“Deposit Rate Advantages as the Largest Banks”

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*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:

\[ p_{\text{small}} - p_{\text{large}} = (R_{\text{small}} - r_{\text{small}}) - (R_{\text{large}} - r_{\text{large}}) \]

• 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