Statement No. 98

For information contact:

George G. Kaufman
(312) 915-7075

Kenneth E. Scott
(415) 723-3070

Statement of the Shadow Financial Regulatory Committee on

The New Depositor Preference Legislation

September 20, 1993

A major revision in the priority order in which uninsured claims on failed banks are paid was contained in the Omnibus Budget Reconciliation Act of August 10, 1993. The provision stipulates that claims of depositors at domestic branches of FDIC insured banks (and claims of the FDIC as subrogee after paying off insured deposits) have preference over other claims in distributions from all future receiverships. (Some 30 states have had similar provisions for state chartered banks.)

Previously, domestic depositors had the status of general creditors at failed national banks, the same status as depositors at foreign branches of U.S. banks and other creditors, including sellers of federal funds.

Depositor preference was included in the Act during the legislative process as a replacement for the Administration’s proposal to raise additional revenues by charging state-chartered banks for examinations by the FDIC. The Office of Management and Budget estimated that by raising the priority ranking of the FDIC, the depositor preference provision would reduce anticipated FDIC losses by as much as $1 billion over the next five years. Because
the banking provision was a small amendment in a very large and complex nonbanking act, it received relatively little public attention.

Although in the short-run the FDIC could experience smaller losses under the new law, the longer-run dynamic implications are less clear. Because foreign depositors, federal funds sellers, and other creditors are now at greater risk, they may in time be expected to act to protect themselves to a greater extent. For example, foreign depositors and general creditors can:

- require collateral, to the extent legally allowed, to secure their extensions of credit;

- shorten the maturity of their deposits or obligations, or insert put options which can be exercised when a bank's credit rating is downgraded by a rating agency;

- demand higher returns to compensate for higher risk, or cease dealing at all with more risky banks.

Such actions would affect the risk position of FDIC as insurer. In response, FDIC could:

- redesign its calculation of deposit insurance premiums, to take account of the amount of senior and junior claims as newly defined;

- redesign its calculation of capital and capital requirements, for the same reasons;

- intervene or close banks more quickly (because of the greater likelihood of runs of federal funds or foreign deposits) or less quickly (because of the greater degree of insolvency necessary to inflict a loss on the insurance funds).

As uninsured claimants, banks, and the FDIC take reactive measures, other consequences may ensue. In banks with extensive federal funds and foreign deposits, the premiums for FDIC insurance will be higher than the risk to the insurance fund. Such banks would seek to restructure their contractual arrangements and organizations to reduce the implicit tax. And uninsured domestic depositors might be led to shift funds from smaller banks to large money center banks that are seen as safer because they are
funded with a greater proportion of subordinated foreign deposits and federal funds.

Moody's has already given formal recognition to some of the implications of the new law by creating a separate rating category for bank obligations to nondomestic depositors and other creditors than for obligations to domestic uninsured depositors. For poorly rated banks, Moody's has assigned a lower rating to these other senior obligations than to uninsured domestic deposits.

The full range of important long-run implications of the new depositor preference provision received little attention in the Congressional hearings, unlike the long and thorough hearings held throughout 1991 for the deposit insurance reform provisions of FDICIA. Although the Committee does not take a stand on the ultimate consequences of the deposit preference provision, it wishes to call attention to the dangers of enacting important legislation in haste on the basis of a consideration of static short-term effects without exploring potential longer-run implications.