

Fixed-Premium Deposit Insurance and Collective Action Problems Among Banks

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ABSTRACT

We introduce a monopolistically-competitive model of foreign lending in which fixed-premium deposit insurance increases the probability that banks will experience ex-post collective action difficulties. In addition, "implicit deposit insurance," in which regulators respond to bank failures by merging rather than closing failing banks, provides banks with the incentive to organize their lending package in a manner which increases the regulators' perception that a loan failure is threatening to the banking system. Both forms of deposit insurance increase the degree of credit contraction in bad states, the percentage of expected default, and the expected burden on the deposit insurance institution.

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