

**THE IMPACT OF DEPOSIT INSURANCE ON RISK-TAKING BEHAVIOR:
An Application to Credit Unions**

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Fixed-rate deposit insurance has been posited to provide financial institutions with incentives to increase risk. By guaranteeing the value of depositors' funds at a rate independent of risk, deposit insurance removes the market discipline that otherwise acts to restrain risk-taking behavior.

Previous studies of deposit insurance have been mostly devoted to examining changes in the risk-taking behavior of banks or savings and loans. This study examined changes in credit union risk-taking following establishment of the national Credit Union Share Insurance Fund (NCUSIF) in 1971.

Financial ratios proxying for capital adequacy, liquidity, and loan delinquency were tested to determine if credit unions increased risk following implementation of deposit insurance. Time series tests employing industry average financial ratios for federal and state credit unions did not support the increased risk-taking hypothesis. Although federal credit union capital ratios did fall immediately following adoption of deposit insurance, this was most likely the result of reduced capital requirements, not deposit insurance. Decreases in regulatory capital were typically offset by increases in discretionary capital. Additional time series analyses examining the behavior of both liquidity and loan delinquency ratios further suggested that risk-taking behavior actually declined during the post-insurance period.

Individual credit union data for Iowa state-chartered credit unions were used to examine pre- and post-insurance risk levels. Like the time series results, the majority of these tests rejected the hypothesis that insurance increased risk-taking behavior. Many of these results, again, suggested that deposit insurance was associated with higher levels of capital and greater liquidity. Taken together the results of this study did not support the notion that deposit insurance caused an increase in credit union risk-taking behavior.