Adverse Selection in Deposit Insurance Following the 2023 Banking Crises

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BACKGROUND:

This paper analyzes whether U.S. banks that were riskier and more vulnerable to uninsured deposit runs at the end of 2022 responded by employing various institutional schemes to expand their insured deposits.

Such behavior would indicate adverse selection in the expansion of FDIC insurance that would reduce depositor discipline and exacerbate bank moral hazard incentives.

METHODS:

1. Sample of 4,500 U.S. Banks (FFIEC Call Reports)
2. Riskiness measured based on estimate of uninsured depositor risk

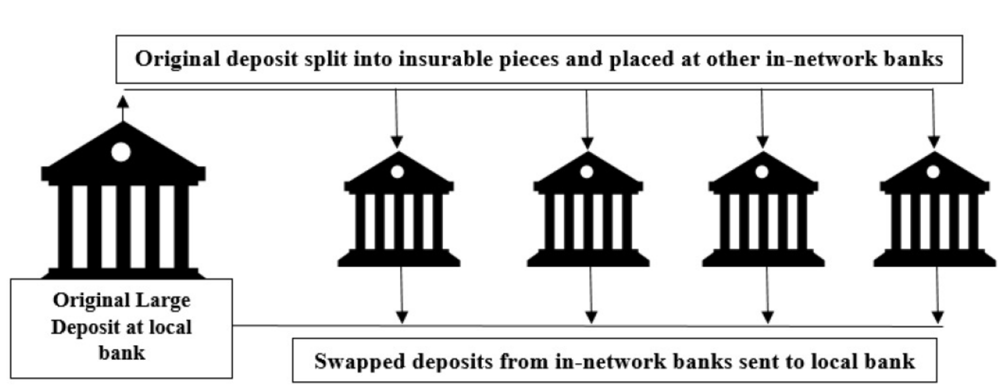
   (Likelihood of Insolvency * UD Loss Given Default)

RESULTS:

Compared to safer banks that were less subject to runs, riskier small and midsized banks were likely to gain insured deposits via reciprocal deposits, sweep deposits and to a lesser extent brokered deposits.

Risky midsized/regional banks, which were at the epicenter of the banking crisis were especially likely to expand their deposit insurance coverage via reciprocal and sweep deposits.

That riskier banks chose to exploit primarily reciprocal and sweep deposits is consistent with recent regulatory policy that reclassifies them as core deposits rather than brokered deposits. By removing restrictions and reducing the possibility of higher FDIC assessment rates, reciprocal and sweep deposits appear to now be subject to greater adverse selection.



RISKY BANKS were more likely to gain insured deposit coverage via institutional mechanisms

Figure 2: Value of Reciprocal Deposits

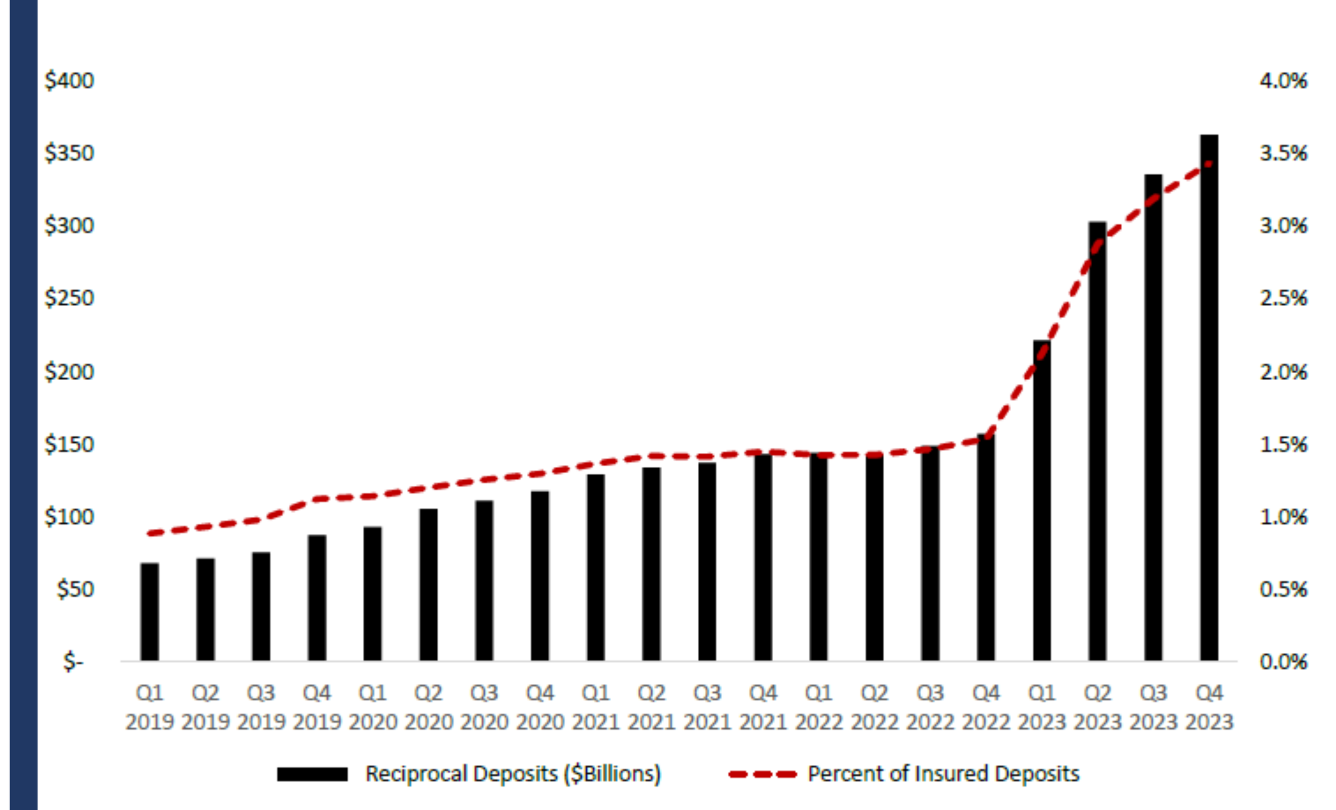
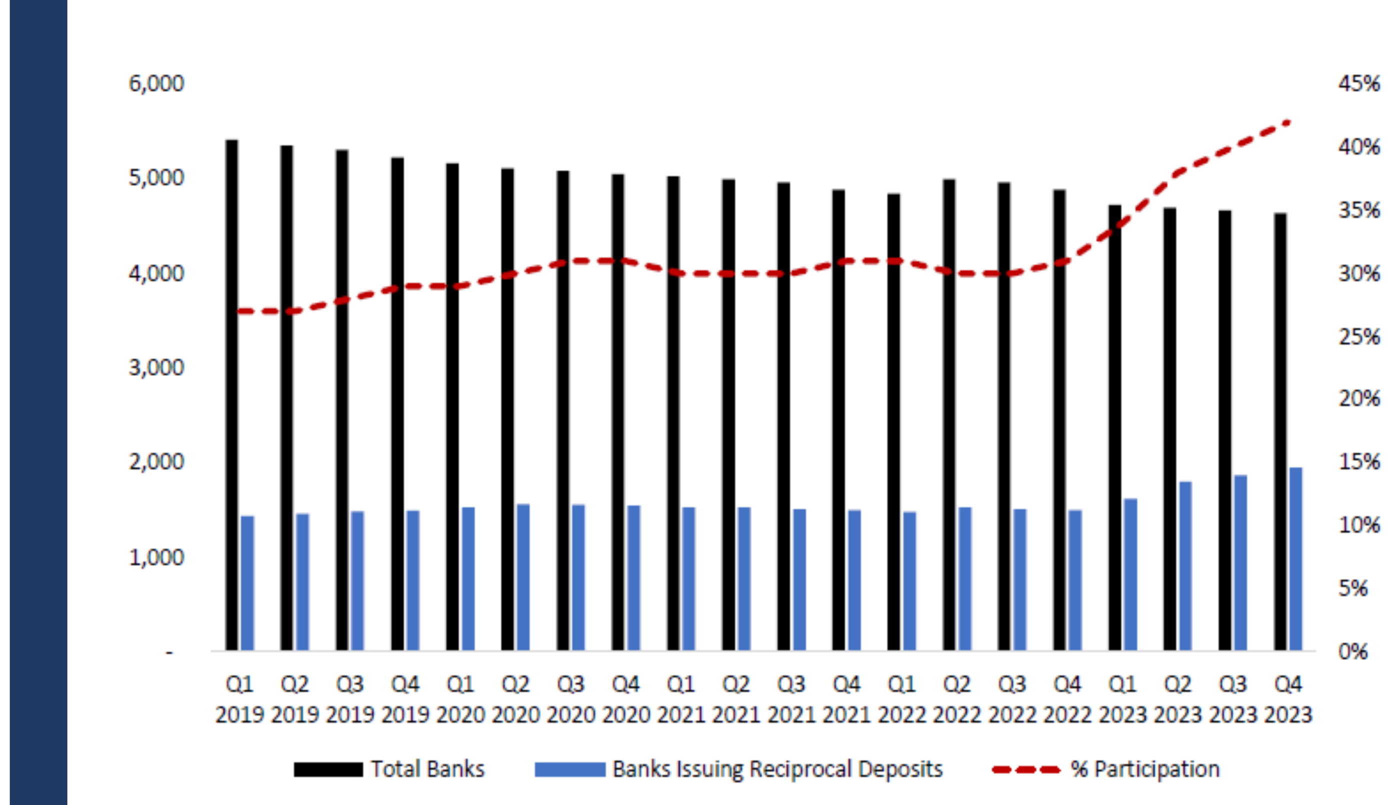


Figure 3: Banks Participating in a Reciprocal Deposit Network



$$BSR = \underbrace{\frac{TDT}{TA - UL}}_{\substack{\text{Likelihood of Insolvency} \\ \text{(Leverage)}}} \text{ X } \underbrace{\frac{UD+STB}{TD+STB+LTD+PS-FHLB}}_{\substack{\text{Uninsured Depositor} \\ \text{Loss Given Default}}}$$

$$\frac{R_{b,t}-R_{b,2022Q4}}{D_{b,2022Q4}} = \alpha_1 + \alpha_2 IR_{b,2022Q4} + \alpha_3 IL_{b,2022Q4} + \beta_1 BSR_{b,2022Q4} + \beta_2 BSR_{b,2022Q4} \times IR_{b,2022Q4} + \beta_3 BSR_{b,2022Q4} \times IL_{b,2022Q4} + \beta_4 X_{b,2022Q4} + \varepsilon_{b,t}$$

Uninsured Deposits (UD)

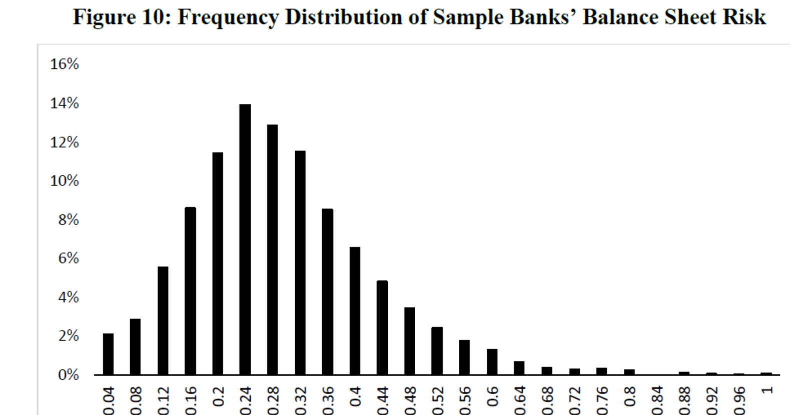
	Q1 2023	Q2 2023	Q3 2023	Q4 2023
BSR	-0.105***	-0.157***	-0.144***	-0.134***
BSR*IR	-0.177***	-0.177***	-0.202***	-0.142***
BSR*IL	-0.009	-0.035	-0.006	-0.003

Reciprocal Deposits

	Q1 2023		Q2 2023		Q3 2023		Q4 2023	
	IM	EM	IM	EM	IM	EM	IM	EM
BSR	0.061***	0.152***	0.113***	0.153***	0.120***	0.163***	0.116***	0.170***
BSR*IR	0.039*	0.115***	0.072**	0.085**	0.078***	0.116***	0.095***	0.120***
BSR*IL	0.035		0.001		-0.000		-0.015	

Take a picture to
link to SSRN Location

Figure 10: Frequency Distribution of Sample Banks' Balance Sheet Risk



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