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Predicting US Bank Failure: A Discriminant Analysis

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Abstract: Using discriminant analysis, we trace U.S. bank failures during the period from 2007 to 2010 to poor investment decisions and large exposure to systemic risk channels. Specifically, we find that the proportion of illiquid loans in their books and the exposure to the interbank funding markets are the main predictors of bank failures. There are indicators that distinguish surviving banks from their failed peers, and these indicators serve as the early warning signals that predict banking failures. This study provides regulators and bank management forecast signals of financial exigency.

1. INTRODUCTION

The impetus of the recent global financial and economic turmoil, originating in the United States, was the failure of a few key financial institutions. We observed a surge in the number of bank failures from 3 in 2007, 25 in 2008, 140 in 2009, and 157 in the year of 2010. The estimated costs of increasing bank failures through purchase and assumption by the Federal Deposit Insurance

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