

Dodd-Frank's Federal Deposit Insurance Reform

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Two contradictory views on the Dodd-Frank Act and the health of community banks

- Harmful to the welfare of community banks
 - Increased compliance costs
 - Some academic support consistent
- The Council of Economic Advisors just put out a report suggesting that the Act has not been detrimental to community bank performance



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Our contribution: Focus on Deposit Insurance Reform

- Rather than focus on the whole, we focus on one narrow aspect of the Act, being its impact on deposit insurance and primarily the pricing that community banks must pay for the coverage



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Why should community bankers care about the Dodd-Frank Act (DFA) and Deposit Insurance Reform?

In addition to increasing the deposit insurance limit to \$250,000, the Act formally differentiated between large banks and smaller, community banks.

Once the DIF surpassed the 1.15% (just accomplished) threshold the Act mandates that banks larger than \$10 billion in total asset pay proportionately more for increasing ratio to 1.35%.

Most importantly for our purpose, the Act changed assessment measures, both the measurement of bank risk was changed from domestic deposits to total liabilities, and the Act lowered assessment rates as the risk measure increased, so as to not raise increased aggregate premiums.

Research question: How much did the DFA reform of deposit insurance assessments indeed help community?





How does changing assessment measures help community banks?

- First, the Act indicated that no more monies should flow to the FDIC with this change. This necessitates a simultaneous reduction in assessment rates.
- Second, the funding models of community banks and non-community banks are drastically different. The expansion of the assessment base was relatively smaller for community banks.



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Community banks rely much more on deposits as a funding source than larger, non-community banks

- Congress and the FDIC knew about the difference in funding sources (2nd Q 2009 special assessment experience)
- They knew full well that this proposed change would help community banks at the expense of larger, non-community banks.
 - Community bankers should be celebrating the fact that the U.S. congress recognized their uniqueness and tried to benefit them.



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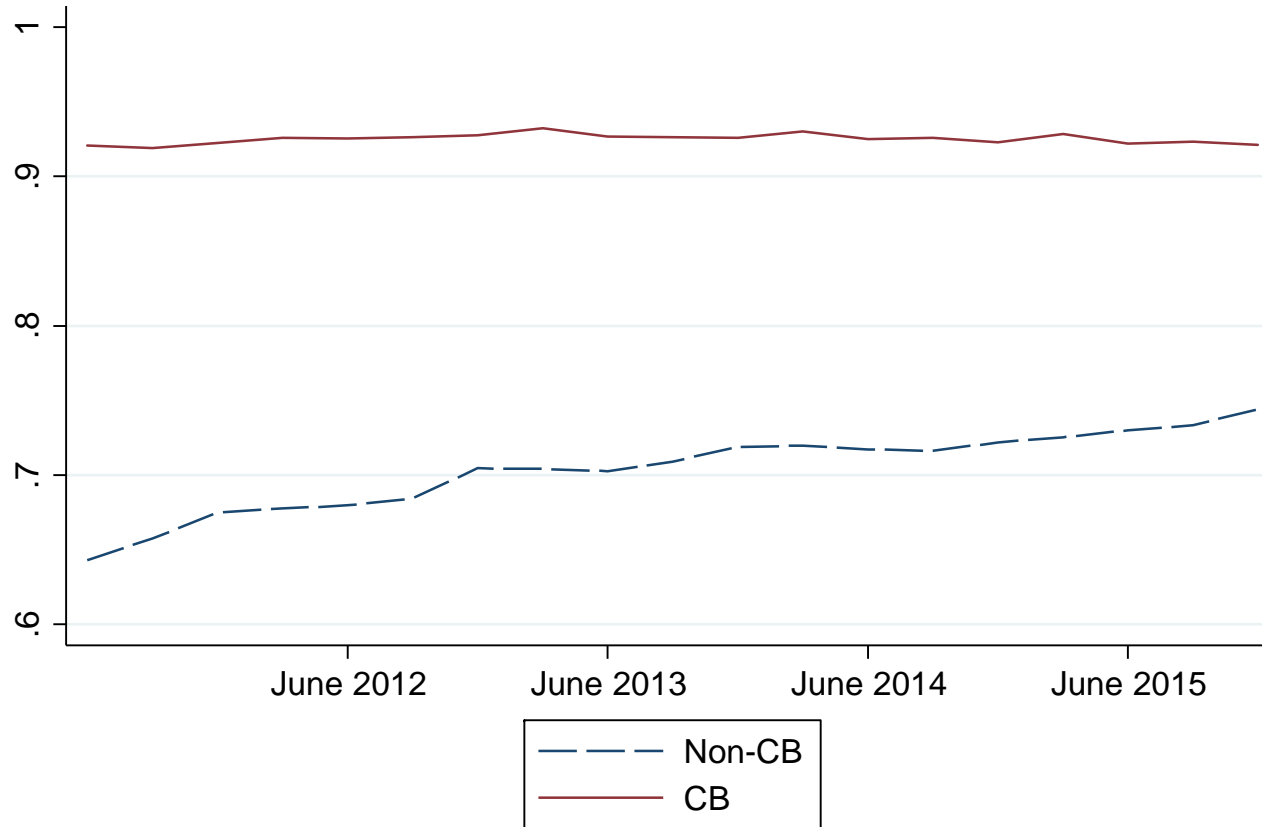
Difference in non-equity funding of U.S. Banks

- In 2011, for all federally-insured institutions, approximately 31% of funds came from non-domestic deposit sources.
 - In contrast, using the FDIC identifier for community banks, only 8% of their funds were from similar non-domestic deposit sources.
 - Bifurcating all banks into community and non-community, the latter fund 34% of their non-equity funding from non-deposit sources, against which levies would now be applied.





Domestic Deposits / Total Liabilities



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Our simulation results: Assume Lower Assessment Rate

- We simulate what banks would pay under the new assessment base versus the old assessment base, assuming that the new assessment rate is 68.4% of the old assessment rate.
 - Since community banks fund only 8% of their non-equity sources from the newly levied non-deposit category, the fact they are now assessed turns out to be relatively small in comparison to the fact that 92% of their funding has a lower assessment rate.
 - This is exactly opposite for non-community banks.



Comments on Simulation

- We *have to simulate* these expenses in large part because the FDIC chooses not to make public individual bank premiums, since these are also determined by the idiosyncratic risk of each institution.
- We ignore any changing risk profile of banks in our simulations, since we are not privy to data indicating the risk of individual financial institutions.
 - We implicitly assume that all banks maintain the same average risk profile over our simulation period as observed in the second quarter 2011.
 - We also ignore the creation of a new risk category labeled “large, and highly complex institutions”.



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Estimates of Initial Gain

- Taking the universe of all FDIC insured depository institutions and separating them into community banks, as identified by the FDIC, and non-community banks:
 - Community banks, after the reform, paid approximately \$700 million less over the first year of implementation, than they would have paid without the reform.
 - By construction, non-community banks were estimated to pay more with the reform, by the same approximate amount.



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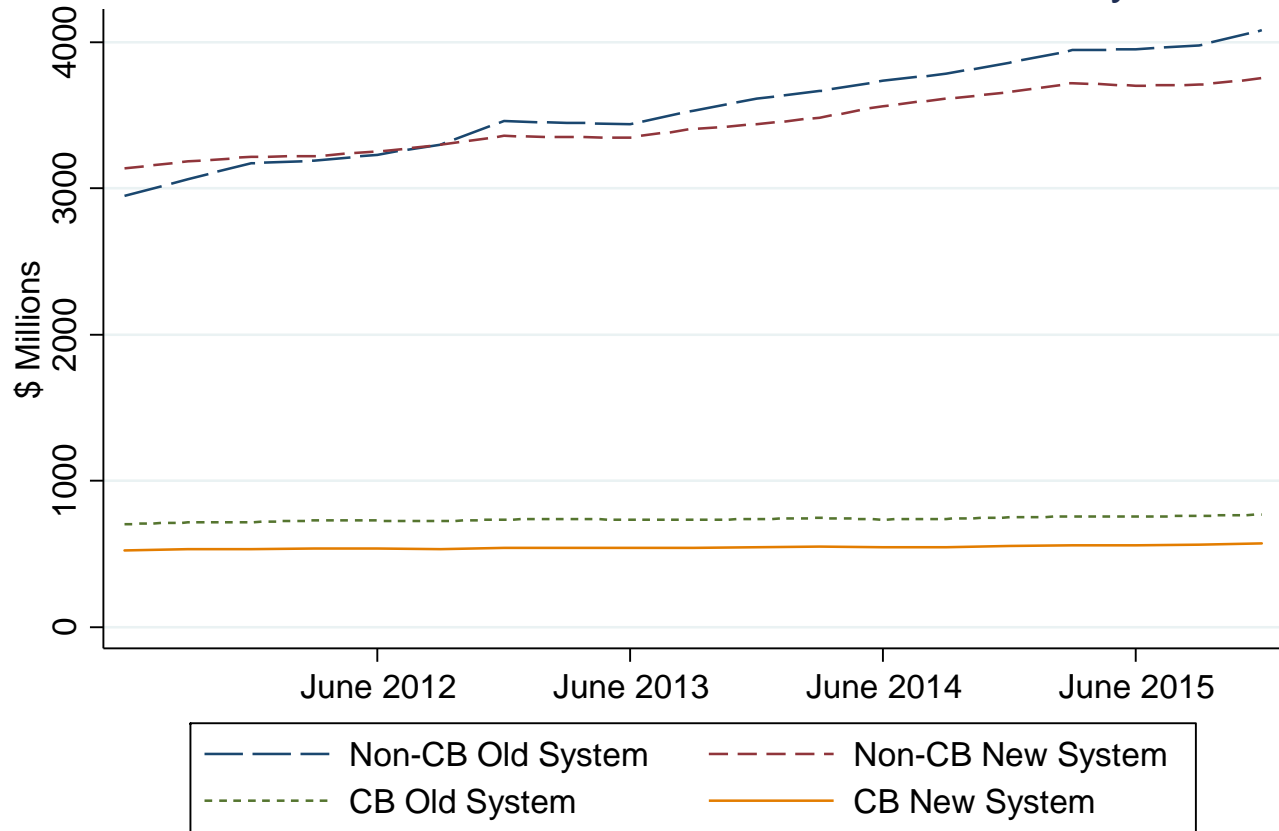
Subsequent Estimates of Gain/Loss

- On average, community banks paid approximately \$190 million less in FDIC insurance premiums on a quarterly basis from the second quarter 2011 through the fourth quarter 2015, for **a total \$3.7 billion** reduction in payments.
- The initial prior that this benefit was equally matched by an increased cost to non-community banks was not borne out, as these banks changed their relative funding to entail relatively more deposit funding.
 - The change in relative funding occurred quickly. Non-community banks one year after the implementation of the reform were no longer paying more than they would have under the old system.



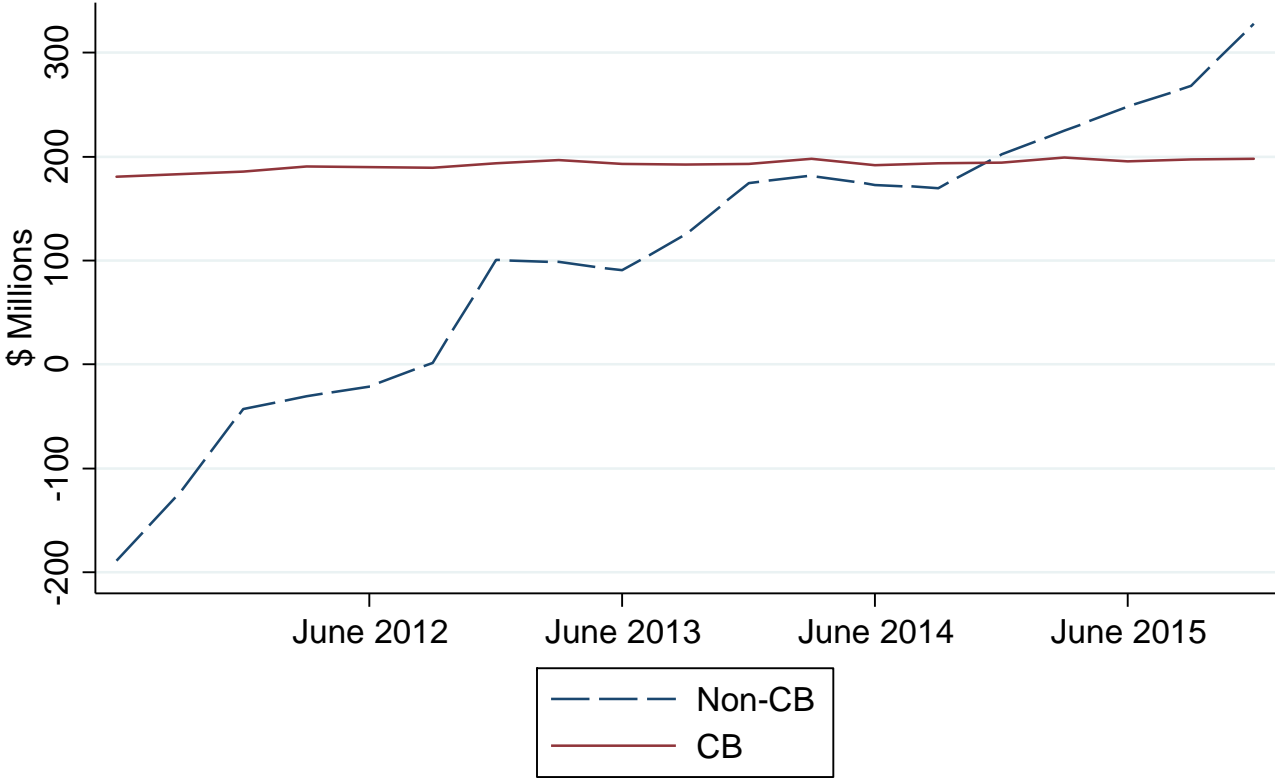


Total Premiums Paid Under the Old and New Systems



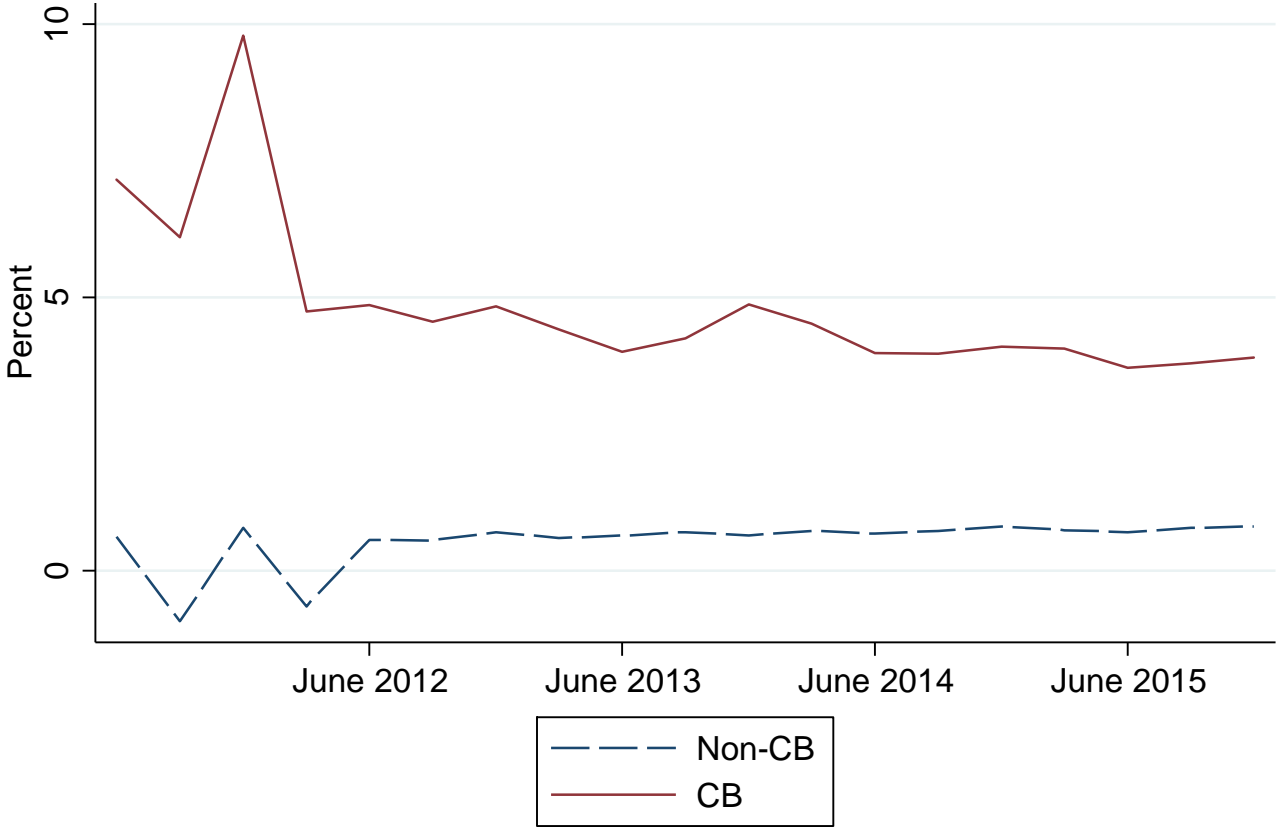


Quarterly Savings Old System Premiums - New System Premiums





Quarterly Savings as a Percent of Net Income





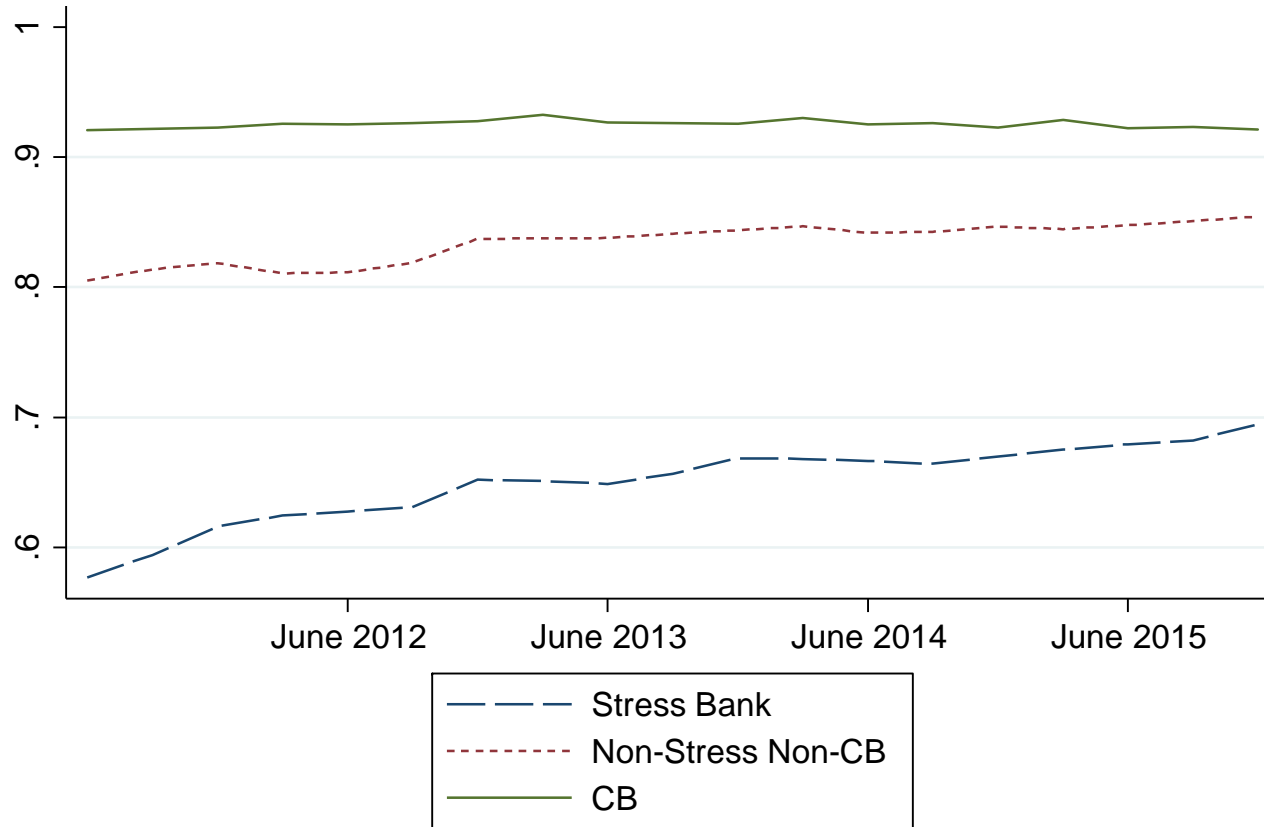
Dichotomizing Non-community banks

- We separate non-community banks into those 19 originally stressed tested and all others.
 - We observe that it is only the stress-tested banks that saw increased premiums paid after the reform.
 - Suggesting the non-stress tested banks also utilize sufficient deposit funding to benefit by the reform.
 - Interestingly, by the 4th Q 2015, even the stress-tested banks were utilizing non-deposit funds relatively less so they are now benefitting from the reform.





Domestic Deposits / Total Liabilities



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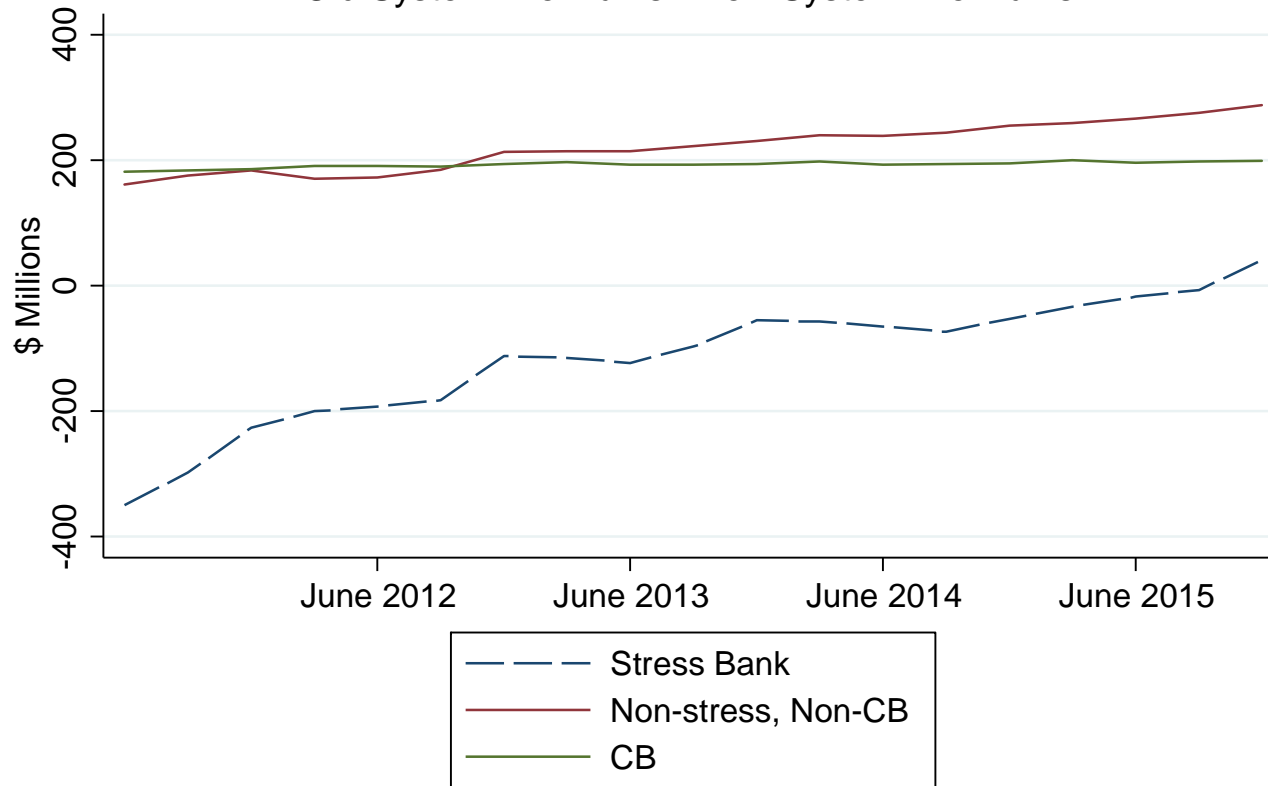
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Quarterly Savings

Old System Premiums - New System Premiums



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Conclusion

- Policy/regulatory changes can and do influence behavior. One should not assume that all initial responses after policy moves will be permanent.
 - Good practice to enumerate anticipated effects and unintended consequences (e.g. DIF not growing as rapidly after the change).
- Community bankers should recognize they won one battle with Dodd-Frank in the guise of deposit insurance reform. (They still might have lost the war!)
 - For the first time, the U.S. Congress appeared to recognize their uniqueness in actions, as well as words.
 - The gains to community banks in lowered deposit insurance premiums seem to have been permanent, but the benefits appear tempered some by the fact that the DIF has itself grown more slowly with the reform.





Conclusion II

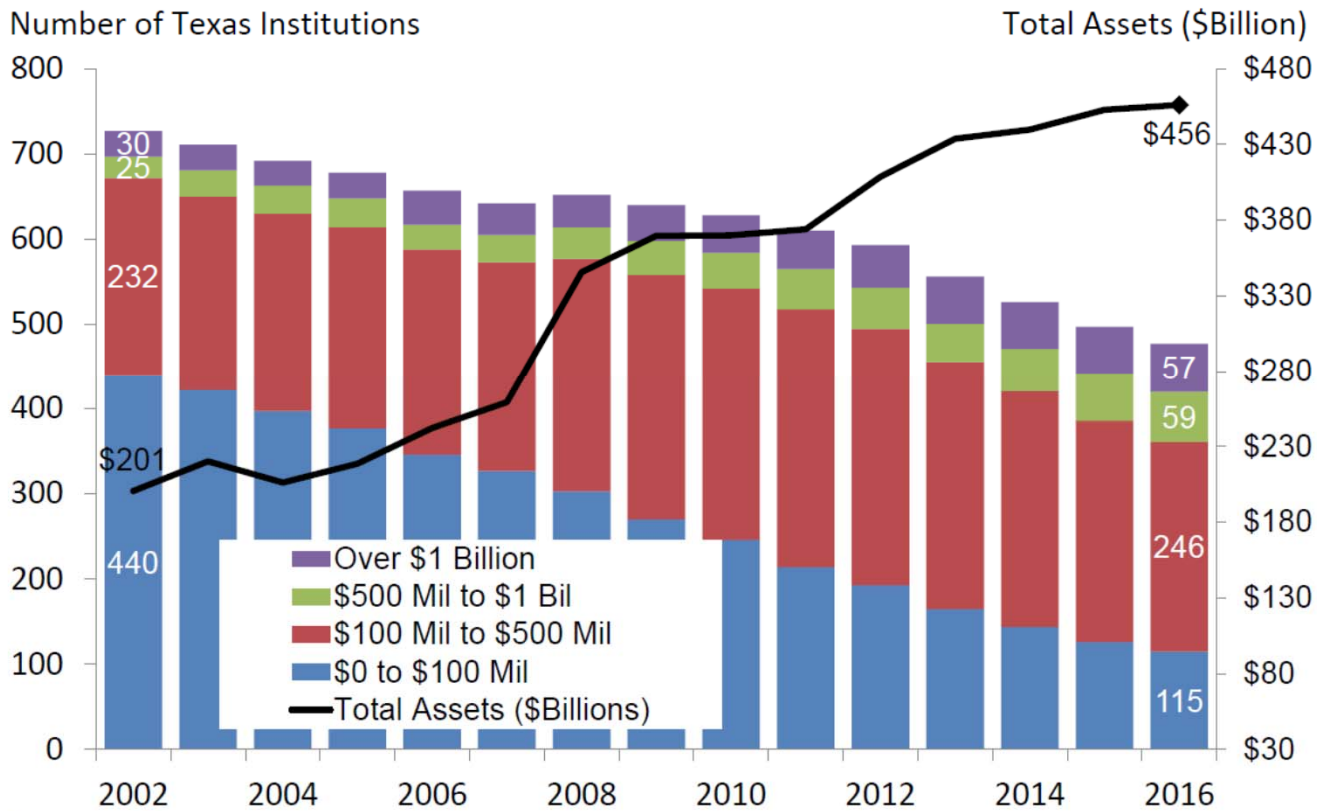
- Advice for Banking researchers
 - Use the FDIC’s careful distinction of community banks, rather than simply relying on some arbitrary total asset size benchmark to differentiate between community banks and non-community banks.
 - The benefit is that this will allow studies to be more directly comparable to one another.



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Industry consolidation marches on. While some grow into larger banks, the smallest banks are the most frequent M&A targets.



Source: FDIC.

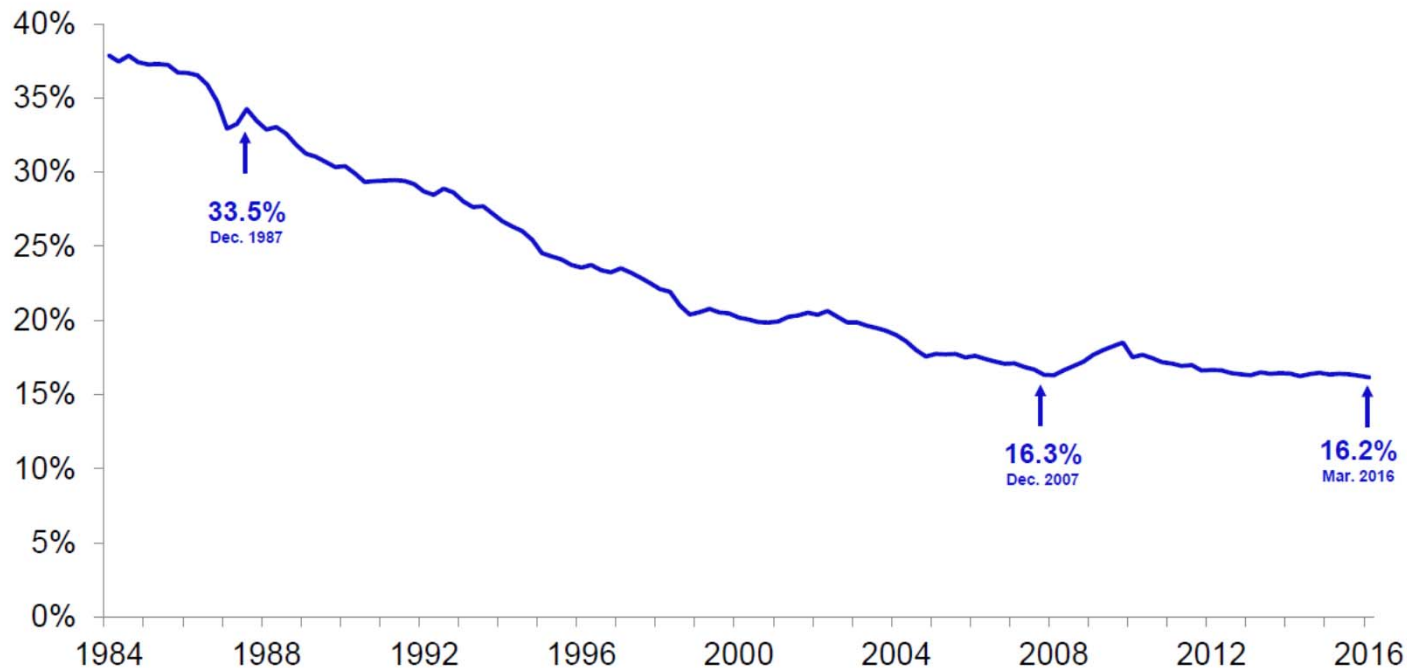
Note: Data are from first quarter of each respective year.





After losing half of their share of banking industry loans in the 20 years leading up to the crisis, U.S. community banks have seen their market share remain virtually unchanged since December 2007.

Community Bank Share of U.S. Bank and Thrift Total Loans and Leases



Source: FDIC. Per the FDIC research definition of the community bank (2012).

