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Economic Perspectives on Societal Challenges: Equality of Opportunity, Market Regulation, and Financial Stability - EPoS

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INTERVIEW

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Why it is risky that US banks' deposit financing increased to almost 90 percent

Interview with Maxi Guennewig, EPoS Economic Research Center

Bonn, Mannheim, 10.12.2023 – ***US banks increasingly rely on deposit financing: The share of deposits increased from 70 percent of total liabilities for the 30 largest US banks before the Great Financial Crisis to almost 90 percent. Why do US banks issue more deposits, in particular, uninsured deposits? Maxi Guennewig explains that issuing uninsured deposits allows banks to inflict losses on the government in times of crisis. EPoS Economic Research Center publishes these findings in the discussion paper "Bank Resolution, Deposit Insurance, and Fragility".***

Mr Guennewig, has the US government not learned the lessons from the Great Financial Crisis?

Maxi Guennewig: Lessons were learned. Yet, the current bank regulation may not be optimal to prevent financial fragility in times of crisis. Let's look at the reforms first: Before 2008, governments could only rescue failing banks considered "too big to fail" by injecting costly public funds, i.e. using bailouts. Nowadays, governments can put failing banks into resolution which allows governments to impose losses on bank creditors. During a bank resolution, governments continue to provide partial deposit insurance with the goal of curbing financial fragility – and this is important.

We find, if the government provides a sufficiently large amount of deposit insurance, banks finance exclusively using insured and uninsured deposits. This is what we see in the actual numbers. Upon arrival of unfavourable news about the value of bank assets, uninsured depositors withdraw in anticipation of intervention. This imposes losses on insured depositors. The fragility resulting from the anticipation of bail-ins thus stands in the way of resolution, and the government is forced to conduct bailouts after all.

In other words, do banks inflict their losses on the government via uninsured deposits?

Maxi Guennewig: Yes. By issuing uninsured deposits, banks are able to impose losses on insured depositors and thus on the government.

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What is your recommendation to policymakers?

Maxi Guennewig: Policymakers who design banking regulation should take this mechanism into account. Otherwise, the post-crisis reforms may fail to achieve their purpose and spur financial fragility instead. The potential costs for governments are huge.

The presented discussion paper is a publication without peer review of the Collaborative Research Center Transregio 224 EPoS. Access the full discussion paper here:
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The Collaborative Research Center (CRC) Transregio 224 EPoS
Established in 2018, the Collaborative Research Center Transregio 224 EPoS, a cooperation of the universities Bonn and Mannheim, is a long-term research institution funded by the German Research Foundation (Deutsche Forschungsgemeinschaft, DFG). EPoS addresses three key societal challenges: how to promote equality of opportunity; how to regulate markets in light of the internationalization and digitalization of economic activity; and how to safeguard the stability of the financial system.

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