“Optimal Deposit Insurance”

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* The views expressed are my own and do not necessarily reflect those of Banca d’Italia
Outline

• Description of the paper
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  • Main ingredients
  • Main mechanisms at work

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  • Possible extensions
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• Conclusions
Description of the paper

Motivation

• Theory providing a characterization of the optimal coverage of DI (δ)
Description of the paper

Main ingredients

- Diamond Dybvig (1983)
  - Demandable deposits with sequential service constraint
  - Preference uncertainty: early/late consumers
  - Illiquid investments

- Aggregate uncertainty (fundamental- and panic-based bank failures)

- Competitive banks set interest rate on deposits

- Fiscal costs (distortionary taxation)
Description of the paper

Basic mechanism 1: balancing of direct costs-benefits of DI

- Aggregate risk (s) => 3 regions
  - Bad realizations (unique eq. with failure)
  - Intermediate realizations (multiple equilibria)
  - Good realizations (unique no-failure eq.)

- Setting a higher DI coverage (δ)
  - shrinks the regions of failure and multiplicity
  - expands the no-failure region

- On the other hand, a higher DI coverage (δ) increases the costs sustained by the DI fund in those failures that cannot be avoided faced (fundamental runs)
Description of the paper

Basic mechanism 2: fiscal externality ("moral hazard")

• Bankers are competitive and set deposit rate (r) by maximizing the utility of their own depositors
  • They internalize the implications of a given “r” on the probability and severity of a failure of their own bank
  • But they neglect the implications for the other depositors, i.e. the tax-payers

• Decentralized choice by banks lead to too high levels of “r”
  • Costly as higher interest rates mean more likely and more severe bank failures
Description of the paper

Basic mechanism 3: coordination banks-DI

• Interest rate paid in equilibrium on deposits increases with DI coverage

• ...weakening the effectiveness of the increase in DI coverage

• If banks and DI coordinated, they would choose a
  • lower interest rate
  • higher DI coverage
Description of the paper

*Basic mechanism 4: macroprudential factor*

- The failure of a bank has a direct impact on the severity of other banks’ failure (fire sales)
Comments

General comments

• First attempt to conceptualize optimal DI coverage
• Conceived to provide practical guidance to policy makers
• Essential reading!
Comments

Possible extensions

LOLR

• LOLR and DI direct substitutes...
• ...or indirect complements: private info on the side of LOLR has potential to destabilize (Angeletos, Pavan 2007)
Comments

Possible extensions

Wholesale market

- How would the tradeoff change? More safety needed on deposits from DI? Or DI less effective?
Comments

Possible extensions

Bank regulation (capital, liquidity, funding)
- Smaller need (more stable)
- Smaller costs (fundamental runs less likely)
Possible extensions

Commitment and credibility

• If ex post (actual) coverage only depends on ex post efficiency (as in TBTF theories) then setting coverage is in principle useless...

• ...but explicit DI may *reduce* moral hazard if it credibly limit implicit guarantees....and leaves out non-deposit creditors (Gropp, Vesala, 2004)

=> calibration shall depend on extent of expected implicit guarantee (from DI, LOLR...)
Comments

Messages

• Is the paper advocating
  • deposit rate ceilings?
  • a tax on deposit interests?
Conclusions

• Consistent conceptual framework for defining an optimal level of deposit insurance

• It goes a long way in its efforts to provide practical guidance to policy makers in calibrating DI coverage

• Prescriptions need to be followed “with a grain of salt”

• Further developments are possible and could envisage to integrate missing factors
Thanks!