CHAZEN INSTITUTE RESEARCH BRIEF

The Downside of Deposit Insurance

KEY TAKEAWAYS

- International expansions of deposit insurance promote the adoption of riskier assets in banking systems.
- By promoting increased asset risk, deposit insurance leads to the increased likelihood and severity of banking crises.
- Banks are more likely to make riskier investments that would not be feasible without the safety net protections that deposit insurance provides.

Deposit insurance has been used by many countries for decades to protect depositors from losses if a bank is unable to pay its debts on time, and in turn to avoid banking panics. While deposit insurance can, in theory, make the banking system more stable by reducing liquidity risk, it has also been shown to increase the risk appetite of banks and undermine financial stability in the long run.

In "The Spread of Deposit Insurance and the Global Rise in Bank Asset Risk Since the 1970s," **Charles Calomiris, Chazen Senior Scholar at Columbia Business School**, and Sophia Chen, an economist at the International Monetary Fund (IMF), track the expansion of deposit insurance generosity – and show that its steady rise has increased asset risk in banking systems by freeing banks from the constraints of market discipline. The authors show that this also has increased the frequency and severity of banking crises over recent decades.

Research

Calomiris and Chen analyze the origins of deposit insurance, its changing generosity over time, and the relationship of that growth to the increase in asset risk in banking systems. Their analysis uses three asset risk measures including: loans-to-assets, the proportion of mortgage lending a bank engages in, and bank debt-to-asset ratios. The research model also employs the IMF's International Financial Statistics (IFS) database on aggregate banking system balance sheets, which covers many countries and stretches back to the 1970s.

Their research is unique because typically the causes and consequences of deposit insurance have been discussed independently of one another.

Results

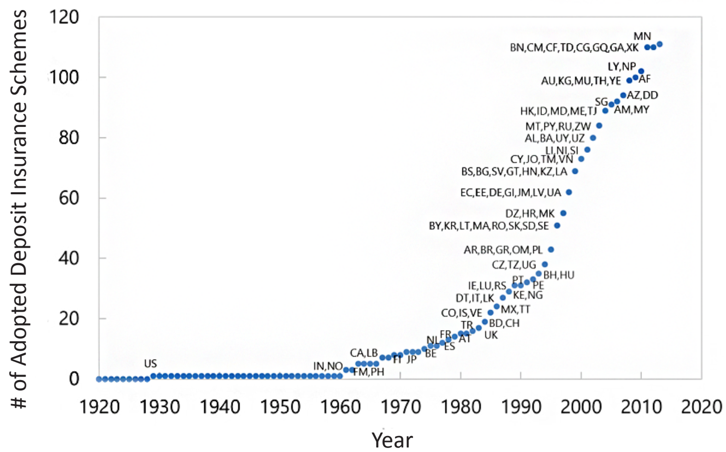
Taking the long view, the researchers found that increases in deposit insurance coverage globally has resulted in an increase of asset risk in banking systems.

They also found a correlation between generous deposit insurance and higher proportions of household loans (or mortgage loans); a fact that is true for both advanced and emerging or developing economies. This shows that deposit insurance not only expands the asset risk of banking systems, but does so in a way that favors risky household and mortgage lending. One reason the researchers propose for explaining this phenomenon, which requires further research, is that high rates of mortgage lending entail liquidity risks (and perhaps other risks) that would not be feasible for banks to bear without safety net protections. Another possible explanation is political: governments that protect banks may be better able to require banks to divert resources to risk-subsidized housing loans.

The researchers also note that increases in deposit insurance expansion are not offset by reductions in leverage. On the contrary, instructed increases in deposit insurance coverage tend to raise leverage ratios.

Furthermore, the research indicates that increased deposit insurance generosity leads to increases in loans-to-GDP, household-loans-to-GDP, and mortgage loans-to-GDP. Overall, the result is an increased likelihood and severity of banking crises.

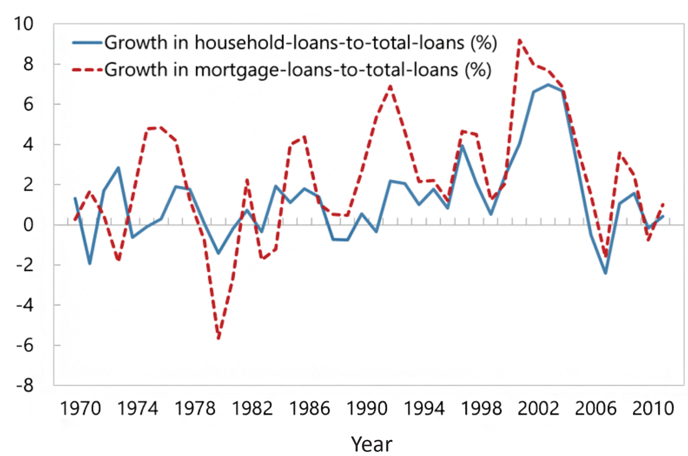
Deposit Insurance Adoption



Note: This figure plots the year of deposit insurance adoption by country. Data labels in the figure use International Organization for Standardization (ISO) country codes.

Source: Demirgüç-Kunt, Kane and Laeven (2005), Demirgüç-Kunt, Kane and Laeven (2014), national sources, and authors' calculations.

Growth in Household and Mortgage Loans



Note: This figure plots time series of annual growth in household loans as a fraction of total loans, and mortgage loans as a fraction of total loans. Growth is computed as log differences.

Source: Cerutti, Dagher, and Dell'Ariccia (2017) and authors' calculations.

Download the full paper:
http://www.nber.org/papers/w24936

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