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Abstract

This study intends to solve a puzzle in the banking literature: why an increasing number of countries adopt a deposit insurance scheme (DIS) while prior studies have shown that it increases the likelihood of banking crises? Using a dataset of 64 countries over the period 1970–2009, our study shows that the adoption of a DIS is associated with a 2.0–4.7 percentage points higher likelihood of banking crises (the “direct effect”), while it is associated with a 10.1–11.1 percentage points lower likelihood of non-banking financial crises (the “spillover effect”). Since the “spillover effect” is larger than the “direct effect”, a DIS actually increases overall financial stability. Additionally, we analyze the mechanisms through which a DIS affects financial crises. First, we