

Bank runs and deposit insurance



Fractional reserve banking

- ▶ Banks retain only a small amount of deposit as cash reserves to accommodate deposit withdrawals
- ▶ This is known as fractional reserve banking
- ▶ If the withdrawals are higher than the cash reserves, a bank may fail
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Causes and prevention of bank runs

- ▶ If loans are not repaid, banks may not be able to repay deposits → giving depositors to withdraw if they have this information
- ▶ It is not necessary to have such information, we will see how the expectation of others withdrawing will cause a bank run
- ▶ Bank runs can be avoided if depositors do not face losses from a failing bank
- ▶ Deposit insurance affects the incentives of banks when taking risks and the competition between them

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Expectations about other depositors

- ▶ Banks hold cash for some depositors to withdraw
- ▶ Banks can obtain additional cash to repay more deposits
- ▶ Banks are repaying deposits on a first-come-first-served basis, making expectations about the behaviour of other depositors essential
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Andreas Krause

Chapter 14.1.1
The breakdown of liquidity insurance

Discussion of model results

- ▶ Bank runs can become self-fulfilling: no fundamental reason needs to exist
- ▶ Expecting others to withdraw, makes it rational to withdraw
- ? If a bank faces a liquidity problem from deposit withdrawals, is it always best to withdraw yourself?
- ! Banks might obtain liquidity support from the central bank or other banks through interbank loans, making staying with the bank more attractive

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Bank risks and withdrawals

- ▶ Banks' abilities to repay deposits depend on the risks in their loans and the withdrawal rate of depositors
- ▶ Allowing bank to liquidate assets increases their ability to meet withdrawals
- ▶ The remaining assets are then used to repay the remaining depositors, each obtaining a larger share
- ▶ This trade-off will be investigated

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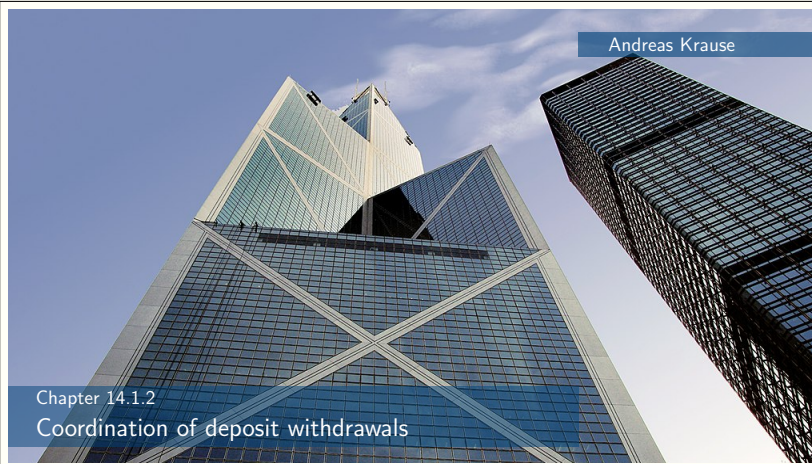
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Chapter 14.1.2
Coordination of deposit withdrawals

Discussion of model results

- ▶ A bank run may occur even if it is not profitable and not withdrawing deposits would yield a higher profit.
- ▶ The equilibrium exhibits a coordination problem between depositors whether to withdraw or not.
- ? Can banks easily and quickly sell their assets?
- ! The market for bank assets will be limited as the valuation of loans is difficult and buyers are subject to adverse selection.

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Insuring deposits

- ▶ Banks or depositors could purchase insurance against any losses, this would avoid a bank run
- ▶ Such deposit insurance is often provided by governments for free or a fixed premium, based on total deposits
- ▶ Depositors would not demand a risk premium for their deposits
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Chapter 17.1.1
Fixed-price deposit insurance

Discussion of model results

- ▶ Fixed-price deposit insurance induces banks to increase risks (excessive risk taking)
- ▶ The price of deposit insurance needs to take into account the risk banks take to avoid moral hazard
- ? With many governments providing free deposit insurance, why are bank failures not more common?
 - ! Banks are heavily regulated, in terms of capital requirements; the time delay of repayments and inconvenience of deposit insurance makes depositors not indifferent to bank failures

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- ▶ Fixed-price deposit insurance induces banks to **increase risks**, creating moral hazard
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Incomplete deposit insurance coverage

- ▶ Deposit insurance is usually limited to a certain amount of deposits per bank
- ▶ With deposit insurance competition between banks is affected as there the value of insured deposits is higher than uninsured deposits
- ▶ We will assess how this competition affects the preferences of banks for deposit insurance

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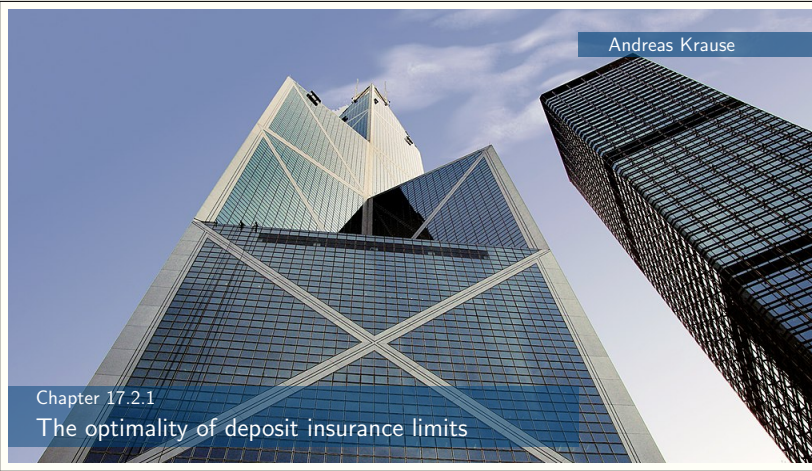
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Chapter 17.2.1
The optimality of deposit insurance limits

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- ▶ Banks balance lower deposit rates due to deposit insurance with higher competition due to offering a more valuable 'product'
- ▶ This results in a limit on the amount of deposits that are insured
- 7 Would a retail bank providing loans to low-income borrowers and financing these with many small deposits advocate for a limit on deposit coverage?
- ! This is unlikely as we need $\pi > \frac{1}{1+r}$ and the bank would need to be very safe; they would rather have no deposit insurance to limit competition

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Summary of key results

- ▶ Bank runs can occur due to depositors forming expectations about other depositors' behaviour
- ▶ Bank runs can be self-fulfilling and need not have a fundamental reason
- ▶ Deposit insurance prevents bank runs, but it affects the incentives of banks to take higher risks
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