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Deposit insurance and the risk premium in bank deposit rates

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Abstract

By placing a ceiling on the amount of possible depositor loss, deposit insurance should result in a lower deposit risk premium. However, this effect may be modified if either the insurance promise has low credibility or the moral hazard incentives generated by deposit insurance result in a greater probability of bank default. Using financial and institutional panel data from thirteen countries, we find that the risk premium is over 40 basis points higher on average in uninsured countries than in countries that offer insurance up to some pre-specified maximum. However, the risk premium has a non-linear relationship with the level of maximum insurance coverage, suggesting that the market recognizes the moral hazard potential. Moreover, the effect of deposit insurance on the risk premium is weaker in countries with strong creditor rights, consistent with the view that investors view the latter as a substitute for explicit deposit insurance.
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1. Introduction

What effect does the provision of deposit insurance have on the risk premium required by holders of bank deposits? At first glance, the answer seems obvious: by

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eliminating the possibility of loss, deposit insurance provides protection to depositors and thereby induces a lower risk premium. However, there are at least two modifying influences on this relationship. First, the promise to insure depositors may have imperfect credibility, thereby negating the offered protection and curbing the fall in the risk premium. Second, even if the promise to pay is fully credible, the moral hazard incentives created by fixed rate deposit insurance may increase the probability of bank default. For deposits which are only partially insured (e.g., because of an upper limit on the size of insured deposits), this increases the probability of receiving a lower-than-expected payout and therefore raises the risk premium on these deposits.

A number of other authors have examined one or other of these issues in isolation. Consistent with the notion that the deposit risk premium reflects insurer credibility, Cook and Spellman (1996) analyze 233 US thrifts during 1987 and 1988 and conclude that most of the elevation in risk premia during that period was due to increases in guarantor risk. Similarly, Flannery and Sorescu (1996) examine 422 issues of subordinated notes and debentures by US institutions between 1983 and 1991 and find that yields on these securities changed in line with variations in the perceived strength of the insurance guarantee. With regard to the moral hazard effect, Grossman (1992), Kane (1989), Keeley (1990) and White (1991), among others, attribute periods of high bank failure rates to this problem. Moreover, Brewer and Mondschean (1994) conclude that depositors in US savings and loan associations during the 1980s required higher deposit rates from institutions with strong moral hazard characteristics, while Shoven et al. (1992) argue that high treasury bill yields during the same period reflected the need for these securities to remain competitive with the CD rates offered by high-risk, but insured, institutions. Thus, these groups of authors emphasize the importance of both insurer credibility and moral hazard incentives for the setting of risk premia on deposits. However, their data come from a single insurance system with a single insurer, so they are unable to address the extent to which these effects are reflected in risk premia on deposits with different levels of insurance coverage and different insurers. Moreover, they typically focus on the implications of either imperfect credibility or moral hazard incentives; they do not explicitly examine the extent to which both of these factors affect deposit risk premia.

In this paper, we examine the extent to which insurer credibility and moral hazard effects are simultaneously present in interest rate data from thirteen countries that differ in the amount of formal depositor protection that they offer. We find that the risk premium is, on average, significantly higher on deposits in countries that do not offer explicit insurance than it is on deposits in countries that provide insurance up to some maximum level, consistent with deposit insurance schemes having high credibility. However, we also find some weak evidence that the marginal impact of insurance on the risk premium becomes smaller as the maximum insurance coverage increases, consistent with the view that generous insurance schemes encourage morally hazardous behavior.

We also consider other determinants of the deposit risk premium. Most of the single-country studies cited above recognize that the risk premium depends not only on the level of insurance coverage, but also on the risk characteristics of the offering

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