The dissertation focuses on bank regulation: bank panics, deposit insurance and liquidity. Relevant banking literature is reviewed in the first chapter.

The second chapter analyses the adverse selection problem of deposit insurance. It is shown that the deposit insurer can screen low-risk and high-risk banks by designing a self-selection mechanism so that each bank obtains a risk-based insurance premium; high-risk banks obtain full insurance coverage and low-risk bank partial coverage. The demand of deposit insurance crucially depends on whether bank risk is observable to depositors or not.

The third chapter studies how bank competition influences the negative incentive effects of deposit insurance. Competition for deposits proves to be more dangerous than competition for borrowers. Depositors favor extreme risk taking, since they receive a high payment whether the bank succeeds or fails. If the bank succeeds, it can pay high interest on deposits, whereas in the reserve case the insurer pays an equal indemnity to fully insured depositors.

The fourth and fifth chapters study bank runs. It is shown that a bank can raise demand deposits and yet avoid runs if it also raises time deposits, which have relatively low liquidation value. Hence, runs can be prevented without deposit insurance, and the negative incentive effects of the insurance can also be avoided.

The sixth chapter focuses on the incentive problem between the bank and depositors (or the deposit insurer): bank’s shareholders’ limited liability makes risk shifting lucrative. It is shown how intertemporal diversification of lending decisions - bank’s loan portfolio consists of overlapping long-term loans and is thus reinvested gradually over a long time-span - may solve the incentive problem of risk shifting. Moreover, maturity mismatch - illiquidity of long-term loans and liquidity of deposits - proves to be optimal. The bank can commit to a safe lending strategy by investing in illiquid assets. Liquidity of deposits serves as a tool of market discipline, since it gives depositors an option to withdraw deposits immediately when they observe bank’s credit losses. The optimality of maturity mismatch stands in sharp contrast to the implications of the classical bank run models, in which maturity mismatch makes banks susceptible to destructive runs.