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# Market Reaction to Risky Banks: Did Generous Deposit Guarantee Change It?

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**Summary.** — Turkey experienced a massive banking crisis in February 2001, resulting in the loss of more than a thousand managerial jobs and the closure of 21% of all bank branches in the market. In this paper, we study the behavior of the market and the banks in Turkey before the crisis, from 1988 to 2000, which includes the period of full deposit insurance. The empirical results showed that not only depositors but also borrowers reacted negatively to risky banks and punished them even more during the period of generous government guarantee. However, in the same period, banks were found to increase their moral hazard behavior significantly. Although the International Monetary Fund and the World Bank recommend explicit deposit insurance for developing countries, the findings of this paper suggest that deposit insurance may not be an effective policy tool to improve market confidence, and it does not guarantee a stable economic environment even when the market reacts negatively to the moral hazard behavior of banks.
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*Key words* — deposit insurance, market discipline, moral hazard, Turkey

## 1. INTRODUCTION

Governments have historically intervened extensively in the banking sector to promote financial stability. Often, their intervention policies have blocked some natural mechanisms and have resulted in undesired outcomes. One of those policies, government-sponsored deposit insurance, aims to maintain financial stability by minimizing the likelihood of bank runs. However, recent empirical evidence showed that explicit government guarantees reduced the market participation of depositors and adversely affected bank stability (Barth, Caprio, & Levine, 2004; Demirguc-Kunt & Detragiache, 2002; Demirguc-Kunt & Huizinga, 2004).

In this paper, we present contrary empirical evidence of declining market participation under explicit government guarantee to depositors. In volatile political and macroeconomic environments with insufficient regulations and poor supervision, the governments may lose their credibility. It can be argued that this loss of confidence in government motivates bank stakeholders [1] to be more involved in disciplining risky banks, even under full insurance. Toward this end, we analyzed the behavior of the market and the banks in Turkey for the period during 1988–2000. Turkey's explicit deposit insurance was established in 1983 and expanded to full coverage after the economic crisis in 1994. After eleven years of an explicit limited-coverage scheme, the transition from implicit blanket guarantee back to limited coverage took another seven years. Rapid political turnover and the involvement of the business and public communities in the distorted banking system of Turkey added to the corruption and significantly impaired the credibility of the incumbent governments (Chhibber, 2004). This environment might encourage stakeholders to react strongly to excessive risk-taking by banks. To our knowledge, previous empirical studies in the literature have not examined the long sub-periods that might erode the credibility of the insurance system.

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We examine the reactions of two important stakeholders—depositors and borrowers—toward the risky behavior of banks before and after a period of extensive government guarantee. The reaction of small savers or depositors against bank risk-taking has been studied extensively, but there has been a paucity of research on the interests of borrowers at risk. Kim, Kliger, and Vale (2003) demonstrated empirically that significant switching costs in the banking sector increased the inclination of borrowers to choose banks that were able to extend the line of credit or provide new loans on demand. Following this argument, we investigate the possibility that borrowers would lessen their relationship with risky banks in order to avoid possible switching costs incurred in the event of bank failures.

Our empirical results showed that bank depositors and borrowers reacted negatively to risky banks and punished them even more during the period of generous government guarantee, controlling for some bank characteristics, macroeconomic conditions, and yearly effects. Although depositors and borrowers lessened their relationship with risky banks, these banks were found to increase their moral hazard behavior significantly, especially after the introduction of 100% deposit insurance. Knowing that Turkey experienced a massive financial crisis in 2001, the results of this study reinforce previous evidence that market reaction would not prevent the fragility of the banking system, unless banks manage risk effectively and the government maintains sound supervision of banks and a stable macroeconomic environment.

This study contributes to the existing literature in two respects. First, we study how market participants' reactions changed with the introduction of generous government guarantee. Second, we examine the disciplining role of borrowers in addition to the role of depositors. To the best of our knowledge, there is only one empirical study that shows the significance of the role played by borrowers in disciplining banks (Kim, Kristiansen, & Vale, 2005 demonstrated with Norwegian banks).

This paper is organized as follows. The next section provides information about the Turkish banking system and the development of deposit insurance in Turkey. Section 3 contains a brief review of the literature on market reaction, the empirical models, and the data. The estimated results are reported and interpreted in Section 4. The paper concludes in Section 5.

## 2. BACKGROUND

### (a) *The banking sector in Turkey*

The banking sector constitutes a large part of the Turkish financial system. Denizer, Gultekin and Gultekin (2000) stated that the financial system and the banking system are synonymous in Turkey. Banks have dominated every aspect of financial activity and have been responsible for the expansion of the financial system in the country. However, the size of the banking sector is relatively small, compared to other upper-middle-income countries. For example, the ratio of bank deposits to the nominal GDP was 37.70% in Turkey in 2000, whereas the average of this ratio for the upper-middle-income countries was 43.50%. Moreover, the private credits provided by deposit money banks and other financial institutions constituted, on average, 43.9% of the GDP in these countries, but it was only 18.77% of the GDP in Turkey in 2000. [2]

The deregulation of banking and other financial services started in 1980 in order to develop a competitive and efficient financial system. The initial reforms eliminated interest rate restrictions on deposits and loans, facilitated the entry of new banks into the system, and introduced new financial instruments and institutions. As a result, there was an increase in the number of banks. For example, the number of banks was 37 in 1980, 64 in 1990, and 81 in 2000. These reforms resulted in fierce competition in the banking sector and high interest rates. Furthermore, the emergence of money brokers called "bankers" caused interest rates on savings to increase significantly via Ponzi financing methods (see, for example, Akyuz & Boratav, 2003). However, the financial distress in the real sector and unhealthy competition in banking resulted in the failure of six banks in total during 1983–84. These collapses caused the Central Bank to regulate the interest rates on deposits and to introduce the deposit insurance system in order to prevent potential bank runs. The Central Bank continued to regulate deposit rates until 1988 for the sake of maintaining positive rates of return (Denizer, 1997). Even though banks behaved competitively [3] in terms of determining price for deposits and bank loans throughout the period of analysis (1988–2000), regulatory and supervisory mechanisms in the Turkish banking sector have arguably been lagging behind the deregulation of the finan-

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