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Deposit Insurance, Moral Hazard and Market Monitoring

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Abstract

The paper analyses the relationship between deposit insurance, debt-holder monitoring, and risk taking. In a stylised banking model we show that deposit insurance may reduce moral hazard, if deposit insurance credibly leaves out non-deposit creditors. Testing the model using EU bank level data yields evidence consistent with the model, suggesting that explicit deposit insurance may serve as a commitment device to limit the safety net and permit monitoring by uninsured subordinated debt holders. We further find that credible limits to the safety net reduce risk taking of smaller banks with low charter values and sizeable subordinated debt shares only. However, we also find that the introduction of explicit deposit insurance tends to increase the share of insured deposits in banks' liabilities.

Subject: Empirical Banking, The Eurozone

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