The National Depositor Preference Law

by James B. Thomson

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.

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. 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. 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." 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

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities with No Depositor Preference</th>
<th>Liabilities with Depositor Preference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Collateral (CA)</td>
<td>Collateralized claims (CC)</td>
<td>Collateralized claims (CC)</td>
</tr>
<tr>
<td>General assets (GA)</td>
<td>Senior claims (SC)</td>
<td>Deposit claims (SDC)</td>
</tr>
<tr>
<td></td>
<td>Insured deposits (FDIC)</td>
<td>Insured deposits (FDIC)</td>
</tr>
<tr>
<td></td>
<td>Uninsured deposits (UD)</td>
<td>Uninsured deposits (UD)</td>
</tr>
<tr>
<td></td>
<td>General creditor claims (GCC)</td>
<td>Other senior claims (OSC)</td>
</tr>
<tr>
<td></td>
<td>Subordinated debt claims (SDB)</td>
<td>General creditor claims (GCC)</td>
</tr>
<tr>
<td></td>
<td>Equity (E)</td>
<td>Subordinated debt claims (SDB)</td>
</tr>
</tbody>
</table>

### 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 OBRA. 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.

### 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 I  PAYMENTS TO SENIOR CLAIMANTS
(Millions of dollars)

<table>
<thead>
<tr>
<th>Claimant</th>
<th>No Depositor Preference (GA = $10 Million)</th>
<th>Depositor Preference</th>
<th>Intended Outcome (GA = $10 Million)</th>
<th>Unintended Outcome (GA = $9.16 Million)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$0.000</td>
<td>$2.727</td>
<td>$0.000</td>
<td>$0.000</td>
</tr>
<tr>
<td>FDIC</td>
<td>$2.500</td>
<td>$7.727</td>
<td>$2.498</td>
<td>$2.498</td>
</tr>
<tr>
<td>UD</td>
<td>$0.833</td>
<td>$0.000</td>
<td>$0.000</td>
<td>$0.000</td>
</tr>
</tbody>
</table>

NOTES:

*W* = Weight of the *i*th claimant in the general asset pool.

GA = General asset pool remaining after secured creditors' claims.

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.

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 $5,500 and $2,000, respectively.

A recent study of state depositor preference laws finds that the unintended effects negate most of the intended ones. 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

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.


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.


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