Bank Capital, Liquidity Creation and Deposit Insurance
by
Zuzana Fungacova, Laurent Weill, Mingming Zhou

Discussant: Sris Chatterjee
MAIN IDEAS

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