Discussion of:

Deposit Insurance, Bank Regulation, and Narrow Banking

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Rethinking Optimal Deposit Insurance (Yale University)
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A common narrative

- It is important for bank deposits to be safe …
  - for a variety of reasons
- … and therefore we need deposit insurance
- However, insurance distorts banks' incentives ($\rightarrow$ too much risk) …
- … so we need to closely regulate and supervise banks
  - which is difficult to do well, and is quite costly
- Perhaps it would be better to have *narrow banks*
  - that hold only safe, liquid assets (ex: reserves at the central bank)
- This paper: evaluate this narrative from a new angle
  - shows: features of deposit insurance are important for the answer

A framework

- Starting point: a monetary general equilibrium model where:
  - bank deposits are used as a medium of exchange
  - frictions ⇒ deposits must be backed by assets
    - transactions cannot be financed by "pure" bank credit
- Such models are favorably inclined toward narrow banking
- If the supply of safe assets is "naturally large" …
  - think: large stock of govt debt for fiscal purposes
- … then having banks hold only safe assets is efficient
  - no need for deposit insurance (or costly bank capital)
  - no benefit here to tying deposit-taking and lending together

- Assume instead: the supply of safe assets is limited
  - and much smaller than the demand for deposits as a medium of exchange

⇒ Requiring all banks to be narrow restricts deposit creation
  - which limits transactions, real activity; lowers welfare

- Note: different from the usual case against narrow banking
  - usual case: if banks can only hold safe assets → too little credit, investment
  - here: investment can be financed efficiently in other ways (private credit)
    - if banks are narrow → there will be *too few deposits*
    - we need banks to lend as *side effect* of creating deposits

- To make this point in a sharp way: bank lending has a negative NPV

  ⇒ without the demand for deposits, these loans would not be made

The question

Q: In this environment where creating deposits is difficult …

… what is the optimal composition of assets in the banking system?

- what combination of safe vs. (less-desirable) risky assets?
- how should those assets be allocated across banks?
- how do features of the deposit insurance system affect the answer?

A benchmark

- With no incentive problems → answer would be straightforward
  - all safe assets should be held by banks
    - best alternative use is only as a store of value
  - create additional deposits backed by risky assets until the marginal cost …
  - equals the marginal benefit of deposits in supporting economic activity
- Results:
  - we want the banking system to hold a mix of safe and risky assets
    - so … requiring banks to be narrow is bad
  - insuring deposits is important → supports more real activity
  - how the assets are distributed across banks does not matter
    - allowing banks to specialize in either direction is completely neutral

Moral hazard?

- Back to the common narrative: DI distorts banks' incentives
- Paper adds: hidden effort (e) for risky assets
  - in bad aggregate state: assets are worthless with prob. $\alpha(e)$
- Banker uses deposits plus own funds (capital) to invest
  - high effort is optimal $\Leftrightarrow$ bank capital is large enough
- Deposit insurance premium cannot be conditioned on effort …
- … but it *can* be conditioned on the bank's choice of capital
  - which (in equilibrium) reveals what the effort level will be

$\Rightarrow$ Deposit insurance does not distort incentives

- results are unchanged from the benchmark case

Fake assets

- There is also an incentive problem for safe assets
- Instead of buying govt bonds, bank can create "fake" bonds
  - cost ψ to create; will be worthless for sure
  - banker can use deposits to pay cost ψ, keep the difference
    - represents … outright lies? Subprime CDO^2 ?
    - most difficult element of the model for me to interpret
- Solution is again for the banker to hold capital
  - will buy real bonds $\Leftrightarrow$ bank capital is large enough
- Key issue: is this cost ψ the same for broad and narrow banks?
  - or does it differ by bank type? In which direction?

Results

- If ψ is the same for narrow and broad banks:
  - distribution of assets across banks is again irrelevant
- If friction is smaller in narrow banks:
  - all safe assets will migrate to narrow banks (and welfare ↑)
- If friction is larger in narrow banks:
  - narrow banks are not viable in equilibrium …
  - … unless broad banks face binding leverage constraint (→ inefficient)
- These results are interesting, intuitive
  - key takeaways depend on which case we focus on

Q: What are the most relevant case(s)?

Comments

1. Narrow or shadow banks?
2. Regulation and supervision
3. A capital requirement?

1. Narrow or shadow banks?

- What are the most relevant case(s)?

- Paper argues that frictions are likely *larger* in narrow banks
  - benefit of narrow banks: we don't need this costly regulation
  - but if they are unregulated, frictions might be large

  "[P]roponents of narrow banking … assume that a portfolio of safe bank asset holdings is essentially costless to monitor. However, stablecoin arrangements … can be fraught with issues of misrepresentation."

- But … is Tether a narrow bank? Or a *shadow bank*?
  - assets include corporate bonds, precious metals, Bitcoin, etc.

    https://tether.to/en/transparency/?tab=reports

- Could a modified model be used to think about shadow banking?

A model of shadow banks?

- Suppose deposit insurance cannot be priced efficiently
  - so it ends up distorting incentives
- Define "shadow bank" as no deposit insurance

Q: Should we allow shadow banks to operate?

  - could hold capital to mitigate information frictions (as in the model)
  - what asset portfolio would they hold? (would they look like Tether?)
- Could such a model address:
  - the optimal composition of banking between regulated and shadow banks?
  - the size/boundary of the safety net?

2. Reg/Sup

- Important to distinguish between *regulation* and *supervision*
- I think most proponents envision narrow banks being *regulated*
  - any institution taking deposits in the U.S. is regulated
- But narrow banks should be much easier to *supervise*
  - simpler rules; much easier to verify compliance (I think)
- The relevant case to me is *smaller* frictions in narrow banks

  $\Rightarrow$ efficient for all safe assets to be held in narrow banks
    - best way to intermediate safe assets into deposits
- Logic is clear, but … are we comfortable with this answer?

- Suppose (again) deposit insurance cannot be priced perfectly

Q: Would moving all safe assets out of broad banks cause problems?

  - their asset portfolio becomes riskier on average
  - deposit insurance needs to play a bigger role
    - even bigger moral hazard?

- Could a model like this address:
  - the optimal division on safe assets between broad and narrow banks?
  - whether allowing narrow banks to operate is somehow undesirable?

3. No capital requirements?

- Paper emphasizes: no role for capital regulation …
  - *"in this environment, government-imposed capital requirements at best have no effect, and at worst reduce welfare."*
- But … the DI premium depends on bank's choice of capital

Two interpretations:

1. We don't need capital requirements
   - banks will voluntarily choose to hold the efficient amount of capital
2. There is a minimum capital requirement
   - penalty for falling below the requirement is a higher DI premium

- These two interpretations seem … equivalent?
  - put the second way → result seems more conventional

Wrapping up

- Paper presents an interesting framework
- … that can be used to study a range of issues
- If deposit insurance is priced perfectly:
  - do not want shadow (uninsured, risky) banks to operate
  - but allowing narrow banks to operate may raise welfare (my take)
- If not … what happens? Do the answers change?
  - might we want shadow banks to be available as an option?
  - do narrow banks become more worrisome?
  - are there other interesting questions here?