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Deposit insurance, bank regulation, and financial system risks

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Abstract

Empirical evidence is presented to show that in modern times banks can hedge liquidity shocks but could not do so prior to FDIC insurance. However, the government's limitations in properly pricing FDIC insurance are leading to many current examples of moral hazard. A model is presented to show that if insurance premiums are set to be "actuarially fair," incentives for banks to take excessive systematic risks remain. Motivated by empirical evidence that money market mutual funds also can hedge liquidity shocks, I consider an alternative government insurance system that mitigates distortions to risk-taking yet preserves liquidity hedging and information synergies.

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G21; G22; G28

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