2017 Biennial IADI Research Conference

Designing an optimal deposit insurance system – Theory and Practice

International Association of Deposit Insurers

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"Optimal Deposit Insurance"

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

International Association of Deposit Insurers

Outline

- Description of the paper
    - Motivation
    - Main ingredients
    - Main mechanisms at work
- Comments
    - General comments
    - Possible extensions
    - Some unclear messages
- Conclusions

Description of the paper

Motivation

- Theory providing a characterization of the optimal coverage of DI (δ)

Description of the paper

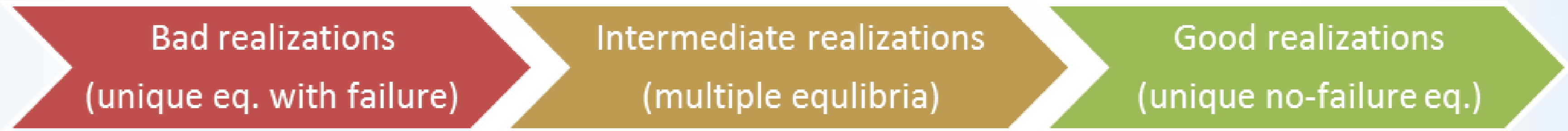
Main ingredients

- 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



- 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 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

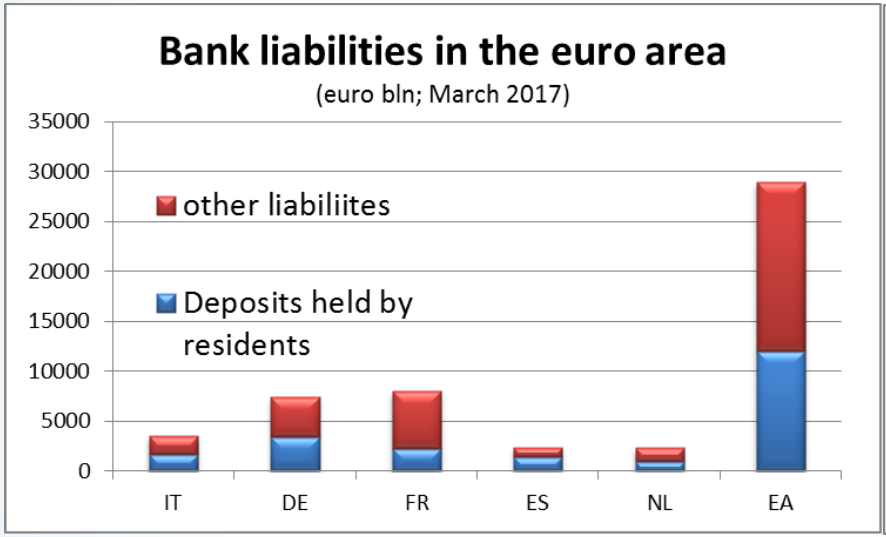
LOLR

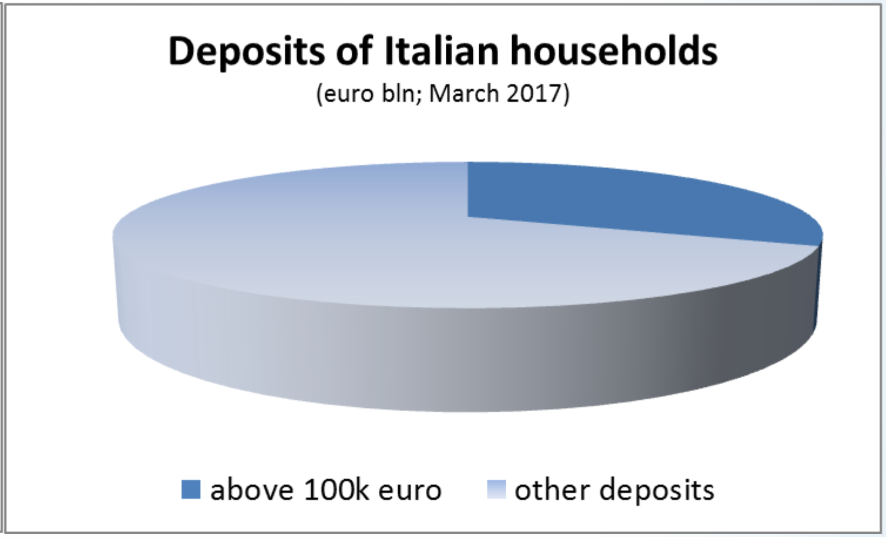
- LOLR and DI direct substitutes…
- …or indirect complements: private info on the side of LOLR has potential to destabilize (Angeletos, Pavan 2007)

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)

Comments

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!