

# Deposit Insurance & Resolution of Failed Banks

Discussion

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FDIC Annual Bank Research Conference

September 2019

# Key Theme

Two very interesting papers on the interaction between deposit insurance and bank's incentives related to:

- ▶ Activities in the Fed Funds Market
- ▶ Bidding for Failed Banks

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- ▶ Activities in the Fed Funds Market
- ▶ Bidding for Failed Banks
  
- ▶ Lots of work on the effects of deposit insurance on risk-taking.
- ▶ But not much on these other dimensions.
- ▶ Very relevant papers for Deposit Insurance Policies.

# Deposit Insurance Premiums & Arbitrage

## Key Idea

- ▶ Interest on Excess Reserve  $\uparrow \rightarrow$  Demand for short-term funds (e.g., by banks from GSE)  $\uparrow \rightarrow$  Short term rate  $\uparrow$
- ▶ However, bank size goes up as a result, leading to higher deposit insurance premium.
- ▶ Profitability of IOER arbitrage goes down and thus DIP works as an offsetting force.
- ▶ Crucial to understand the effect of DIP on the supply and demand for federal funds.
- ▶ Good work on exploiting kink in assessment of deposit insurance.

# Deposit Insurance Premiums & Arbitrage: Comments

- ▶ Maybe useful to relate to the literature on limits to arbitrage and ask a bigger question
  - ▶ Why don't the IOER and Effective Fed Funds Rate converge?
  - ▶ In fact  $\text{IOER} \geq \text{Effective Fed Funds Rate}$ . Why?

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- ▶ What frictions are at play and how important is DIP compared to other potential frictions: capital requirement, transactions costs?
- ▶ It will be important to look at the behavior of large banks.

# Resolving Failed Banks

## Key Idea

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- ▶ FDIC's resolution mechanism is complex:
  - ▶ Flexibility: allows multiple dimensions of bidding.
  - ▶ Opacity: uncertainty about the scoring rule.
- ▶ A rigorous structural model to back out the valuation of bidders from observed bid.
- ▶ Quantity losses to FDIC using alternate mechanism.
- ▶ Key message: FDIC can lower its resolution cost by 17% by eliminating opacity in scoring rule!

# Resolving Failed Banks: Comments

- ▶ The effect of uncertainty in scoring rule in the model:
  - ▶ Bidders can submit multiple bid and hope to win for some combination of bids and scoring rule.
  - ▶ Low-valuation bidders can bid even less hoping that a good shock will allow them to win anyway.

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  - ▶ What if the auction fails with transparent rule?

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- ▶ Question: Is there any benefit to lack of transparency in scoring rule that is not captured in the model?
  - ▶ What if the auction fails with transparent rule?
  - ▶ Rule-bound versus discretion?
    - ▶ Importance of hard versus soft information?
    - ▶ Rule-bound model may attract different/more bidders.
    - ▶ Multiple resolution at the same time: capacity constraints/legal constraints.

# Conclusions

- ▶ Papers are tackling very important issues
- ▶ Some work remains in terms of digging deeper into the issues.
- ▶ Good luck!