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

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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

Narative of this paper

- High ratio of nonintexp/asset = high quality service provision
- High quality service $\rightarrow$ depositors monitor banks less
- Higher scope for agency conflict
- Rationalizes lower funding costs of banks with riskier assets

Discussion

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

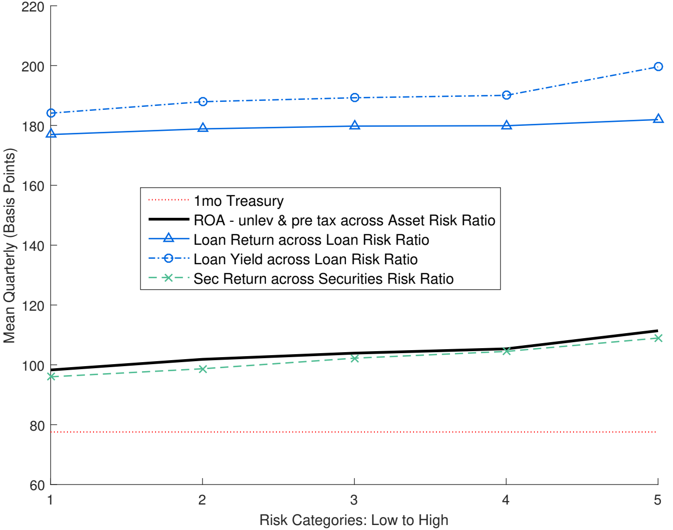
Change in non-interest expense due to loans & deposits

Fama-MacBeth regressions annual cross-sections Small BHC sample	(Annual Change in Non-Interest Expense)/ Assets (1)	(2)	(3)
Change in Loan / Assets	0.46 (0.03)		0.23 (0.04)
Change in Deposits / Assets		0.56 (0.10)	0.36 (0.05)
R^2	0.18	0.16	0.20
Time FE	Y	Y	Y
Controls	Y	Y	Y
Obs	$13,250$	$13,250$	$13,250$

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

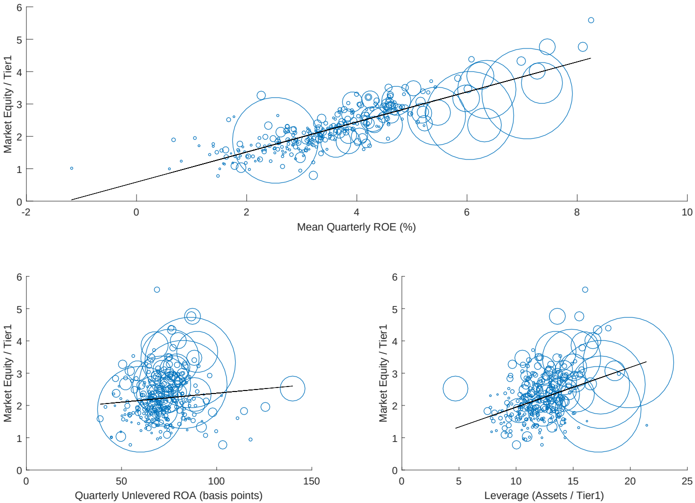
Improve Risk-Adjustment - here w/ RWA
Risk-neutral loan pricing?



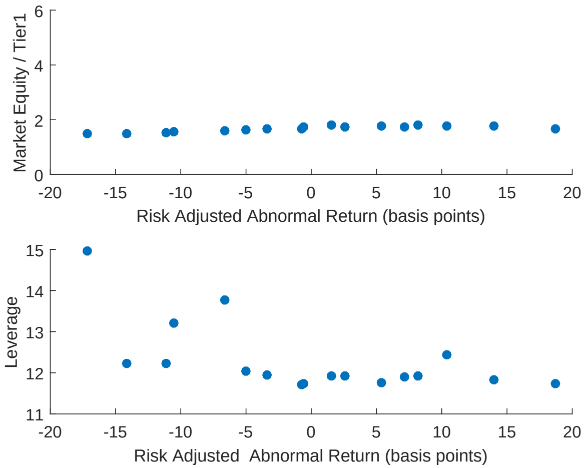
Market discipline by depositors?

- 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. $\nexists$ 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

Market discipline by equity? Begenau & Stafford (2017)
Pre-Crisis Stock Market Valuation of Banks



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

	Leverage Quintile				
	Low	2	3	4	High
1999-2007					
Mean abnROA | Risk (bps)	2.59	-0.89	-0.15	-0.38	-0.91
t - statistic	(4.20)	(-2.20)	(-0.30)	(-1.01)	(-1.35)
Mean ROE	2.90	3.17	3.29	3.58	3.83
Mean Multiple	1.87	1.93	2.01	2.15	2.44

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

Minor comments

- 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

Minor comments ctd

- Try risk-adjustment with risk weighted assets