Mimicking Regulatory Peers

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Summary

Bank regulators' disclosure and use of peer information through the Uniform Bank Performance Report (UBPR) affect banks' decisions regarding regulatory capital.

- Banks' regulatory capital ratios become more sensitive to the peer group average in the UBPR regime.
- Banks use either loan loss provisions (LLPs) or risk-weighted assets (RWAs) to manage their regulatory capital ratios depending on their capital levels relative to the peer group average.
- Bank lending decisions become sensitive to their regulatory capital ratio rankings in the peer group.
- The recognition of expected losses is delayed.

Uniform Bank Performance Report (UBPR)

- To facilitate the evaluation of bank conditions, the Federal Financial Institutions Examination Council (FFIEC) introduced the UBPR in 2004
- The FFIEC defined bank peer groups and made the peer information publicly available
- Bank examiners should compare a bank's capital ratio with the UBPR peer group averages
- Peer group averages are not considered supervisory targets, but intended to provide insight into performance of similar banks
  - ▷ However, it may affect banks' decisions regarding regulatory capital ratios
  - ▷ Banks may consider the UBPR peer group average a form of stricter capital requirements, since most banks hold capital well above the regulatory minimum.

Why do banks mimic peers?

I predict and find that banks mimic the UBPR peer group average regulatory capital ratio to shape market participants' (e.g., bank regulators, depositors) perceptions of their stability

- Tier 1 capital ratio rankings in the UBPR peer group have predictive power for the likelihood that a bank will receive severe regulatory enforcement actions
- Tier 1 capital ratio rankings become more important determinants of deposit flows in the UBPR regime

Banks' responses to UBPR

Well-capitalized banks (Maintain their rankings)

Being sensitive to the peer group avg. by mimicking peers' LLPs

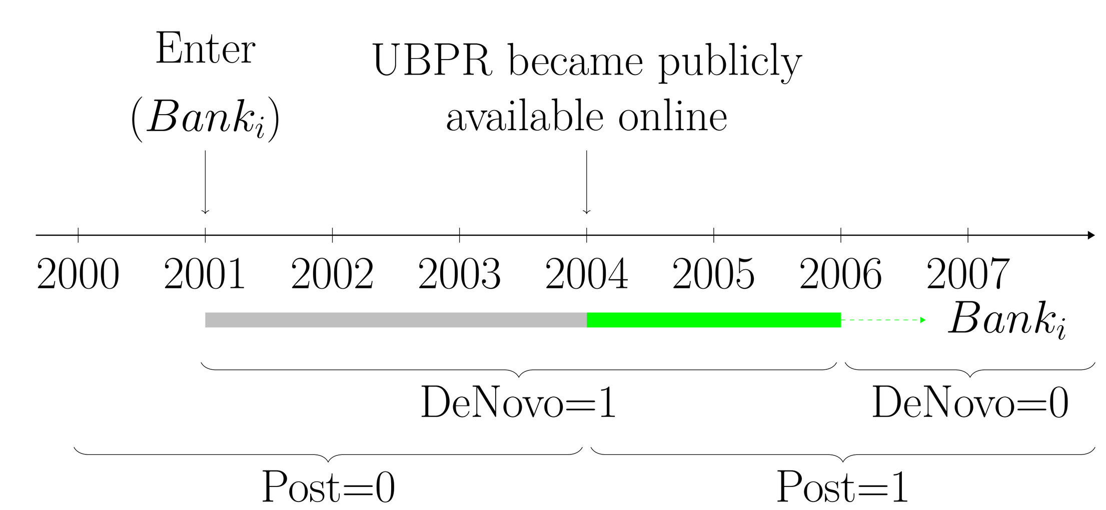
Peer Group Avg.

Increasing *Tier1* targeting the peer group avg. by reducing RWAs and LLPs

Under-capitalized banks (Move closer to the Avg.)

Identification

- Estimating peer effects is challenging because of the reflection problem – if a bank's capital ratio is a function of the capital ratios of peer banks, then vice versa is also true
- The UBPR setting mitigates the reflection problem by permitting a difference-in-differences (DID) methodology
- Control: Existing banks – grouped based on size
- Treatment: *De novo* banks – grouped with cohorts for the first 5 years, then moved to sized based groups



$$
\begin{aligned}
y_{i,t} = \alpha &+ \beta_1\, \bar{y}_{-i,t} \times \mathit{DeNovo} \times \mathit{Post} \\
&+ \beta_2\, \bar{y}_{-i,t} \times \mathit{DeNovo} + \ldots \\
&+ \gamma' X_{i,t-1} + \psi' \bar{X}_{-i,t-1} + \delta_i + \theta_t + \epsilon_{i,t}
\end{aligned}
$$

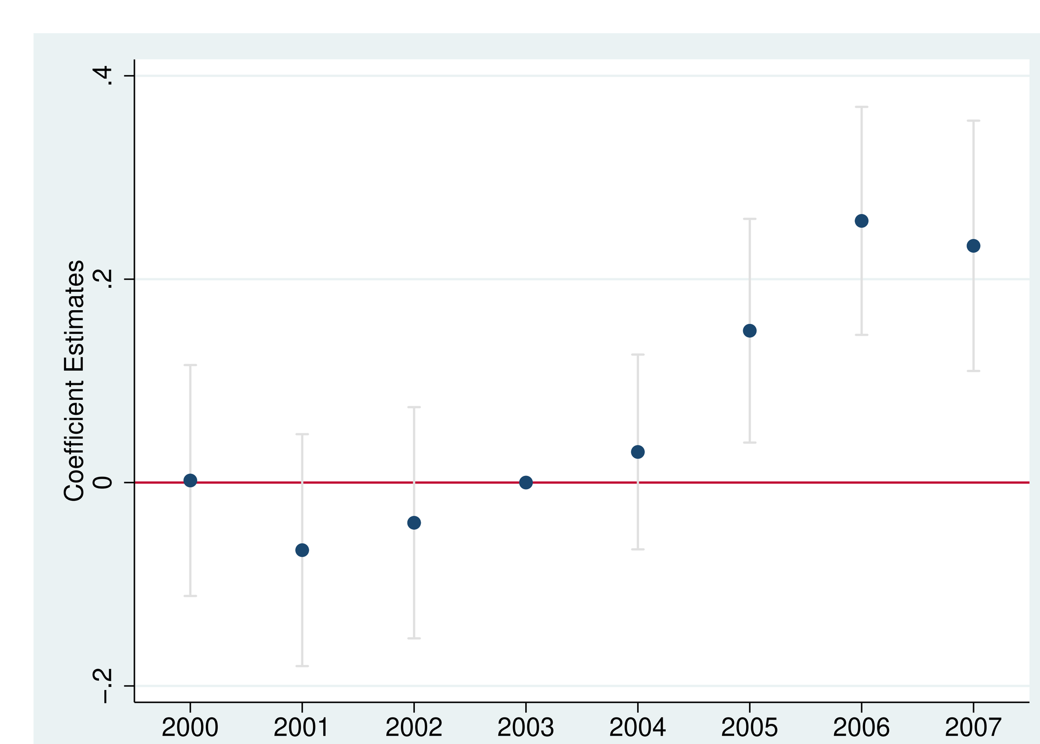
- β_1 captures the changes in sensitivities to cohorts' decisions before and after the UBPR for *de novo* banks relative to control banks

Main Results

- Tier 1 capital ratios of *DeNovo* banks become more sensitive to their cohorts' average tier 1 capital ratio in the post-UBPR period relative to control banks.

Dependent:	$Tier1_{i,t}$		
	(1)	(2)	(3)
$Tier1\ peer_{i,t} \times DeNovo \times Post$	0.166***	0.231***	0.188***
	(3.74)	(5.71)	(4.73)
$Tier1\ peer_{i,t} \times DeNovo$	0.839***	0.320***	0.396***
	(13.33)	(8.03)	(10.16)
Observations	245,748	243,129	243,129
Adjusted R^2	0.871	0.880	0.880
Peer Avg Characteristics	N	N	Y
Controls	N	Y	Y
Time FE, Bank FE	Y	Y	Y

- Parallel trends for Tier 1 Capital Ratios ($Tier\ 1\ peer_{i,t} \times DeNovo \times Year\ \ dummies$)



Mechanism

- Well-capitalized banks mimic their cohorts' average LLPs to maintain their tier 1 capital ratio rankings
- Under-capitalized banks reduce RWAs to increase tier 1 capital ratios
- Under-capitalized banks adjust their loan composition by decreasing the proportion of commercial and industrial (C&I) loans and increasing the proportion of real estate loans.

$$\mathit{Tier\ 1\ Capital\ Ratio} \uparrow = \frac{\mathit{Tier\ 1\ Capital}}{\mathit{RWAs} \downarrow}$$

Consequences

- *DeNovo* banks' lending decisions become more sensitive to their tier 1 capital ratio rankings in the UBPR regime compared to control banks

Dependent:	$\Delta ln(Loans)_{i,t}$	
	(1)	(2)
$Tier1\ \ Bottom_{i,t-1} \times DeNovo \times Post$	-0.013***	
	(-3.05)	
$Tier1\ \ Top_{i,t-1} \times DeNovo \times Post$		0.018***
		(3.36)
Observations	183,994	183,994
Adjusted R^2	0.279	0.279
Controls, Time FE, Bank FE	Y	Y

- The recognition of expected losses is delayed

Dependent:	$LLP_{i,t}$		
	(1)	(2)	(3)
Tier1 Level	All	Bottom	Top
$\Delta NPL_{i,t+1} \times DeNovo \times Post$	-0.034***	-0.010	-0.046**
	(-2.59)	(-0.51)	(-2.14)
Observations	239,374	84,356	76,863
Adjusted R^2	0.453	0.492	0.499
Controls, Time FE, Bank FE	Y	Y	Y

Contact Information

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