Trust in public institutions is essential for a well-functioning economy. Prior research from UChicago economists, for example, shows that a lack of trust prevents companies from using financial information in informal economies and participating in public procurement. In this paper, the authors study how trust impacts deposits at banks.

The authors examine this question in the context of a unique event in India that resulted in significant and unexpected supervisory penalties on several large banks. In 2013, a news investigation into a money-laundering scheme at three major commercial banks resulted in the Reserve Bank of India (RBI) examining all commercial banks’ financial records, internal controls, and compliance mechanisms and enacting the first significant penalties against banks. Importantly, these penalties were publicly disclosed.

The authors study depositors’ reactions to the penalties, arguing that if depositors believe that the penalties are indicative of systemic deficiencies in all banks, they may withdraw their funds from neighboring nonoffending banks as well. However, if depositors believe that the regulator correctly identified and disciplined bad banks, they may transfer their funds to these nonoffending banks. In other words, the authors use the neighboring nonoffending banks’
depositors’ reactions to the penalties to indicate their trust in the banking system. Depositors located near offending banks are more likely to know about the penalties—through word-of-mouth, neighborhood social networks, or observation of other depositors’ actions.

The authors study depositors’ responses to the regulatory penalties using branch-level deposit data covering commercial banks in India. Since it’s possible that banks in regions prone to withdrawals might receive more penalties, the authors take additional measures to isolate the impact of penalties on neighboring nonoffending banks. Thanks to policies mandating financial inclusion, the locations of bank branches are determined quasi-randomly. This allows the authors to assume that the distance between nonoffending branches and offending branches is not systematically related to the likelihood that offending banks receive penalties. The authors proceed by measuring the effects of penalties on deposits at offending banks and nonoffending banks nearby. They find the following:

- News of penalties leads to deposit withdrawals from both offending and neighboring nonoffending branches. At banks receiving penalties, total deposits decline by 10%-11% in the year after the penalties (compared to banks not receiving penalties). Importantly, deposits decline at nonoffending branches in an amount that is consistent with their distance from the offending branch. Specifically, for every halving of the distance to an offending branch, deposits at neighboring nonoffending branches decline by 0.35%-1.58%.

- Withdrawals are more pronounced in regions where state-level measures of trust—as measured with nationally-representative survey data—are lower.

- The authors use granular data to explore the determinants of trust in institutions. They show that information access and the quality of local services are the most important determinants of trust in institutions, particularly trust in courts and banks.

- Given the decline in deposits, the authors consider the effects of banking penalties on local markets. They show that credit disbursed by non-offending neighboring banks declines. They also find that nighttime light intensity—an indicator of economic activity—declines significantly in towns and villages that are more exposed to offending banks.

- Finally, the authors investigate where the withdrawn deposits go. They find evidence that some deposits move to regional rural banks that are government-owned but smaller than the public sector commercial banks.

The upshot is that trust in public institutions is a key determinant of depositors’ responses to the disclosure of supervisory action. This has significant implications for regulators, particularly in developing markets, and highlights the need to build and maintain trust in public institutions as an important precursor to policies that encourage market discipline through increasing supervisory transparency.