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Repudiation Risk and Restitution Costs: Toward Understanding Premiums on Insured Deposits

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DOUGLAS O. COOK
LEWIS J. SPELLMAN

Repudiation Risk and Restitution Costs: Toward Understanding Premiums on Insured Deposits

THERE IS A WIDELY HELD IMPRESSION that federally insured deposits are the risk equivalent of Treasury securities. Despite this impression, this paper provides evidence of risk pricing of insured deposits. If there is risk pricing of guaranteed deposits, investors in deposit instruments evidently price the possibility of loss from incomplete or costly deposit insurance coverage.

The risk pricing of insured deposits is tantamount to believing the guarantee might be repudiated in whole or in part and there are plausible reasons for this belief. The market, for example, might be concerned with an imprecise and hedged articulation of the guarantee in law,¹ a regulatory history of rolling back insurance

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1. In order for a federal guarantee to be full faith and credit or what has been termed explicit, the guarantee must be unqualified and statutory. In contrast, an implicit guarantee is either a mere conjecture on the part of the market that the government will back the guarantor's obligation or a form of statutory promise rather than a statutory commitment.

The deposit insurance guarantee at the time covered by the data in this paper was implicit as it rested only on promises that have taken various forms (Kane and Foster 1987). Aside from incidental verbal assurances and claims made by the President of the United States, such as "The savings and loan deposits are backed by the full faith and credit of the Government and they are sound, dollar good" (New York Times, January 28, 1989, p. 1) and by regulators (for example, Wall 1988), there had been several promises by Congress. A Joint Congressional Resolution (S 2617, March 23, 1982) indicated there is a "sense of Congress" that there is a full faith and credit guarantee (ff&c) on the deposit insurance agencies' obli-

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