

THE IMPACT OF DEPOSIT INSURANCE ON THE BANKING SYSTEM'S STABILITY

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ABSTRACT

This paper analyzes the impact of deposit insurance on the banking system's stability. The analysis is based on a review of the relevant literature dealing with the issue of deposit insurance. The aim of this paper is to determine the direction of the impact of deposit insurance on the stability of the banking system. Based on the reviewed research results, it can be concluded that the direction of the impact of deposit insurance on banking system stability is not influenced by the mere introduction of the mechanism itself but by the (non)fulfillment of certain conditions necessary for its optimal application.

Keywords: deposit insurance, banking system's stability, banking risk, market discipline, deposit insurance premium.

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INTRODUCTION

The banking business is characterized by a significant discrepancy between funding sources and investments in terms of maturity, liquidity, and risk. Banks use long-term assets to cover short-term deposit withdrawal requests, which is an important source of bank instability [1]. Banks possess liquid assets only to cover ordinary, day-to-day depositors' withdrawal requirements [2]. Due to the fragility of banking operations and the banks' importance for the financial and economic system, significant restrictions have been imposed on banking activities, including regulations on market entry, interest rate policies, capital requirements, and the protection of depositors' rights [3]. In addition to regular supervision and regulation, the key external mechanisms for maintaining the stability of the banking sector in most countries are the lender of last resort, backed by the central bank, and deposit insurance [2].

The focus of this research is on deposit insurance. The main purpose of this mechanism is to protect depositors' rights and strengthen their confidence in the banking system and their willingness to entrust their money to banks [4], which should ultimately lead to the stabilization of banking operations. The inception of deposit insurance dates back to the 19th century in the United States, which successfully established a viable deposit insurance framework in the 1930s [5]. Currently, a deposit insurance system is in place in 145 countries [6].

This paper analyzes the impact of deposit insurance on the stability of the banking system. The aim is to determine whether the deposit insurance mechanism promotes the stability of the banking system or has a destabilizing effect, as well as to examine the preconditions necessary for deposit insurance to fulfill its intended purpose. The paper is structured as follows: the first part analyzes the direction of the influence of deposit insurance on banking stability, while the second part considers ways to eliminate or at least minimize the shortcomings and potential destructive effects of the deposit insurance mechanism.

DEPOSIT INSURANCE AS A FACTOR OF (IN)STABILITY OF THE BANKING SYSTEM

Throughout banking history, it has been a frequent occurrence for depositors to forfeit their savings due to bank failures. As a result, early signs of a banking crisis have typically prompted widespread withdrawals of deposits, which usually resulted in the downfall of the banking system, followed by the destabilization of the monetary system, a decrease in foreign capital, and a slowdown in the real economy [7], [8]. Preventing such devastating crises is primarily the task of the central bank, which, as a lender of last resort, should help banks in trouble and prevent the crisis from spilling over to the rest of the banking system. However, the existence of a rescue institution can be an incentive for banks to engage in risky business arrangements [7].

Over time, deposit insurance has emerged as a more efficient and desirable mechanism for protecting banking stability. Depositors are aware of a guarantee that their deposits are safe even if their bank fails, so there is a small possibility of a bank run. They are encouraged by the fact that insured deposits have rarely not been paid [9]. In addition, this solution has become popular for at least two other reasons: *first*, reserves to cover losses are formed with insured banks' money and not with government money, and *second*, this mechanism primarily serves as a support for small depositors and small banks [8]. In addition to its important role in preventing banking crises, deposit insurance has proven to be an effective tool in banking crisis management [10]. By strengthening confidence in the banking system, deposit insurance also leads to deepening of the financial market, which is an important factor in accelerating economic development [11]. Also, a positive effect of its implementation is the prevention of foreign capital outflows [12] and encouragement of money transfers from unstable to stable banks [2]. In addition, deposit insurance has enabled banks to use dividend policies less often to prove their creditworthiness [13].

On the other hand, there must be awareness of the potentially harmful consequences of implementing deposit insurance. Owners of insured deposits do not show a remarkable willingness to actively supervise banks, which opens the door for risky investments [2]. This is especially present in countries where the fund for covering potential losses of depositors is formed in advance (*ex-ante*) [14]. As a result, deposit insurance is becoming a strong factor of destabilization. Its negative impact on the banking system's stability before a crisis far outweighs the positive effects that this mechanism has during a crisis [10]. Freed from the active supervision of depositors, banks engage in potentially high-yield but also extremely risky activities while neglecting the logic of optimizing the structure of investments, which will ultimately harm not only them but also overall economic trends [15]. In

addition to depositors, deposit insurance largely demotivates other stakeholders, such as supervisors, politicians, borrowers, and taxpayers [8], to actively supervise the operations of banks whose deposits are insured [2]. In essence, this provides an opportunity for unscrupulous banks to achieve above-average benefits at the expense of conscientious banks and taxpayers if there is a need to save those banks with government money [16]. They also benefit from the fact that the price of deposit insurance in many systems is too low, i.e., it is not adjusted to the risk covered by the insurance [15], [17].

It is important to highlight that the beneficial effect of deposit insurance on depositors' trust in the banking system is primarily constrained. The practice has shown that deposit insurance makes a small contribution to the increase of banks' deposit potential and far more to the increase in their lending activity [18], [19].

CONDITIONS FOR OPTIMAL APPLICATION OF DEPOSIT INSURANCE

Decades of experience with the deposit insurance mechanism have shown that its introduction alone is not a guarantee of banking system stability or a sufficient factor in preventing a bank run [20]. In some cases, depositors in banking systems with explicit deposit insurance mechanisms have suffered significantly higher losses than depositors in systems without such mechanisms [21]. For the application of deposit insurance to be optimal and purposeful, appropriate conditions must be met.

First, there must be an adequate regulatory environment that encourages banks to operate responsibly and regularly inform clients and supervisors about the quality and riskiness of their operations [8]. The outcome of such an environment should be the establishment of compulsory deposit insurance¹ [8], which is adequately funded [2], managed by competent and independent staff [2], and introduced deliberately, rather than under pressure from a banking crisis [8]. In an efficient regulatory environment, the problem of asymmetric information between regulators and supervisors on one side and banks on the other is eliminated or at least mitigated [22]. This is achieved by creating an incentive-based deposit insurance system in which stable banks are motivated to adequately inform regulators and supervisors about their operations in order to reduce deposit insurance costs [23].

Second, a crucial factor in the successful application of deposit insurance is the insurance premium policy. The premium should be sufficient to replenish the insurance fund but not so high as to jeopardize banks' liquidity, solvency, and profitability [2]. Research indicates that the most effective approach is to adjust premiums according to risk [15]. Nonetheless, calculating risk-adjusted deposit insurance premiums presents a considerable challenge for many regulators, who struggle to align premiums with the actual risk associated with banks' activities [22]. As a result, this approach should be implemented gradually [2]. However, evidence suggests that merely having a risk-adjusted premium does not provide sufficient motivation for banks to lower the risk associated with their operations [15].

Third, the proper application of deposit insurance requires an appropriate level of market discipline among banks. This is achieved primarily by motivating depositors to actively monitor their banks' operations. Depositors will be prepared to do this only if there is partial deposit coverage, a co-insurance obligation, exclusion of large and influential depositors from the insurance system, and prevention of practices such as splitting deposits across accounts to gain higher coverage [16]. When their deposits are uninsured, large depositors—such as banks, governments, and large corporations—are motivated to supervise and “discipline” their banks [2]. For effective bank discipline, these depositors must also be adequately informed about the performance and risk level of their banks [24]. Moreover, market discipline is strengthened if the deposit insurance system is partially or entirely controlled by banks. In a system that is financed and managed by the banks themselves, supervision is more efficient because banks have an interest in identifying and reporting problematic institutions to protect the overall sector [1].

Optimizing the application of deposit insurance remains more theoretical than practical. Nonetheless, even if fully realized, this should not serve as an excuse to neglect the important role of the lender of last resort in maintaining banking sector stability [25]. Finally, if deposit insurance fails to deliver the expected results, it should be abolished [26], and more cost-effective and efficient alternatives should be implemented, such as investing in liquid money market instruments or adopting a “narrow bank” model [14].

¹ Research has shown that when participation in the deposit insurance system is voluntary, stable and successful banks generally opt out of the system, which ultimately contributes to its collapse [8].

CONCLUSION

Deposit insurance plays a crucial role in stabilizing the banking system by boosting depositor confidence and reducing the likelihood of bank runs. Such runs can lead to a depletion of banks' liquid assets, potentially causing failure in the banking and monetary systems, and ultimately leading to a recession in the real economy. Deposit insurance reduces the probability of significant capital outflows and contributes to the deepening of financial markets, thus providing the economy with additional funding sources.

On the other hand, deposit insurance often relieves banks from active depositor oversight, allowing them to engage in risky activities, neglect the optimal structure of investments, reduce overall financial system efficiency, and contribute to systemic risk.

To enable deposit insurance to fulfill its core objective of enhancing banking sector stability, it is essential to: create an effective regulatory framework; ensure the system is managed by competent and impartial leadership with adequate funding; implement sound premium policies that reflect the risk profile of insured banks; address asymmetric information between banks and regulators; and strengthen market discipline by encouraging depositors to supervise banks through limited insurance coverage and by establishing a system that is financed and managed by the banks themselves.

The deposit insurance mechanism should only be applied when conditions for its successful implementation are met. Otherwise, it is more effective to consider alternative mechanisms that may be more cost-efficient and operationally sound.

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