Deposit Insurance and the Coexistence of Commercial and Shadow Banks

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Motivation and research questions

- Government insurance of deposits is controversial
  - Prevent bank runs
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- How does the design of the deposit insurance program affect the structure of the financial system?

Our approach

- Key features
  - Agents can transfer assets either to “commercial” banks or “shadow” banks
  - Commercial banks issue insured deposits, shadow banks do not
  - Commercial banks find out likelihood of eventual failure
  - Banks trade risky and riskless assets
  - Bank failures realized
  - Insurance payments and premia settled

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- Under three financing regimes
  1. Lump-sum taxes
  2. Deposit-based premia
  3. Risky-asset-based premia

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- What if there is no subsidy?

No subsidy $\Rightarrow$ no asset price distortion

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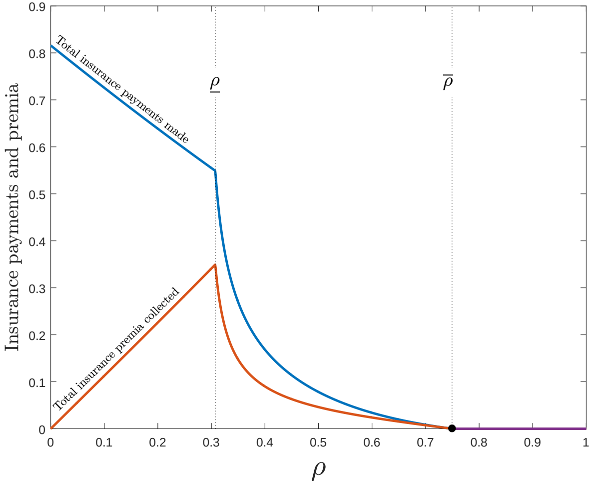
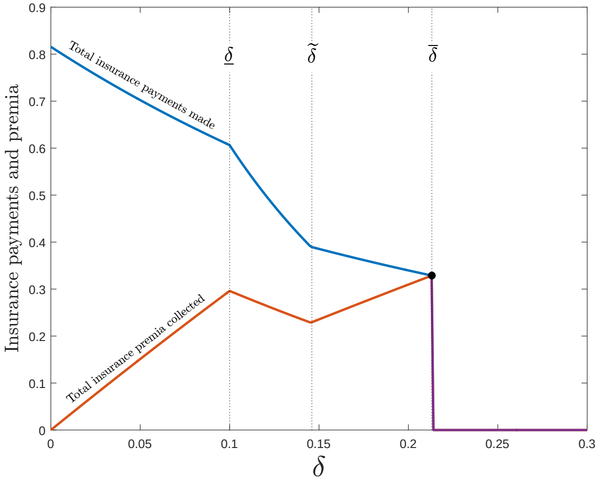
- Are all revenue neutral insurance programs identical?

Commercial banking collapses under risky-asset-based premia



Commercial banking survives under deposit-based premia



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  - **Deposit-based premia:** into commercial banks
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- Cautionary tale about design of deposit insurance programs
- Might defeat the very purpose of insurance by shifting risky assets to vulnerable shadow banks