

Wealth and Risk Effects of Adopting Deposit Insurance in Canada: Evidence of Risk Shifting by Banks and Trust Companies

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Abstract

This paper confirms that adopting explicit deposit insurance expanded risk-shifting incentives for Canadian Banks and Trust Companies. By transferring responsibility for monitoring non-systematic risk to the Canadian Deposit Insurance Corporation (CDIC), deposit insurance eliminated the compensation previously paid to large-block stockholder monitors. This transfer fueled a redistribution of insured-institution stock from poorly diversified large-block shareholders to diversified investors. Also, subsequent changes in market volatility support the hypothesis that CDIC insurance and the absorption of catastrophic risk it provided reduced systematic risk in the stock market as a whole even as it increased non-systematic risk in the banking and trust-company sector.

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