size.
- If banks are opaque, risk may not be captured by call report proxies
  - Omitted variable bias if risk correlated with size
  - If big banks riskier (Demsetz and Strahan 1997), estimate of funding advantage biased downward.

Other concerns

- Size (as opposed to large dummy) insignificant
  - They take as sign dummy not picking up “generic” benefits of size
  - However, Warburton et al. find bond risk spreads decreasing in size *and* size dummies.
- Result disappears if limit sample to $1 billion banks
- Exclude the one third of sample that have zero premia
  - Results hold (attenuated) if include
  - Run probit to see if large banks more likely to post zero premia

Conclusion

- Important, largely convincing, contribution to recent literature on funding advantages for large banks

- First paper to rigorously document funding advantage on uninsured deposits

Robustness checks

- Result holds if include zero premium banks
- Holds if include banks present entire sample period
- Holds within MSA
- Holds within cities (NYC, LA, Dallas, Philadephia)
  - Not Chicago