Banking system stability

Finance, Banking

The aim of this study is to examine if there is a link between Deposit Insurance, Bank Stability, Risk Taking and Moral Hazards. Starting with examination of Deposit Insurance around the world and then moving onto the EU. It is found that Deposit Insurance alone can not provide Bank Stability but requires the support of mature banking regulations, supervision, credibility and strong contracting environments in order to successfully provide Bank stability. However it is found that where there is weak provision of the points highlighted above Explicit Deposit Insurance tends to increase Moral hazard, Risk Taking which then affects the Stability of Banks and vice versa when all points are catered for.

Introduction:

Over recent time-periods financial instability caused through systematic banking crises has affected not only developing but also developed countries of similarity. The consequence of such an event is not only disastrous but also costly politically (at macroeconomic level) and socially since taxpayers foot the bill of these disturbances and both depositor and borrowers lose access to their funds and credit facilities respectively which may result in bankruptcy. However this affect does not stop here but also spreads throughout the economy which causes deceleration in growth, some solvent banks to fail due to contagion, derailment of stabilisation programs and also increasespovertyin severe cases. A recent example of this is in turkey which caused confidence to fall amongst domestic institutions resulting in a currency crisis due to enormous foreign capital flight.

Consequently to limit such crises which result in Banking instability many safety nets were constructed and one which will be considered in this study is Deposit Insurance, which was originally formed in the US (1933) in the middle of thegreat depressionwith the intent to prevent extensive banks runs. Deposit Insurance Systems have rapidly expanded across the global over the last 25 years and a question which poses everyacademicand policymakers mind is that does Deposit Insurance System have a Link with Banking Stability? Therefore the remaining of this study will draw upon various studies previously conducted by institutes such as The World Bank, The ECB and Academic Organisations and aim to answer the question proposed above.

Empirical Analysis:

In this section various empirical findings will be consulted which will assist in answering the question proposed in the opening and this will commerce with a paper by Demirguc-Kunt and Detragiache [2000], which then continues through to another paper by Demirguc-Kunt and Kane [2001]. These two papers analyse deposit insurance around the globe using econometric models and provides a good foundation to the remaining of this study. Thereafter a paper by Gropp and Vesala [2004] will be considered which concentrates on the EU's deposit insurance and banking stability.

The authors Demirguc-Kunt and Detragiache [2000]1 use cross-sectional data on 61 countries from 1980-1997 and highlight some critical points which indicate that with the presence of explicit deposit insurance bank stability tends to be unfavourable due to deregulated bank interest rates.

However if this point is inverted this then means that in developed institutes where careful regulation and supervision is provided, bank stability is unaffected. In-addition it was also found that when coverage was increased to unlimited coverage and also included foreign currency, interbank deposits and actual share of deposit, bank stability became a lot more fragile.

Therefore it is possible for one to conclude that in environments where institutional weakness is present banking stability is affected by deposit insurance and this may be the case for developing and emerging economies. Furthermore by increasing the coverage offered to depositors it becomes clearly evident that banking stability is once again destabilised, however this seems to be the case when schemes are funded by the government as apposed to private organisations.

Moving over to the study conducted by Demirguc-Kunt and Kane [2001]2 they examine cross country differences in deposit insurance design and their affects on bank stability. According to the authors they find results empirically significant and in support of the results found by Demirguc-Kunt and Detragiache [2000]. They find that when institutes reside in weak environments where deposit insurance arrangements are poorly designed there is the increased tendency and probability for bank instability and future crises.

This proposition can be confirmed when the frequency of bank crises around the world is considered and it is statistically been proven by Demirguc-Kunt and Kane [2001] that where explicit deposit insurance is inadequately designed crisis are often quite high. In-addition to frail environments it has also been flagged that those countries with poor contracting environments also have the tendency to suffer from banking instability. The principle reason is that the regulations and supervision of such countries will not be fully developed, and with a partially developed banking structure it is relatively impossible to impose property rights and contract enforcement which would allow for information to be provided to its depositors in a timely manner to limit banking instability.

As a result of these empirical findings it is possible to express that in countries with poor supervision, regulation and contracting, deposit insurance invites bank to exploit the weakness in supervision and increase the amount of risky projects they take on and this is once again in equivalence to the findings of Kane [1989] and Demirguc-Kunt and Detragiache [2000]. Now turning to the EU and utilising the study conducted by Gropp and Vesala [2004]3 to answer the question proposed it is found that the author's empirical findings are quite striking since they provided conflicting result to the ones already provided when econometrics analysis using data on all banks in 15 EU is conducted which is supported by their findings.