Discussion
“Hidden Cost of Better Bank Services: Carefree Depositors in Riskier Banks”
by Dong Beom Choi and Ulysses Velasquez

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SFS Cavalcade 2017 Nashville
Summary

Interesting correlations

- Within the sample of small banks, those with a high ratio of non-interest-expense–to–asset have
  - higher ratio of “core” deposits to assets
  - less interest expenses per $ liabilities
  - lower interest rate on core deposits & total deposits
  - lower liquid asset share, lower non-loan-asset share
  - higher asset yields and net charge-off rates

Narrative of this paper

- High ratio of nonintexp/asset = high quality service provision
- High quality service → depositors monitor banks less
- Higher scope for agency conflict
- Rationalizes lower funding costs of banks with riskier assets
1. Mechanism revisited:
   1.1 Measurement & concept of deposit service quality?
   1.2 Accounting for bank business models?
   1.3 Who monitors banks?

2. Suggestion: reframe the paper to study degree of agency conflict and strength of market discipline from uninsured capital providers to banks
Measurement and concept of deposit service quality

- Non-interest expenses = 
  53% Salaries + 33% Other + 14% Fixed asset expense

- Evidence on the link between non-interest expenses and quality of deposit service?

- High salary share could be
  - direct sign of agency conflict when managers extract higher rents w/o involvement of depositors
  - associated with other business segments

- How to allocate costs across deposits and loans?

- Regression at the bank level, shows change in non-interest expenses is associated with loans, too
<table>
<thead>
<tr>
<th>Fama-MacBeth regressions</th>
<th>(Annual Change in Non-Interest Expense)/ Assets</th>
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</thead>
<tbody>
<tr>
<td>annual cross-sections</td>
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<tr>
<td>Small BHC sample</td>
<td>(1)</td>
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<td>(2)</td>
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<td>(3)</td>
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<tr>
<td>Change in Loan / Assets</td>
<td>0.46</td>
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<td>(0.03)</td>
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<td>0.23</td>
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<td>(0.04)</td>
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<tr>
<td>Change in Deposits / Assets</td>
<td>0.56</td>
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<td>(0.10)</td>
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<td></td>
<td>0.36</td>
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<td>(0.05)</td>
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<tr>
<td>$R^2$</td>
<td>0.18</td>
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<td>0.16</td>
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<td>13,250</td>
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Accounting for Differences in Business Models
High non-interest expense ratios proxy for traditional banking?

• Reinterpret:
  • higher non-interest expenses associated with traditional banking: i.e. loans and deposits
  • need branch and employees for lending business as well

• Implies
  • credit exposure sits on balance sheet rather than in form of securities, i.e. lower liquidity ratios
    • e.g. RE: MBS are guaranteed, on balance sheet mortgages not
  • conjecture: banks with higher trad-banking harder hit by crisis
  • agency conflict or unlucky business model choice?

• Check:
  • Control for loan/assets or RE loans/ assets
  • Also run regressions prior to 2007
Improve Risk-Adjustment - here w/ RWA

Risk-neutral loan pricing?
Market discipline by depositors?

- **Claim**
  - “... attenuated creditor surveillance” due to (i) more deposit insurance and (ii) less discipline through less runable debt
  - but w/ deposit insurance already no incentives to monitor or run, i.e. .FileNotFoundException additional market discipline

- **Market discipline matters but by whom?**
  - Egan, Hortaçsu, Matvos (2017): uninsured depositors matter

- **Suggestion:**
  - Investigate degree of market discipline from uninsured capital providers
Pre-Crisis Stock Market Valuation of Banks

![Graphs showing the relationship between market equity, tier-1 capital, mean quarterly ROE, quarterly unlevered ROA, and leverage (Assets / Tier1).]
Begenau & Stafford (2017): Pre-Crisis Stock Market Valuation of Abnormal Returns
Begenau & Stafford (2017): Catering to inefficient markets

- Banks with low asset performance use leverage for higher ROE
- Market values ROE

<table>
<thead>
<tr>
<th>Leverage Quintile</th>
<th>Low</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>High</th>
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<tbody>
<tr>
<td><strong>1999-2007</strong></td>
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<tr>
<td>Mean abnROA</td>
<td>2.59</td>
<td>-0.89</td>
<td>-0.15</td>
<td>-0.38</td>
<td>-0.91</td>
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<tr>
<td>t - statistic</td>
<td>(4.20)</td>
<td>(-2.20)</td>
<td>(-0.30)</td>
<td>(-1.01)</td>
<td>(-1.35)</td>
</tr>
<tr>
<td>Mean ROE</td>
<td>2.90</td>
<td>3.17</td>
<td>3.29</td>
<td>3.58</td>
<td>3.83</td>
</tr>
<tr>
<td>Mean Multiple</td>
<td>1.87</td>
<td>1.93</td>
<td>2.01</td>
<td>2.15</td>
<td>2.44</td>
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Conclusion

- Nice paper with lot’s of interesting correlations
- Potential for different narrative
  - Widely believed that deposits are a great source of funding
  - Traditional banking (i.e. loans funded by deposits) might in fact be very costly
  - Authors highlight lower ROA at banks with high non-interest expense ratios
- Exciting research questions
  - How much market discipline is there for banks?
  - How costly are banks’ business models
- Would like to see how much of the R2 in the regressions can be attributed to non-interest expenses alone
- Would like to see the interaction of size and non-interest expense in the regressions. Is it that larger banks
- Why should “more service” only attract core depositors?
- Interest rate differentials might be a sign of market power
  - Finding: higher non-interest expenses associated with higher spread between $r_{non-core} - r_{core}$
  - Reinterpret: higher expenses & more branches associated with higher market power
    - different deposit accounts affected differently by market power can generate spread
    - control for deposit market power, e.g. Drechsler, Savov, and Schnabl (2014)
- Check also 2014 paper by Vladimir Yankov on deposit competition and asymmetric response to monetary policy
• Try risk-adjustment with risk weighted assets