Bank Capital, Liquidity Creation and Deposit Insurance

by

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MAIN IDEAS

1. Application of Berger-Bauwman (2009) Measures of Liquidity
2. Examine the Effects of Deposit Insurance on Liquidity Creation-Bank Capital Relationship
3. A Natural Experiment: Russia 2004

MAIN RESULTS

1. In general, Bank Capital and Liquidity Creation are Negatively Correlated, at 1% significance level, BOTH before and after Deposit Insurance, Supporting the Fragility-Crowding Out Hypothesis.
2. For Large Banks, the relationship is insignificant, but still mostly negative, unlike the US situation.
3. The relationship is also not significant for State-Controlled and Foreign-Ownership Banks.

Financial Fragility and Deposit Insurance

1. The negative effect of capital on liquidity creation as suggested by Diamond and Rajan (2000, 2001) depends ***crucially*** on deposit insurance coverage being incomplete (Berger-Bauwman, 2009).
2. Deposit Insurance may reduce this negative effect, which is the premise of this paper.

Recent Evidence from the Crisis

Victoria Ivashina and David Scharfstein (2009)

1. After 9/15/2008, there was a run by short-term bank creditors, making it difficult to roll-over short-term debt.
2. Simultaneous run by borrowers who drew down their credit lines, leading to a spike in industrial and commercial loans.
3. Banks cut their lending less if they had better access to deposit financing and if they had to rely less on short-term debt.

Comparison to Berger-Bauwman Measures

1. LC1 was a special case of mat-nonfat measure in Berger-Bauwman
2. Therefore, how different is LC1 from LC3? (LC3 has the lowest R-Square)
3. LC2 is closest to Berger-Bauwman's most preferred measure: cat-fat, but how close?

Comparison to Berger-Bauwman's Results

1. In Berger-Bauwman, the relation is positive for large banks, supporting the Risk Absorption Theory.
2. Also, the relation is negative for small banks, supporting the Fragility-Crowding Out Theory.
3. This paper finds slightly different results: WHY?

Other Comments

1. What is the effect of the Shadow Banking System?
2. What can we learn from alternative models of relationship-banking and fragility (e.g., Song and Thakor, RFS 2010)?

Concluding Comments

1. Very good application of Liquidity Measures
2. Relevant for Policy Formulation
3. Important for Emerging Market Research