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The National Depositor Preference Law

by James B. Thomson

The national depositor preference law was added to the 1993 budget act to reduce the government's cost of providing deposit insurance. A careful look at depositor preference and its attendant effects suggests that it will provide only minor cost savings. In fact, in some cases it could increase the Federal Deposit Insurance Corporation's losses from bank failures.

Last August 10, Congress passed the Omnibus Budget Reconciliation Act of 1993 (OBRA93). Contained in this legislation was a provision that dramatically revised the priority of claims on failed depository institutions. The Act's effect was to give depositors (and, by implication, the Federal Deposit Insurance Corporation [FDIC]) a superior, or preferred, claim on a failed bank's assets relative to that of other general creditors. By doing so, Congress hoped to reduce the FDIC's losses from bank failures. In fact, the Office of Management and Budget estimated that a national depositor preference law could cut the FDIC's expected losses by $1 billion over the next five years.[1]

Being buried in a much larger piece of legislation, depositor preference received little public attention and was passed with almost no debate. This is unfortunate, because economic policies often have unintended, secondary effects that dominate the intended ones. In the case of depositor preference laws, the general creditors of banking firms are likely to take action to protect their claims. As a consequence, the loss exposure of the FDIC could actually *increase*.

In this article, we take a critical look at depositor preference. The first section outlines the new legislation and the FDIC's implementation of it, and the second examines the way in which depositor preference restructures a bank's liabilities. We then examine the possible reactions of nondeposit creditors to this restructuring and discuss the implications for policy.

The Legislative Provisions

Title III of OBRA93 instituted depositor preference for all insured depository institutions by amending Section 11(d)(11) of the Federal Deposit Insurance Corporation Act.[2] The amendment establishes the following priority of payment in resolving failed depositories:

1. Administrative expenses of the receiver
2. Deposit liabilities
3. General or senior liabilities
4. Subordinated obligations
5. Shareholder claims

Prior to passage, general or other senior liabilities had the same priority of payment as deposits. As before, secured creditors of the failed institution will have their claims satisfied first, up to the amount of the collateral. This is an important detail, since one avenue for general or senior creditors to pursue in reaction to depositor preference laws is to take collateral to protect their claim.

On August 13, 1993, the FDIC issued an interim rule interpreting the depositor preference amendment.[3] The importance of this rule is that it clarifies what the FDIC will consider as administrative expenses of the receiver. Under the FDIC's interpretation, these include "post-appointment obligations incurred by the receiver as part of the liquidation of an institution ... and certain expenses incurred prior to the appointment of the receiver."[4] In other words, the receiver (which for most banks and thrifts is the FDIC) may pay expenses it deems consistent with the orderly closure of the institution, even

A SIMPLE BANK BALANCE SHEET

Assets	Liabilities with No Depositor Preference
Collateral (CA)	Collateralized claims (CC)
General assets (GA)	Senior claims (SC)
	Insured deposits (FDIC)
	Uninsured deposits (UD)
	General creditor claims (GCC)
	Subordinated debt claims (SDB)
	Equity (E)
	Liabilities with Depositor Preference
	Collateralized claims (CC)
	Deposit claims (SDC)
	Insured deposits (FDIC)
	Uninsured deposits (UD)
	Other senior claims (OSC)
	General creditor claims (GCC)
	Subordinated debt claims (SDB)
	Equity (E)

if those expenses were incurred prior to closure. These pre-receivership costs include payment of the institution's last payroll, guard services, data processing services, utilities, and leases. Examples of expenses that would be excluded from administrative expenses are items such as golden parachute claims, severance pay claims, and liabilities arising from the repudiation of contracts.

One issue not addressed by the interim rule is the status of deposits in foreign branches of insured depositories. Such deposits are excluded from the assessment base of the FDIC and thus, for purposes of deposit insurance, are different from domestic deposit claims. Consequently, a reasonable interpretation of the depositor preference statute is that foreign depositors are considered general creditors.[5] It is possible that the FDIC's final ruling will reflect this view.

■ A Simple Look at Depositor Preference

To understand the impact of depositor preference, it is useful to look at a simple example of the bank receivership process both before and after passage of OBRA93.[6] We assume here that the administrative claims of the receiver have already been paid. Above, we show a simplified bank balance sheet with and without depositor preference. Liabilities are listed in order of priority of payment.

When a depository enters receivership, secured creditors take possession of the specific collateral securing their claim. For simplicity, we assume that collateral equals collateralized claims (CA = CC), so that the value of the collateral exactly exhausts the claims of the secured creditors.[7] Without depositor preference, the general asset pool (GA) is used first to pay the claims of senior creditors. If this amount is less than the general asset pool, then the residual funds (GA – SC) are used to meet the claims of the junior (subordinated) creditors, with any remainder accruing to equityholders. If, however, senior creditor claims exceed the value of the institution's assets, then each senior claimant will share in the shortfall in proportion to his claim. That is, each will receive W_i*(GA) in payments, where W_i is the percentage of total senior claims accounted for by the i^{th} senior creditor (i = FDIC, uninsured deposits [UD], and general creditor claims [GCC]).

To see how depositor preference is intended to work, consider the following example. Let the value of collateralized assets and collateralized claims be equal. Furthermore, let the total general asset pool equal $10 million and senior claims equal $12 million, distributed as follows: insured deposits (FDIC) = $8 million, uninsured deposits = $3 million, and general creditor claims = $1 million.[8] The proportion of senior claims by type are W_{FDIC} = 0.6667 (8/12), W_{UD} = 0.25, and W_{GCC} = 0.0833. Since senior claims exceed the general asset pool by $2 million, senior creditors are not repaid in full: Each loses $0.17 per dollar of claim. Without depositor preference, total payments to senior creditors are $6.667 million to the FDIC, $2.500 million to uninsured depositors, and $0.833 million to general creditors (see table 1).

Under depositor preference, general creditor claims would be paid after those of both the uninsured depositors and the FDIC (see box). Therefore, after netting out the collateralized claims, the available general asset pool is used first to satisfy the claims of depositors, with any remaining funds going to satisfy the claims of the other senior creditors and then the subordinated debtholders. Using numbers from the above example, we can see the intended effect of depositor preference. Depositors' claims (the FDIC and uninsured depositors) equal $11 million. By giving each a higher priority of payment in receivership, general creditor claims now provide them with a loss buffer. Since general assets equal $10 million, the FDIC and uninsured depositors will exhaust the asset pool. Losses per dollar of deposit are $0.09, 45 percent less than without depositor preference. For comparison purposes, payments are $7.273 million to the FDIC, $2.727 million to uninsured depositors, and $0 to general creditors. Depositor preference reduces the losses of the FDIC and uninsured depositors by redistributing wealth to them from the general creditors.

■ Unintended Effects of Depositor Preference

The above example illustrates how depositor preference is intended to work. However, general creditors of insured depositories will certainly respond to the changes in the priority of their claims and the attendant increase in riskiness. At the very least, they will charge the depository institution a

TABLE 1 PAYMENTS TO SENIOR CLAIMANTS (Millions of dollars)

	No Depositor Preference (GA = $10 Million)		Depositor Preference: Intended Outcome (GA = $10 Million)		Depositor Preference: Unintended Outcome (GA = $9.16 Million)	
Claimant	W_i	Payment	W_i	Payment	W_i	Payment
FDIC	0.6667	$6.667	0.7273	$7.273	0.7273	$6.662
UD	0.2500	$2.500	0.2727	$2.727	0.2727	$2.498
GCC	0.0833	$0.833	—	$0.000	—	$0.000

NOTES:
W_i = Weight of the i^{th} claimant in the general asset pool.
GA = General asset pool remaining after secured creditors' claim.
FDIC = Federal Deposit Insurance Corporation's claim.
UD = Uninsured depositors' claim.
GCC = General creditors' claim.
SOURCE: Author's calculations.

higher rate of interest to compensate for their increased risk of loss. As the cost of nondeposit funds rises relative to deposits, depositories will decrease their funding in nondeposit markets. Thus, the loss buffer that nondeposit creditors afford to uninsured depositors and the FDIC will be reduced.

A second possible response by senior nondeposit creditors would be to shorten the average maturity of their claims. By doing so, they would enhance their ability to "run" on the institution if its condition deteriorates. In fact, financially distressed depositories may find it difficult or even impossible to issue unsecured nondeposit claims. This response has two implications: First, if nondeposit creditors can effectively exit a troubled institution before it is closed, little or no loss cushion will be afforded to the uninsured depositors or the FDIC by the general creditors. Second, the failure of nondeposit creditors to renew their claims could trigger a liquidity crisis that would result in closure of the institution.[9]

The third option for unsecured creditors is to take collateral against their claim. By becoming secured creditors, they transform their claim into one that is senior (to the extent of the collateral) to deposit claims. This in turn will have two effects on the claims of uninsured depositors and the FDIC. First, the loss buffer afforded by general creditor claims will be reduced. Second, and more important, the general asset pool available to pay unsecured claims will also shrink. If enough general creditor claims take collateral, the total loss exposure of the FDIC and uninsured depositors could increase.

To see this, consider the example in the previous section. If $840,000 of general creditor claims become fully secured (that is, 100 percent collateralized) in response to the depositor preference law, then the general asset pool available to pay the FDIC and uninsured depositors would be $9.16 million. The total payouts would then be $6.662 million to the FDIC, $2.498 million to uninsured depositors, and $0 to general creditors. As a result, depositor preference would increase the losses of the FDIC and uninsured depositors by $5,000 and $2,000, respectively.

A recent study of state depositor preference laws finds that the unintended effects negate most of the intended ones.[10] The authors conclude that introducing depositor preference at the federal level "would sharply increase the use of collateralization by nondeposit creditors...." They also show that the highest degree of collateralization by nondeposit creditors in states with depositor preference laws is in troubled and insolvent thrifts. Overall, the study concludes that depositor preference may provide marginal benefits to the deposit insurer and uninsured depositors, but it also warns that each could experience higher losses if enough nondeposit creditors secure their claims by taking collateral.

■ Conclusion

The overall impact of national depositor preference is likely to be minimal. Clearly, the law will result in some changes in the liability structure of banks. Depositors and the FDIC will benefit from these changes to the extent that nondeposit creditors serve as a loss buffer when a bank is closed. The FDIC may also gain in another way. Deposit insurance premiums are assessed only on domestic deposits. Since depositor preference raises a bank's cost of nondeposit funds relative to deposits, it reduces the advantages of issuing senior nondeposit liabilities to avoid deposit insurance assessments. This is especially true if foreign deposits are classified as nondeposit liabilities under the new law.

On the flip side, nondeposit creditors will not react passively to the subordination of their claims. This means that while depositor preference may produce some cost savings for the FDIC in the short term, the long-term benefits are likely to be greatly diminished. Moreover, if a sufficient number of nondeposit creditors take collateral and hence convert their claims to ones senior to deposits, the losses of uninsured depositors and the FDIC could actually increase.

Footnotes

1. The Office of Management and Budget's estimate can be found in Statement 98 of the Shadow Financial Regulatory Committee, "The New Depositor Preference Legislation," issued September 20, 1993.

2. 12 U.S.C. 1821 (d)(11). At the time national depositor preference was enacted, 29 states had similar laws covering state-chartered banks and 18 had statutes covering state-chartered thrift institutions.

3. The interim rule was issued because the law went into effect immediately upon enactment of the legislation. Thus, the FDIC did not have the luxury of issuing a rule for comment and then implementing a revised version. See *Federal Register*, vol. 58, no. 155 (August 13, 1993), pp. 43,069 – 070. At the time of this writing, the FDIC had not issued its final ruling.

4. Ibid.

5. In fact, the Shadow Financial Regulatory Committee adopted this interpretation. See "The New Depositor Preference Legislation" (footnote 1).

6. For a more thorough presentation of how depositor preference affects the cost of capital for banks and federal deposit insurance, see William P. Osterberg and James B. Thomson, "Depositor Preference and the Cost of Capital for Insured Depository Institutions," Federal Reserve Bank of Cleveland, Working Paper 9405 (forthcoming).

7. If CA > CC, then the excess collateral (CA – CC) is dumped into the general asset pool for distribution to noncollateralized creditors. If CC > CA, then the ex post unsecured claims (CC – CA) are lumped into the senior claim pool as a general creditor.

8. The FDIC guarantees the principal and interest of all deposit accounts up to $100,000. When a bank enters receivership, it is appropriate to think of the FDIC as paying off the insured depositors in exchange for their claim on the institution's assets. Hence, our discussion of how depositor preference works refers to deposits as uninsured depositor claims and FDIC claims.

9. The decision to close a bank is based on one of two measures of solvency: the incapacity to pay obligations as they mature or book-value balance-sheet insolvency. Inability to renew nondeposit credits could trigger insolvency under the maturing obligations test. See James B. Thomson, "Modeling the Bank Regulator's Closure Option: A Two-Step Logit Regression Approach," *Journal of Financial Services Research*, vol. 6, no. 1 (May 1992), pp. 5–23.

10. See Eric Hirschhorn and David Zervos, "Policies to Change the Priority of Claimants: The Case of Depositor Preference Laws," *Journal of Financial Services Research*, vol. 4, no. 1 (March 1990), pp. 111–26.

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