Unveiling the Influence of Banks' Legal Form on Regulatory Impacts

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Abstract

This study investigates the impacts of regulatory changes in the U.S. banking sector on banks of different legal forms: Subchapter S corporation banks vs. C corporation banks. It primarily focuses on the Dodd-Frank Act, a pivotal regulatory reform implemented in response to the 2008 financial crisis to strengthen financial stability. Using financial data from Call Reports, our difference-in-differences analysis reveals that S banks experienced a greater decline in yields on earning assets and a disproportionate increase in funding costs compared to C corporation banks after the regulatory changes. Decomposition exercises show that S banks adopted a more conservative lending approach and maintained higher interest-bearing deposits, likely due to the new regulations' stringent capital conservation buffer and restrictions on sources of capital, such as Trust Preferred Securities. This research sheds light on the intricate dynamics of business structure and regulatory frameworks in the banking industry. Crucially, these findings offer a plausible explanation for the observed decline of S banks post-crisis despite the enduring tax advantages associated with their legal structure.

Keywords: S-corporation banks, Dodd-Frank

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1 Introduction

Following the enactment of the Small Business Job Protection Act (SBJPA) in 1996, commercial banks were allowed to adopt the S corporation status. Because of the substantial tax advantages associated with the S corporation legal form, the number of subchapter S banks and their relative importance in the banking industry steadily increased from 1997 to 2008. However, this trend saw a marked slowdown in the wake of the 2008 financial crisis and an apparent reversal after the Great Recession. Furthermore, the share of assets and deposits held by S banks in the industry exhibited similar reversals post-financial crisis despite the persistent tax advantages of S banks (Pacheco et al. (2022)). Our study delves into the underlying factors driving this shift, particularly examining how the Dodd-Frank Act, which was implemented in the aftermath of the financial crisis, have disproportionately impacted S banks compared to their C corporation counterparts.

Subchapter S corporation banks, commonly known as S banks, are treated as passthrough entities for taxation purposes. Unlike the traditional C corporation status, all corporate earnings flow through to the S banks' shareholders and are solely subject to personal income taxation. The S corporate status effectively eliminates the double taxation concerns. Furthermore, it mitigates the taxable gain associated with selling shares in banking firms. However, the S corporation's legal status carries a set of limitations, including a cap on the number of shareholders, the inability to issue preferred stocks, and the requirement that shareholders be U.S. citizens. Additionally, because corporate profits and losses are allocated in proportion to ownership stakes, shareholders are obliged to fulfill their income tax obligations, irrespective of whether they have received actual distributions from the bank. S banks provide a distinctive avenue for examining the intricate dynamics of business structure and regulatory frameworks within the U.S. banking sector. In the United States, the financial system's vulnerability exposed by the financial crisis led to the introduction of the Dodd-Frank Act of 2010 (DFA). This legislation addressed excessive leverage and systemic risk, which played significant roles in the crisis.

Using financial data provided in the Report of Condition and Income (Call Reports) that

all commercial banks are required to file with the Federal Deposit Insurance Corporation (FDIC), we conduct an empirical analysis of two key financial ratios in the banking industry: Yield on Earning Assets and Cost of Funding Earning Assets. The analysis controls for various factors, including bank size, quality, and geographic locations. We employ a difference-in-differences (DiD) approach to compare S banks and C banks before and after 2010, the pivotal year marked by the introduction of the DFA.

Our analysis reveals that, following that regulatory change, S banks experienced a disproportionally larger decline in yields on earning assets and a relatively greater increase in funding cost of earning assets compared to C banks. Importantly, our analysis remained robust even when accounting for factors such as banks switching legal forms, banking entries and exits, and bank hierarchical structures involving bank holding companies.

Our analysis extends to decomposition exercises to explore the underlying reasons for the observed divergence between S and C banks. We find that Subchapter S banks adopted a more conservative approach to lending and prioritized allocating their earning asset portfolios to safer short-term assets, such as U.S. Treasury securities. In addition, S banks maintained a comparatively higher share of interest-bearing deposits than their C bank counterparts. These behaviors became particularly pronounced following the implementation of Dodd-Frank act.

The observed phenomenon can be attributed to S banks' responses to regulatory changes and the unique pressures stemming from their legal form. I addition to all the main changes that DFA imposed on the big banks, it has introduced regulatory changes that uniquely affect smaller institutions, constituting most S banks. In particular, the regulations introduced a more stringent capital conservation buffer, which restricts the distribution of dividends if a bank's risk-based capital ratios fall below specific thresholds. In addition, the DFA disqualified the Trust Preferred Securities (TruPS), a key funding mechanism for S banks, as a component of banks' Tier 1 capital. Because the calculation of bank capital buffer requirement is based on Tier 1 capital ratios, the restriction of the use of TruPS further constrained S banks' financing options.¹.

As S banks rely heavily on dividend distributions to cover tax liabilities related to owning bank shares, this regulatory requirement may prompt them to adopt a more cautious lending strategy in the post-DFA era, ensuring compliance with the capital conservation buffer and safeguarding dividend payouts. This regulatory landscape also implies that S banks face heightened shareholder demands to maintain a certain proportion of high-quality deposits, often carrying higher interest rates.

This research examines the differing impacts of banking regulations on financial institutions, depending on their tax legal forms. It calls into question whether financial reforms should be uniformly applied to all types of banks. S banks are an important financial intermediary, providing essential capital to a wide swath of the economies. Importantly, small businesses and agricultural producers disproportionately rely on S bank financing. Although S banks' overall shares of assets and deposits account for less than ten percent of the banking industry, they provide approximately 15 percent of small business loans and around half of the small agricultural loans.²

A recent strand of the literature, like Celerier et al. (2020), Biswas et al. (2022), Horváth (2020), and Sobiech et al. (2021), have revealed that differing taxation burdens on banks can influence their credit supply decisions. Our findings extend this understanding by illustrating that imposing uniform regulatory burdens on banks with different tax statuses can disproportionately affect the S bank sector of the banking industry, causing these banks to reduce their credit supply as a risk-mitigation strategy. This contraction in credit supply is significant, as prior studies such as Albertazzi and Marchetti (2010) have shown that it is associated with low bank capitalization and limited liquidity. Consequently, our findings suggest that banking regulations can disproportionately elevate the cost of financing for those businesses reliant on S Bank financing, such as small businesses and small agricultural

¹For more discussions, see section 2.2

²These figures are calculated from the Call reports data. The Call reports define small business loans as commercial and industrial loans less than \$1,000,000, and small agricultural loans as loans to finance agricultural production and other loans to farmers less than \$500,000.

producers.

In addition, this research contributes to the literature evaluating the impact of organizational form status on bank performance. Our study, akin to Mayberry et al. (2015), documents the effects of bank legal form status on banking practices and risk-taking behaviors, specifically focusing on how banks determine interest rates for both loans and deposits. Similar to Depken et al. (2010), we demonstrate that S banks offer lower deposit rates and higher loan rates than similar C banks in the years before the Great Recession. Our paper further highlights that financial regulations have significantly eroded the advantages S banks once enjoyed regarding earning yields and deposit costs.

Our paper also adds to the literature on the conversion between S and C banks. Previous studies, such as Cyree et al. (2010), Donohoe et al. (2019), Harvey and Padget (2000), Hodder et al. (2003), and Mehran and Suher (2009), investigate various aspects of bank conversions between the S and C organizational forms. These aspects include bank capitalization, growth, dividend payouts, asset growth, advertising, and competition intensity. We empirically demonstrate that banks have largely ceased converting from C to S banks after the implementation of the financial regulations. Our findings align with Hodder et al. (2003), emphasizing that non-tax factors can expose banks to costly regulatory interventions.

The rest of the paper is organized as follows: Section 2 summarizes the legal form of organization in the banking industry and the Legal and regulatory background. Section 3 describes the data and presents summary statistics. Section 4 details the empirical model and the results. Section 5 discusses the results and provides effect decomposition studies. Section 6 concludes

2 Legal and Regulatory Backgrounds

This section explores the distinction between S and C legal forms within the banking sector and analyzes their influence on regulatory dynamics and banking practices. Additionally, this section delves into the contextual framework of the Dodd-Frank Act, examining its varying impacts on banks based on their sizes and legal forms.

2.1 Legal form of Organization in Banking Industry

The choice of organizational form impacts various aspects of a business, such as taxation, capital accessibility, and liability exposure (Ayers et al. (1996)). The main difference between S corporations and C corporations is their tax treatment. C corporations are subject to taxes at the corporate level, and shareholders must pay taxes again on any dividend payouts. In contrast, S corporations maintain non-tax-related corporate advantages like limited liability and perpetual existence while avoiding double taxation. In particular, S corporations do not pay corporate income taxes and shareholder dividends are tax-free. Their taxable business income "passes through" to individual shareholders and is taxed as ordinary income in the year earned, regardless of whether it's distributed to shareholders that year.³

To qualify for S corporation status, corporations must meet specific criteria that restrict capital-raising capabilities. Shareholders must be individuals, certain qualifying trusts or estates, and U.S. citizens. Shareholders cannot be partnerships, corporations, or nonresident aliens. Additionally, a company can't have more than 100 shareholders. Other restrictions include having a single class of stock and being a domestic corporation. These regulations limit S corporations from becoming publicly traded. Furthermore, since S corporation shareholders are taxed on their proportionate share of income regardless of distribution, they provide fewer opportunities for shareholders to defer taxes than C corporations.

Historically, banks were not eligible to be S corporations until the 1996 Small Business Job Protection Act. They can elect the Subchapter S legal form provided they meet the S corporation requirements. S banks face the same regulations as C banks but face unique challenges (Donohoe et al. (2019)) and additional expenses when adopting S corporation status. This includes writing off deferred tax assets upon conversion (SFAS No. 109, para. 127, FASB 1992), which reduces Tier 1 capital and exposes them to costly interventions if

 $^{^{3}}$ Taxable dividend income or capital gains (e.g., on passively held securities) received by an S corporation are taxed as such at the shareholder level (Erickson and wu Wang (2007)).

capital falls below certain thresholds (Hodder et al. (2003)). Additionally, S banks cannot use net operating loss carry-forwards and may face penalties for unrealized gains during conversion. There is also a five-year waiting period for legal status conversion. Nonetheless, S corporations remain a popular organizational form for US banks.

2.2 Financial Regulation Backgrounds

The financial industry underwent substantial regulatory changes after the 2008 financial crisis, mainly through the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA) in the United States and the Basel III international regulatory framework. The DFA, signed into law in 2010, focused on financial stability, accountability, and consumer protection. It established government agencies such as the Financial Stability Oversight Council and the Consumer Financial Protection Bureau. Basel III, introduced by the Basel Committee on Banking Supervision on 2010 and implemented much later, targeted global banking by strengthening capital quality and adequacy, improving risk management, and establishing stricter liquidity standards. These regulations standardized the banking leverage ratio and broadened the scope of capital requirements.

A sizable literature has explored the impacts of DFA and Basel III on banks. Numerous studies have documented the disparate effects of these regulations on banks of different sizes. For instance, Bouwman et al. (2018) scrutinizes the DFA regulations that categorize banks based on their size and reveals that banks scale their assets and loans more slowly if they are below but near the DFA size thresholds. Berger and Udell (2002) find that the DFA regulatory compliance requirements reduce incentives for all banks to extend small loans, which are essential for smaller banks. DeYoung et al. (2018) evaluate capital ratio and liquidity regulations under Basel III. They find that smaller banks respond to higher capital ratio requirements by increasing their liquidity ratios, while larger banks do not demonstrate this behavior. These results suggest that additional liquidity requirements are only appropriate for larger banks.

Furthermore, the DFA directly affects S bank financing by altering the criteria for Tier

1 capital. Prior to the DFA, bank holding companies (BHCs) could issue Trust Preferred Stocks (TruPS), which were structured essentially as subordinated or unsecured debt.4 The banks under the control of these BHCs could then borrow from TruPS to meet the Tier 1 capital requirement. This instrument was particularly attractive to smaller banks and, even more so, to S banks, as it provided a solution to the restriction on issuing preferred stocks. However, the DFA eliminated TruPS from Tier 1 capital, further constraining S banks' ability to raise capital.

Basel III also introduces an added layer of complexity for S banks through the capital conservation buffer requirement. This regulation requires that banks maintain a buffer above the minimum capital requirement. This buffer should amount to 2.5 percent of a bank's total risk-weighted assets and must be comprised solely of Common Equity Tier 1 (CET1) capital. When the buffer falls below 2.5 percent, automatic constraints on capital distribution (e.g., dividends, share buybacks, and discretionary bonus payments) are imposed to replenish the buffer. If an S bank fails to meet the capital conservation buffer and faces restrictions on making distributions, shareholders are obligated to pay taxes on the bank's net income from their own funds, creating a financial challenge. This situation significantly hinders S banks in attracting new shareholders or raising additional capital from existing ones. Moreover, it may prompt banks to hold a specific proportion of high-quality deposits, impacting their risk-taking strategies.⁴

⁴In the U.S., 75 percent of small banks with assets of less than \$100 million, as well as all large banks with more than \$10 billion in assets, have Bank Holding Companies (BHCs). These holding companies do not oversee the day-to-day operations of the banks they own. However, they wield significant control over management and company policies. They have the authority to hire and fire managers, establish and assess strategies, and monitor the performance of their subsidiaries' businesses. BHCs can take the form of either C corporations or pass-through entities. If an S corporation holding company possesses a significant stake (greater than 25 percent) in a C bank, it can become the bank's holding company. When an S corporation holding company owns 100 percent of a bank, all of the subsidiary's assets, liabilities, and items of income, deduction, and credit are treated as those of the parent.

3 Summary Statistics

The dataset used in this paper comes from the Bank Call Report, a mandated filing that all FDIC-insured banks in the US must submit quarterly to the Federal Deposit Insurance Corporation (FDIC). The dataset spans from the first quarter of 2003 to the final quarter of 2019, providing comprehensive coverage of banking activity during this period. We chose to begin our data collection in 2003 to avoid the impact of the Dot-Com bubble. Similarly, we conclude our dataset at the end of 2019 to exclude the influence of the COVID-19 pandemic. We also focus on banks operating within the 50 states of the United States and the District of Columbia.

In total, there are 497,226 bank-quarter observations contained within this dataset, which are grouped into 14,431 unique clusters, which consist the highest level of a bank's management. This means that banks managed by the same "bank holding company" are considered to be in the same cluster.

Figure 1 summarizes the trends of S and C banks during the data period. Specifically, we analyze the trends related to the number of banks, as well as the relative shares of S banks in terms of assets and deposits. In the left panel of Figure 1, the black line with circle markers illustrates a continuous decline in the number of C banks over time. During the data period, the total number of C banks has fallen by more than 50 percent, which is indicative of a consistent consolidation trend among these banks. In contrast, the red line with cross markers demonstrates a different pattern for S banks. Initially, the number of S banks steadily increased leading up to the Great Recession of 2008-2009. However, in the aftermath of the recession, the trend reversed, and there was a noticeable decline in the number of S banks. After the passage of new regulations, such as the Dodd-Frank Act in the Third Quarter of 2010, as depicted by the vertical red dashed line, the number of S banks continued on a declining trajectory, matching the consolidation patterns experienced by the C banks. By the end of 2019, the total number of S banks had fallen below the 2003 level.

The right panel of Figure 1 illustrates the trends in the relative share of assets and deposits held by S banks. The black line with circle markers represents the relative share



Figure 1: Relative Importance of Subchapter S Banks

of assets, while the red line with cross markers represents the relative share of deposits held by S banks. Prior to the Great Recession, both lines displayed an upward trend, indicating that S banks were steadily gaining importance in terms of their share of assets and deposits in the industry. During the Great Recession, S banks maintained a share of assets at around 11 percent, while their share of deposits remained steady at approximately 7 percent. However, after the enactment of new banking regulations in 2010, there was a noticeable decrease in the relative shares of assets and deposits held by S banks. This indicates that the economic implications of the new regulations disproportionately affected these banks, causing a decrease in their relative importance within the industry.

S and C banks exhibit notable differences across various financial metrics, Table 1 summarizes these differences in four such metrics: asset size, tier 1 risk capital ratio, efficiency ratio, and dividend payout ratio.

In terms of asset size, C banks are, on average, substantially larger, having an average asset size of approximately \$2.604 billion. In contrast, S banks have significantly smaller average assets, averaging around \$220 million. The distribution of C bank asset size is highly skewed, with the median C bank holding only \$179 million, compared to \$113 million for the median S bank. C banks' asset size also exhibits much higher variance, indicating a

wider range of bank sizes within C banks.

	C Banks		S Banks			
VARIABLE	Mean	Med.	STD. DEV.	Mean	Med.	STD. DEV.
Asset (\$ Billions)	2.604	0.179	40.943	0.220	0.113	0.532
TIER 1 RISK CAP. RATIO	17.415	14.432	10.024	16.269	14.278	7.584
Efficiency Ratio	74.009	70.086	29.137	67.725	66.027	20.795
Payout Ratio	1.901	0.000	35.198	5.138	3.699	7.315

Table 1: SUMMARY STATISTICS

Another key contrast lies in the tier 1 risk capital ratio. The tier 1 risk capital ratio is the proportion of a bank's tier 1 capital, which consists of the most reliable and highestquality capital (e.g. equity capital), to its risk-weighted assets. This financial ratio measures a bank's financial strength and ability to absorb losses. On average, C banks have a higher Tier 1 Risk Capital Ratio, approximately 17.4 percent, compared to S banks, which have an average of about 16.3 percent. This suggests that C banks tend to maintain a slightly higher level of capital relative to their risk-weighted assets.

Efficiency ratios provide further insight into the divergence between these bank types. The Efficiency Ratio is noninterest expense less amortization of intangible assets as a percent of net interest income plus noninterest income. A lower efficiency ratio indicates greater efficiency, as the institution operates more efficiently and generates higher profits relative to its operating costs. C banks exhibit an average efficiency ratio of approximately 74.0 percent, whereas S banks have a lower average efficiency ratio of around 67.7 percent. C banks, on average, have higher efficiency ratios, which could imply higher operating costs experienced by C banks.

Payout ratios, which reveal how much a bank distributes to shareholders in dividends, exhibit significant differences. C banks have an average payout ratio of about 1.9 percent, while S banks have a substantially higher average payout ratio of approximately 5.1 percent. This indicates that S banks tend to allocate a more significant portion of their earnings to shareholders through dividends. The legal structure of an S corporation mandates the direct transfer of bank profits to shareholders, who are subsequently accountable for their personal income taxes on the earnings they receive. Consequently, S banks typically distribute ample dividends to cover the tax obligations of their shareholders.

In summary, when comparing C banks to S banks, several differences emerge. S banks tend to have much smaller asset sizes but distribute substantially higher dividends to their shareholders. Performance ratios, including the tier 1 risk capital ratio and efficiency ratios, are comparable between the two types of banks. C banks exhibit slightly higher capital levels relative to risk-weighted assets, while S banks have slightly better efficiency ratios.

Furthermore, C and S banks differ in their lending and financing practices. A noteworthy contrast is the classification of community banks: while 88.7% of C banks fit this category, nearly all S banks, accounting for 98.5%, also fall under this classification. Community banks are identified by the FDIC using specific criteria that highlight their traditional relationship banking approach and limited geographical operations.

Geographical locations further distinguish these bank types. Approximately 37.5% of C banks are headquartered in rural areas, whereas 59.1% of S banks operate in rural regions. Rural areas are typically defined as regions not within a core-based statistical area, indicating their distance from urban centers with populations exceeding 10,000 people.

4 Model and Results

This section presents a regression model in Equation 1 analyzing two key financial ratios in the banking industry: Yield on Earning Assets and Cost of Funding Earning Assets. The dependent variable in the model is denoted as y_{it} , representing the financial ratio of interest. The subscripts *i* and *t* refer to the bank and time period, respectively.

In our analysis, we contrast the trend of these variables pre- and post-implementation of the Dodd-Frank Act, which was introduced in 2010. Throughout our discussion, we denote this point in time as the "implementation year."⁵

The first dependent variable, Yield on Earning Assets, is annualized total interest income as a percent of average earning assets. Earning assets include all loans and other investments that earn interest or dividend income. The yield on Earning Assets measures the effectiveness of the banking institution in generating income from its assets that are actively deployed to generate interest income. A higher yield indicates that the institution's loans and investments generate a higher level of interest income relative to the value of those assets.

The second dependent variable, Cost of Funding Earning Assets, is annualized total interest expense on deposits and other borrowed money, such as inter-bank loans or issued debt, as a percent of average earning assets. It measures the costs of obtaining the funds necessary to support the institution's interest-earning activities. A higher cost of funding earning assets indicates that the institution incurs relatively higher expenses to finance its interest-earning activities.

$$y_{it} = CONST + \alpha_t + \sigma_s + \beta_1 POST_t + \beta_2 SCORP_{it} + \beta_3 POST_t \times SCORP_{it} + \gamma \times X_{it} + \varepsilon_{it}$$
(1)

The model includes two fixed effects, the time-specific fixed effects represented by α_t and the state-specific fixed effects represented by σ_s .

The dummy variable $POST_t$ indicates whether a particular quarter is after the implementation year. The dummy variable $SCORP_{it}$ indicates whether bank *i* is a subchapter S bank in quarter *t*. To capture the potential differential effect of the Dodd-Frank Act on subchapter S banks, the regression also includes the interaction term $POST_t \times SCORP_{it}$.

We also include a set of control variables denoted as X_{it} . The control variables include bank sizes measured by log asset levels and a dummy variable indicating whether a bank is headquartered in rural areas. In addition, the regression includes the Tier 1 risk-based capital ratio and the Efficiency ratio as control variables.

⁵Note that while Basel II was introduced in 2010, its implementation began in 2013, with certain elements coming into effect in 2016. Therefore, our analysis here will primarily focus on the Dodd-Frank Act.

Our regression model also incorporates dummy variables for community banks and mutual ownerships as these two institutional forms may have potential differences in lending and financing practices. Community banks are identified by the FDIC using specific criteria that emphasize their traditional relationship banking approach and limited geographical operations. On the other hand, mutual institutions are exclusively owned and controlled by their depositors. All mutual institutions are taxed like C corporation banks.

The error term, denoted as ε_{it} , represents the unobserved factors or random shocks that affect the financial ratios but are not accounted for by the included variables. We cluster the standard error at the highest bank holding company level. A Bank Holding Company (BHC) has a controlling interest in one or more banks, and exercises control over its subsidiary banks. By clustering robust standard errors, we account for potential arbitrary non-independence between time periods and individual bank units within each bank holding company. This approach helps to ensure that our analysis properly addresses any correlations or dependencies that may exist within the data structure.

Table 2 presents the regression results for the Yield on Earning Asset in the first column. Post implementation, the average yield is 1.21 percent lower, which is statistically significant. Subchapter S banks have on average 0.08 percent higher yield than other banking institutions prior to the implementation. However, this advantage in earning yield disappears post implementation, indicated by the coefficient of -0.112 on the interaction term "Post \times S Corp." The coefficients on bank size, the Tier 1 risk-based capital ratio, and the efficiency ratio all exhibit a statistically significant negative relationship with the yield on earning assets. This suggests that larger and more financially stable banks generally have a lower yield on their earning assets. The location of a bank in rural area significantly decreases its yield. Additionally, being a community bank does not exhibit a significant effect on yields. However, mutual institutions have higher yields with marginal significance.

The second column of Table 2 reports the regression results for the Cost of Funding Earning Assets. After the implementation of those regulations, there is a statistically significant decrease in the average cost of funding by 1.12 percent. Before the implementation,

	Yield on	Cost of Funding
	EARNING ASSET	Earning Asset
Розт	-1.212***	-1.124***
	(0.023)	(0.011)
S Corp	0.082***	-0.056^{***}
	(0.021)	(0.012)
Post \times S Corp	-0.112^{***}	0.046***
	(0.018)	(0.010)
Log Asset	-0.139^{***}	0.026***
	(0.012)	(0.004)
Community Bank	-0.120	0.073***
	(0.081)	(0.026)
Mutual	0.044*	0.352***
	(0.024)	(0.017)
Rural	-0.084^{***}	-0.023^{***}
	(0.017)	(0.008)
TIER 1 RISK CAPITAL RATIO	-0.034^{***}	-0.015^{***}
	(0.001)	(0.000)
Efficiency Ratio	-0.008^{***}	0.001***
	(0.000)	(0.000)
Constant	8.157***	1.285***
	(0.205)	(0.086)
QUARTERLY F.E.	YES	YES
STATE F.E.	YES	YES
R^2	0.514	0.756

 Table 2: Regression Results

NOTES: Standard errors, clustered at the top Bank Holding Company level, are given in parentheses. Three (***), two (**), and one (*) stars indicate statistical significance at the 1%, 5%, and 10% levels, respectively.

Subchapter S banks had a slight advantage with an average cost 0.056 percent lower than other banking institutions. However, this advantage diminishes post-implementation, as indicated by the coefficient of 0.046 on the interaction term "Post \times S Corp." The cost tends to increase with bank size and the efficiency ratio but decreases with the Tier 1 risk-based capital ratio. Larger banks have a higher average cost of financing their earning assets, but financially safer banks have lower average costs. The location of a bank in a rural area has a significant effect on reducing funding costs. Additionally, community banks and mutual institutions typically face higher funding costs.⁶

The key insight of Table 2 is that subchapter S banks enjoyed significant advantages in terms of both yields on assets and funding costs prior to the implementation of those regulations. However, these advantages were substantially diminished after the new regulations were put into effect. It is necessary to discuss a few important aspects of this finding.

Firstly, our finding hinges on the assumption of exogeneity regarding the timing of the regulatory implementation in 2010. We assume that the timing of the implementation of Dodd-Frank Act is independent of the banks' decisions and their legal forms. It is noteworthy that DFA was formulated in response to the Great Recession of 2008-09, which would have significant impacts on both bank yields and costs. However, the inclusion of quarterly fixed effects in our analysis accounts for the average effects of the Great Recession and any macroeconomic cyclicalities on bank earnings and costs.

Secondly, our regression design employs a difference-in-differences (DiD) approach. This approach involves calculating the difference in yields and costs between subchapter S (S Corp) banks and their C Corp counterparts. We then introduce the interaction term "Post \times S Corp" to examine whether this difference changes following the implementation of the

⁶In the online appendix A4, we address a pertinent concern regarding the comparison between predominantly small community S banks and potentially large multinational C banks. Despite controlling for size via asset level in the main regression, a robustness check was carried out by narrowing down our dataset exclusively to community banks as identified by the Federal Reserve Bank. This exercise, outlined in Table A5, underscores the consistency and unaffected magnitude of our main findings across varying bank sizes, reinforcing the robustness of our analysis.

two regulations.

The DiD approach relies on the parallel trend assumption, which assumes that, in the absence of those acts, the average trends for S Corp and C Corp banks would follow parallel paths over time. Essentially, it assumes that the relative differences in yields and costs between these two types of banks would remain stable over time in the absence of the policy change. By assuming parallel trends, any divergences in the differences between the groups can be attributed to the policy change rather than any other factors.

To examine the validity of the parallel trend assumption, we employ an event study design with leads and lags. This design allows us to assess the dynamics of treatment effects over time. In particular, we generate lead and lag variables for the policy indicator related to the implementation of Dodd-Frank. Since Dodd-Frank was passed and implemented in 2010, we create lead variables for subsequent years such as 2011, 2012, and so on. Similarly, lag variables are generated for preceding years like 2009, 2008, and so forth. Then, we incorporate the interaction terms between these lead and lag variables and the subchapter S dummy variable in the DiD model.

By examining the coefficients on the interaction term over time, as shown in Figure 2, we can assess the treatment effects' dynamics. This analysis allows us to evaluate the validity of the parallel trend assumption and ascertain whether the divergence in the differences between subchapter S banks and C banks is a result of the policy change introduced by Dodd-Frank act.

In Figure 2, the reference years are 2003-2004, and the 95 percent confidence intervals of the coefficients are shaded in grey. Panel (A) illustrates that, during the years preceding the implementation year, the differences in Yield on Earning Asset between subchapter S and C banks do not exhibit significant disparity compared to the reference years. However, following the implementation, the difference between S corp and C corp banks starts to fall. The decline in this difference is statistically significant and reaches its lowest point in 2013. Since then, it has remained relatively stable.

Similarly, Panel (B) of Figure 2 shows that the differences in Cost of Funding Earning

Asset between subchapter S and C banks in the years preceding the implementation do not indicate any significant divergence from the reference years. The notable exception is the Year 2009. During this year, the coefficient is significantly lower compared to the reference year, indicating that the funding cost of subchapter S banks is lowered relative to the C banks. However, this trend undergoes a reversal in the subsequent years. Following the implementation, the difference between subchapter S and C banks in terms of Cost of Funding Earning Asset begins to increase and stays significantly positive. Given that the subchapter S banks had relatively lower costs in the preceding years, this increasing trend implies that the cost advantage enjoyed by subchapter S banks has diminished in the years subsequent to the implementation of Dodd-Frank act.

Figure 2: PARALLEL TREND ASSUMPTIONS



Overall, our findings, presented in Table 2 suggest that the implementation of both acts have had a substantial impact on diminishing the advantages of subchapter S banks in both Yield on Earning Asset and Cost of Funding Earning Asset, with these effects persisting in the following years.

4.1 Switching Legal Forms

The regression analysis presented in Table 2 does not take into account banks changing their legal forms over time. However, one potential explanation for the observed divergence in the differences between subchapter S and C banks is that banks with varying earning yields and funding costs may have switched their legal forms following the implementation of the Dodd-Frank Act. This section aims to test this hypothesis.

To address this hypothesis, we employ two approaches. Firstly, we rerun the regression presented in Table 2 using a restricted sample. This restricted sample includes only banks that maintained the same legal form throughout the entire sample period. We exclude banks that changed their legal form or were new entries or exits. In essence, this restricted sample comprises banks that have continuously operated as either subchapter S or C corporations throughout the entire sample period. The restricted sample has 269,056 bank-quarter observations and 7690 clusters.

Table 3 displays the regression results. The coefficients for both Yield on Earning Assets and Cost of Funding Earning Assets exhibit the same signs and are comparable in magnitude to those presented in Table 2 from the main regression. These findings indicate that the main results remain robust when using the restricted sample, wherein only banks that maintained the same legal form throughout the entire sample period were included.

Specifically, the results reaffirm that subchapter S banks enjoyed advantages in both yield and cost of funding prior to the implementation. However, the introduction of new regulations significantly eroded these advantages. Therefore, the main findings of the study hold true even when considering the restricted sample, further supporting the conclusion that changes in regulations had a substantial impact on subchapter S banks' performance in terms of yield and cost of funding.

In the second approach, we examine whether the implementation has had a significant impact on banks' decisions to switch legal forms. We employ logistic regression models with the dependent variables being the banks' legal form changes. Similar to the main regressions, the logit regressions control for quarterly fixed effect and state fixed effect. We also cluster

	YIELD ON	Cost of Funding
	EARNING ASSET	Earning Asset
Розт	-1.236***	-1.137***
	(0.026)	(0.012)
S Corp	0.073**	-0.057^{***}
	(0.032)	(0.017)
Post \times S Corp	-0.104^{***}	0.034**
	(0.023)	(0.013)
Log Asset	-0.195^{***}	0.009^{*}
	(0.021)	(0.005)
Community Bank	-0.359^{**}	0.045
	(0.151)	(0.034)
Mutual	0.050	0.346***
	(0.031)	(0.021)
Rural	-0.079^{***}	-0.003
	(0.025)	(0.010)
TIER 1 RISK CAPITAL RATIO	-0.035^{***}	-0.012^{***}
	(0.002)	(0.001)
Efficiency Ratio	-0.009^{***}	-0.000
	(0.001)	(0.000)
Constant	8.953***	1.467***
	(0.321)	(0.107)
QUARTERLY F.E.	YES	YES
State F.E.	YES	YES
R^2	0.502	0.796

Table 3: Regression Results - Non-Switching Banks

NOTES: Standard errors, clustered at the top Bank Holding Company level, are given in parentheses. Three (***), two (**), and one (*) stars indicate statistical significance at the 1%, 5%, and 10% levels, respectively.

the standard errors at the bank holding company level to address potential heteroscedasticity or correlation within a bank holding company.⁷

In the first regression, presented in the first column of Table 4, the dependent variable takes a value of one if a bank switches its legal form to become an S bank, and zero otherwise. In the second regression, shown in the second column of Table 4, the dependent variable indicates whether a bank switches from being an S bank to a C status.

In Table 4, the logistic regression estimates are presented in terms of odds ratios instead of regression coefficients. Odds ratios are a way to express the change in probabilities associated with a one-unit increase in the independent variable. If the odds ratio of an independent variable is greater than 1, it indicates that an increase in that variable's value leads to an increased likelihood or probability of the event being studied, in this case, the switch in legal form. Conversely, if the odds ratio is less than 1, it suggests that an increase in the variable's value decreases the likelihood or probability of the event.

For example, let's consider the variable "Log Asset" in the context of a C bank switching to an S bank. The odds ratio associated with this variable is 0.851. This means that for a one-unit increase in the logarithm of bank assets, which is equivalent to a tenfold increase in bank assets, the probability of a C bank switching to an S bank is reduced by approximately 14.9% (1 - 0.851 = 0.149).

Similarly, for a switch from an S bank to a C bank, the odds ratio for "Log Asset" is 1.141. This indicates that a one-unit increase in the logarithm of bank assets, corresponding to a tenfold increase in bank assets, increases the probability of an S bank switching to a C bank by approximately 14.1%.

The odds ratios on variable "POST" in Table 4 suggest that the implementation of Dodd-Frank act decreases the likelihood of banks switching to the subchapter S form and increases the likelihood of S banks switching to other legal forms. However, it is important

⁷Some states may not have observed any legal form switches. These states are dropped from the analyses, resulting in a smaller sample size for those particular regressions. For the regression examining switches to S banks, we have a total of 288,224 observations, which are clustered into 10,078 clusters. Similarly, for the regression examining switches from S banks, we have 139,917 observations clustered into 4,688 clusters.

	Switch to S	Switch from S
Post	0.391	4.054
	(0.257)	(4.111)
Log Asset	0.851***	1.141**
	(0.030)	(0.076)
Community Bank	5.324***	0.230***
	(2.360)	(0.079)
Mutual	0.021***	136.618***
	(0.021)	(102.922)
Rural	1.351***	0.566***
	(0.100)	(0.069)
TIER 1 RISK CAPITAL RATIO	0.959***	0.932***
	(0.008)	(0.015)
Efficiency Ratio	0.991***	1.007***
	(0.002)	(0.001)
Yield on Earning Asset	0.746***	0.344^{***}
	(0.059)	(0.029)
Cost of Funding Earning Asset	0.800***	1.104
	(0.061)	(0.148)
Constant	0.042***	1.221
	(0.040)	(1.611)
QUARTERLY F.E.	YES	YES
State F.E.	YES	YES
PSEUDO R^2	0.212	0.220

Table 4: LOGIT ODDS RATIO - SWITCHING LFO

NOTES: The above table shows odds ratios. The Constant estimates baseline odds. Robust standard errors, clustered at the top Bank Holding Company level, are given in parentheses. Three (***), two (**), and one (*) stars indicate statistical significance at the 1%, 5%, and 10% levels, respectively.

to note that the standard errors associated with the odds ratios are high, suggesting that the model has a considerable amount of noise, and the odds ratios for both switching to the subchapter S form and switching from the subchapter S form are not statistically significant from zero. The lack of statistical significance implies that we cannot confidently conclude that the implementation has a significant effect on the likelihood of legal form switches for banks. The high standard errors suggest that there may be other factors at play or that the model may not fully capture the complexities of the decision-making process regarding legal form switches.

Interestingly, the odds ratios associated with the variable "Yield on Earning Assets" in Table 4 show that a higher yield on earning assets decreases the likelihood of banks switching legal forms, both to and from the subchapter S banks. Specifically, a one-unit increase in the yield on earning assets leads to a 25.4 percent decrease in the probability of switching to the subchapter S form and a 65.6 percent decrease in the probability of switching from the subchapter S form.

These findings suggest that the reduction in yields observed after the implementation may have contributed to a less frequent occurrence of legal form switches in the postimplementation environment. In other words, the regulatory modifications ushered in by these acts appear to have introduced more stability in the legal form structure of banks over time. These results shed light on the potential impact of regulatory changes on banks' decision-making processes regarding legal form switches. The inverse relationship between the yield on earning assets and the likelihood of switching legal forms suggests that financial performance, specifically the profitability of banks' earning assets, plays a significant role in determining their choice of legal form.

One concern that may arise is the potential influence of the Great Recession on the observed results. However, we address this concern by conducting additional analyses where we exclude the recession years of 2008-2009 from our dataset. Even after excluding these years, we find that the results remain similar. This robustness indicates that the observed effects are not solely driven by the impact of the recession.

We also examine the odds ratio of bank exits for both subchapter S and C banks. The results of this analysis can be found in the Appendix. Notably, we observe that the implementation of the Dodd-Frank Act has contributed to a higher probability of bank exits for both types of banks. Specifically, our findings indicate that the Dodd-Frank Act has increased the likelihood of exits for S banks to a greater extent compared to their C counterparts.

It is important to note that in our analysis, we do not differentiate between bank exits resulting from ceasing operations or those resulting from mergers with other banks. The results suggest that S banks may be more susceptible to being acquired by larger banks following the implementation. This finding could imply that the regulatory changes brought about by the Dodd-Frank Act have influenced the competitive landscape of the banking industry, leading to increased consolidation and acquisition activities among S banks.

However, it is essential to interpret these results with caution and consider the limitations of our analysis. Further research and investigation are needed to provide a more comprehensive understanding of the factors driving bank exits and the specific mechanisms through which the Dodd-Frank Act has influenced these dynamics.

5 Decomposition Analysis and Discussion

In the preceding sections, we examined the consequences of implementing DFA on the Yield on Earning Assets and the Cost of Funding Earning Assets, highlighting the divergent effects experienced by S banks compared to their C bank counterparts. In this section, we conduct decomposition analyses and discuss the underlying factors that contribute to the disproportionate impacts of these regulations on the yield and costs of S banks.

5.1 Change in Yield on Earning Assets

Loans constitute a significant portion of a bank's earning assets, typically accounting for more than half of the total. The remaining earning assets include lease financing, trading accounts, US treasury securities, and deposits in other institutions. Compared to loans, these other earning assets generally carry lower risks, as evidenced by their lower yields. For instance, the average yields on loans were 6.85 percent before implementation and 5.49 percent after implementation, while the average yields on other earning assets were 3.95 percent and 2.00 percent, respectively.

We investigate the impact of the two acts on loan yields and the composition of earning assets held by banks. These factors could potentially contribute to the divergence in earning asset yields between banks of different LFOs following the implementation. We conduct three separate regression analyses concerning "Yield on Loans," "Yield on Other Earning Assets," and "Share of Loans in Earning Assets," respectively. These regressions employ the same set of control variables as outlined in Equation 1. The detailed results of these regressions are presented in Appendix A2.

Using the estimated coefficients of the regressions, we present the simulated earning asset yields and compositions for a hypothetical median bank in Table 5. This median bank has a median asset level, a median tier 1 risk capital ratio, and a median efficiency ratio.⁸ It is classified as a non-community bank and non-mutual institution, and it is not located in rural areas. The table showcases the simulated yields, considering only changes in LFOs, and whether the bank operates in the post-implementation period.

	Yield on	YIELD ON OTHER	Share of Loans	Overall
	LOANS	EARNING ASSETS	in Earning Assets	Yield
Non-S, Before	7.59	3.41	59.2%	5.89
S Corp, Before	7.73	3.48	59.1%	5.99
Non-S, Post	6.31	2.50	65.4%	4.99
S Corp, Post	6.35	2.54	64.1%	4.98

Table 5: EARNING ASSET YIELDS AND COMPOSITION - MEDIAN BANK

⁸The median log asset is 5.268, the median tier 1 risk ratio is 14.379, and the median efficiency ratio is 68.731.

Similar to the findings presented in Table 2, the median Subchapter S bank exhibited an overall yield advantage of 0.11 percent compared to its C counterpart before Dodd-Frank. However, after the enactment of acts, this advantage for Subchapter S banks vanished, with the S bank's overall yield being 0.01 percent lower than that of the C bank.

To further analyze the changes in overall yields, we performed a back-of-the-envelope decomposition. This decomposition seeks to attribute the alterations in overall yields to shifts in yields and changes in the share of loans within earning assets. Specifically, we computed the overall yield under the assumption that loan and other earning asset yields remained unchanged from pre-implementation levels, while allowing the shares of loans within earning assets to adjust to their post-implementation proportions. In this hypothetical scenario, the S banks' overall yield on earning asset is 5.81 percent higher than that of the C bank. This means that 42.8 percent of the change in overall yield is due to changes in the share of loans within earning assets.

The decomposition exercise reveals that Subchapter S banks tend to adopt a more conservative loan-making approach and prioritize the allocation of earning asset portfolios to safer short-term assets, such as US Treasury securities. This behavioral trend is particularly noticeable after the implementation of Dodd-Frank act. One plausible explanation for this shift can be attributed to the stricter capital rules introduced under Dodd-Frank, including the capital conservation buffer. This buffer restricts a bank's dividend payments if its riskbased capital ratios fall below specified thresholds. As Subchapter S banks rely heavily on dividend distributions to cover tax liabilities related to owning bank shares, this regulatory requirement may prompt them to adopt a more cautious lending strategy post Dodd-Frank, ensuring compliance with the capital conservation buffer and safeguarding dividend payouts.

5.2 Change in Funding Costs of Earning Assets

The funding cost of earning assets primarily encompasses the total interest expense incurred on deposits and other borrowed funds. Deposits are the primary funding source for earning assets in the majority of banks. Alternative forms of borrowed funds, including federal funds purchased, repurchase agreements, and demand notes issued to the US Treasury, typically constitute around 10 percent of earning assets. Notably, the implementation of Dodd-Frank did not alter the difference between Subchapter S and C banks in terms of the average costs associated with utilizing alternative funding sources. In addition, the implementation of Dodd-Frank did not lead to any changes in the proportion of these alternative funding sources in total earning assets. We have documented these observations in Appendix A3. Therefore, this section concentrates on the changes in interest expenses between the two Legal Forms of Organization (LFOs) post-implementation, along with the changes in the shares of different types of deposits.

The data categorizes deposits into two main types: interest-bearing deposits, including savings accounts and certificates of deposits, and non-interest-bearing deposits, comprising non-interest-paying checking accounts. The investigation into regulations' impact involves assessing the average interest rates paid on interest-bearing accounts and the proportion of interest-bearing accounts within total deposits. These factors collectively contribute to the shifts in funding costs for earning assets by the two LFOs post-implementation, as outlined in Table 2. In this context, two supplementary regressions are performed: one on "Interest Cost on Interest-Bearing Deposits" and another on "Share of Interest-Bearing Deposits." These regressions incorporate the same set of control variables as outlined in Equation 1. The comprehensive results of these regressions can be found in Appendix A3.

Using the regression coefficients, the study simulates the interest costs and compositions of deposits for a hypothetical median bank, as presented in Table 6. The term "median bank" retains the definition provided in Section 5.1. This table illustrates the projected interest costs and the proportion of interest-bearing deposits, considering changes only within LFOs and whether the bank operated during the post-implementation period.

Prior to implementation, the interest rate paid on interest-bearing deposits averaged around 1.3 percent. This rate significantly decreased to an average of 0.48 percent post implementation, primarily due to the near-zero Federal Funds Rate for the ten years subsequent to the Great Recession. Interestingly, Subchapter S banks consistently offered interestbearing deposits at approximately 0.035 percent lower rates than C banks, even preceding Dodd-Frank. Moreover, their share of interest-bearing deposits was 0.7 percent lower than C banks prior to the implementation. Consequently, Subchapter S banks enjoyed a relative advantage of 0.032 percent in terms of the average interest rate paid on overall deposits (combining interest-bearing and non-interest-bearing deposits).

	Interest Cost	Share of	Overall
	on Interest-	INTEREST-	Cost of
	Bearing Deposits	Bearing Deposits	DEPOSITS
Non-S, Before	1.33	67.1%	0.89
S Corp, Before	1.29	66.4%	0.86
Non-S, Post	0.49	60.0%	0.30
S Corp, Post	0.46	59.7%	0.27

Table 6: Interest Cost and Composition of Deposits - Median Bank

Following implementation, Subchapter S banks continued to offer interest-bearing deposits at about 0.038 percent lower rates compared to C banks, with this difference remaining largely unchanged. However, the share of interest-bearing deposits for S banks became comparable to that of their C counterparts post implementation (59.7% vs. 60.0%). This adjustment led to a reduction in the funding cost advantage for S banks to 0.024 percent.

We perform a back-of-the-envelope decomposition, similar to that in Section 5.1. Specifically, the overall interest costs were computed under the hypothetical scenario where interest rates on interest-bearing deposits remained unchanged from pre-implementation levels, while permitting the shares of interest-bearing deposits to adjust to their post-implementation proportions. In this scenario, S banks' overall interest costs on deposits would be 0.025 percent lower than that of C banks. Consequently, approximately 91.6 percent of the shift in overall funding costs could be attributed to alterations in the distribution of interest-bearing deposits. This suggests that the alterations in the composition of deposits used to fund earning assets play a pivotal role in the diminution of differences in funding costs for earning assets between Subchapter S and C banks. This change is particularly significant since, prior to the implementation, S banks had a tendency to rely more heavily on non-interest-bearing deposits to fund their earning assets, while this distinction largely faded away following the regulatory changes.

Exploring the strategic responses of Subchapter S banks in adjusting different types of deposits in reaction to regulatory changes is beyond the scope of this paper. However, it is noteworthy that Subchapter S banks encounter greater pressure to uphold high-quality liquidity standards. The inherent structure of the S corporation entails that bank profits are passed through to shareholders, who bear personal income taxes on their share of these profits. Consequently, S banks would typically distribute adequate dividends to cover shareholders' tax obligations.

6 Conclusion

This study provides a nuanced insight into how major banking regulations, specifically the Dodd-Frank Act, has influenced U.S. banks. It specifically highlights how these regulations have affected Subchapter S banks differently compared to their C corporation counterparts. Leveraging data from Call Reports, our empirical analysis has revealed that, following the implementation of the Dodd-Frank Act (DFA), S banks experienced a more pronounced decline in "yields on earning assets" and a disproportionate increase in "funding costs of earning assets" when compared to C banks. These findings remain robust when controlling for factors such as switching in legal forms, and bank entry and exit.

Importantly, it is evident that the regulatory constraints introduced by these changes disproportionately impact S banks. This is primarily due to the unique financial mechanisms of Subchapter S corporations, including their reliance on dividend distributions to fulfill shareholder tax obligations and their dependence on specific forms of capital such as Trust Preferred Securities. As a response, S banks have adopted a more conservative asset allocation strategy, favoring safer, short-term assets.

Our research contributes to the academic discussion by shedding light on the nuanced impacts of legislative changes on banks, depending upon their organizational forms. Our findings provide potential explanations for the observed decline in the Subchapter S bank sector after 2010. Furthermore, the insights provided in this paper hold implications for the financing of small businesses and agricultural producers, given their substantial reliance on S banks as financial intermediaries. Overall, this study examines the unintended consequences of uniformly applied banking regulations, emphasizing the need for policies that consider the distinct attributes and constraints of banks with different legal structures.

For future research, it would be valuable to investigate how S banks specifically adapt their lending and asset allocation strategies in response to these regulatory changes. Additionally, exploring the precise impact on small businesses and agricultural producers and considering potential policy adjustments that could better accommodate the needs of these sectors presents an avenue for further inquiry.

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