On the Inefficiency of Deposit Insurance Caps

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Abstract

This paper investigates the welfare implications of deposit insurance coverage limits. Specifically, we address the policy question of whether a cap on deposit insurance payouts—whereby the insurance authority pays failing bank depositors less than the bank's promised short-term return—improves social welfare. We construct a modified Diamond-Dybvig framework characterized by a continuum of banks, aggregate uncertainty regarding bank failures, and costly asset liquidation. Distinct from recent literature, our model incorporates a privately funded, ex-ante deposit insurance scheme, sequential servicing, and endogenous bank contracts that react to regulatory constraints.

We characterize the global optimum for a social planner and demonstrate that this allocation can be decentralized via a bank contract, although the system remains susceptible to a bank panic Nash equilibrium. Our primary contribution lies in the analysis of coverage caps. By solving a constrained optimization problem where the insurance payout is allowed to be less than or equal to the promised consumption, we prove that the optimal policy requires full coverage. Consequently, imposing a cap on deposit insurance is suboptimal in this environment. Finally, we extend the model to include heterogeneous endowments. We demonstrate that our main result is robust to this extension, showing that the optimality of full coverage persists even when depositors differ in their initial wealth.

JEL Classification: G21; G28; E44
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