Deposit Insurance Reform

BRIAN SULLIVAN: Welcome back to the FDIC Podcast where we talk about banks, our banking system and how that system works for those who actually use our banks. I'm Brian Sullivan at the Federal Deposit Insurance Corporation and today…we take a look at various options to reform deposit insurance.

Now, most folks who would listen to a podcast like this would already know that the FDIC's base deposit insurance coverage is limited to at least $250,000 per depositor, per financial institution…and even more under certain circumstances.

Recall that when Silicon Valley Bank and Signature Bank failed in March of this year, the federal government took the extraordinary step to protect all depositors— both those who are insured *and* the uninsured. This decision was made because it was determined that failure to protect uninsured depositors would have serious adverse effects on financial stability. So, the government invoked the so-called "systemic risk exception" to avoid or to mitigate those risks.

Well, following these bank failures, FDIC Chairman Martin Gruenberg directed the agency to conduct an analysis of the current deposit insurance framework and to place these recent bank failures in the context of the history, the evolution, and indeed the purpose of deposit insurance since the creation of the FDIC, now 90 years ago.

Well, less than two months later, the FDIC released that report. And today we're joined by two senior FDIC economists who were instrumental in producing it. Rosalind Bennett and Jonathan Pogach are part of the FDIC Center for Financial Research. Roz and John, welcome!

JONATHAN POGACH: Thanks for having us.

ROSALIND BENNETT: Thanks for having us.

BRIAN SULLIVAN: Rosalind, let's begin with you. Tell us about this report.

ROSALIND BENNETT: So in response to the events of March 2023, where we had two very large regional bank failures and one that followed quickly thereafter, the Chairman asked us to evaluate deposit insurance coverage levels and options for possibly changing those levels and putting those into historical context.

BRIAN SULLIVAN: Right. The FDIC is, after all, 90 years old. It's been doing deposit insurance for a long time. But what kind of changes are we talking about here?

ROSALIND BENNETT: So any changes that we make to deposit insurance coverage levels would be changes made legislatively, so by Congress. But we did look at different types of deposit insurance coverage levels and types of accounts that might be covered.

BRIAN SULLIVAN: So Jon, a report exploring options for reforming deposit insurance. Does the deposit insurance system *need* reforming?

JONATHAN POGACH: So I think if you think back to March, 2023 and the very rapid runs and the volume of the runs at Silicon Valley Bank and Signature Bank…which were at the time the second and third largest bank failures in American history…certainly suggests that there's reasons to want to reform the system.

In addition, the systemic risk exception, which is invoked at the time, protected all of the uninsured depositors at those institutions, which raises fundamental questions about the role of deposit insurance in the U.S. banking system. So at a minimum, it's worth thinking about is this working as intended and are there ways to make it better?

BRIAN SULLIVAN: John, is it is it *just* these two banks that that are prompting us to have this conversation or is it more systemic?

JONATHAN POGACH: So that's something we talk about quite a bit in the report. And if you look at the system overall, there's a lot more uninsured deposits relative to the total amount of domestic deposits than we've had in a long time. At its peak in 2021, uninsured deposits as a proportion of domestic deposits were higher than at any time since 1949. So there is something different in the system today.

Even though most deposit insurance accounts are fully insured, over 99% are below the deposit insurance limit, that last one percent are very, very large accounts. And that suggests that maybe there's reason for reform, especially when considered and combined with the technological changes that make these bank run so quick.

BRIAN SULLIVAN: Right. Well Roz, let's get into this report. It lays out three options for reform. What are they?

ROSALIND BENNETT: So the first option we talk about is limited coverage. And limited coverage is very much like the system we have now where we have a deposit insurance limit on all accounts….

BRIAN SULLIVAN: ...$250,000.

ROSALIND BENNETT: That's correct but we do leave open an option of changing that limit and perhaps increasing it.

The second option we talk about is *unlimited* coverage, and that would be where all deposits are covered and to an unlimited amount. The third option we talk about is what we call *targeted* coverage. And that coverage would offer a different insurance limit to particular accounts. And we focus on business payment accounts. Those accounts of the types of accounts where businesses will be paying their payroll or are doing operational…any type of operational business of paying vendors and payroll particularly.

BRIAN SULLIVAN: And to be clear, any of these options would require congressional approval.

ROSALIND BENNETT: That's correct.

BRIAN SULLIVAN: Okay. So, Jon, what are the pros and cons? The report lays out the cost and the benefits of each of these options. What are they?

JONATHAN POGACH: So three of the main pros and cons that we think about when talking about each of the options…one is financial stability. One of the reasons the deposit insurance was created is to promote the stability of the banking system. We also think about moral hazard. And what moral hazard is when someone is insured from the risks that they're taking; it provides incentives to take on greater risks. So banks might take on greater risks if they if they're beneficiaries of deposit insurance. Banks that have sound risk management practices are going to think about the potential for withdrawal and manage their risk accordingly. And deposit insurance blunts that.

In addition, we think about how much is this going to cost the bank, right? We have to charge banks for deposit insurance that we provide, and that's another important consideration. And when we think about each of those three options…limited coverage, unlimited coverage and targeted coverage… in the report, we evaluate it along those dimensions.

BRIAN SULLIVAN: Well, Roz, how do each of these options sort of stack up to the costs and the benefits that John just mentioned?

ROSALIND BENNETT: Limited coverage is very similar to the system we have now, just increasing a small amount in the deposit insurance coverage limit would not get to the very large accounts that John was referring to earlier, and therefore it would not provide us the large financial stability benefit.

Unlimited coverage is quite a different system than we have now and would open the door for lots of moral hazard risk and also would cost a lot more for the banks because they'd have provided we'd be providing coverage to all the accounts…unlimited coverage.

Targeted coverage provides, you know, higher or unlimited coverage to business payment accounts, which are those that businesses use to pay payroll or pay their vendors and we feel like those spillover effects from those accounts provide a lot of financial stability benefits.

BRIAN SULLIVAN: So the report concludes that, all in all, when you factor all these costs and all these benefits, it's the targeted coverage that may have the most merit.

ROSALIND BENNETT: That's correct.

BRIAN SULLIVAN: Well, do you see any limitations to the targeted coverage option?

ROSALIND BENNETT: I think the largest challenge that we have in terms of the targeted coverage option is defining which accounts are…

BRIAN SULLIVAN: …what characteristics these accounts have.

ROSALIND BENNETT: Right. As we mentioned earlier, we're really trying to find the accounts that businesses are using to pay their employees, to pay their vendors. Those accounts tend to be accounts that do not pay a lot of interest or don't pay interest at all. So those are types of ways that we could get to it. But I think that is the largest challenge right now.

BRIAN SULLIVAN: Jon, has the FDIC ever done anything like this before?

JONATHAN POGACH: Yeah. So listeners might remember that in 2008, during the financial crisis, there was the Transaction Account Guarantee Program and that covered non-interest bearing accounts at banks that that didn't choose to opt out and that remained in place until 2010 when it was made mandatory and participation of all banks was required under the Dodd-Frank Act. And that was in place through the end of 2012. That is no longer in place, but it does provide some precedent for how this might work.

BRIAN SULLIVAN: The report also talks about other regulatory and supervision-type tools that could support deposit insurance reform, Jon, right?

JONATHAN POGACH: Yeah, so it's important to remember that deposit insurance does not exist in a vacuum and its efficacy is really going to depend on the other kinds of tools that exist in the system, as well as the banking system overall and how it's structured.

So in the report, we talk about a number of changes, some of which are within the regulatory authority of the agencies, some of which might require legislative changes. Those include the traditional regulatory and supervisory tools that people are familiar with. It also includes deposit insurance pricing, which means as the FDIC, we can charge more for deposit insurance to banks to take on greater risk. For example, the high levels of uninsured deposits if that's perceived as being more risky, we can charge banks more for that. It is a tool that can be used, but we can't perfectly price for risk.

We also talk about two other tools…collateralization of large uninsured deposits for example, which would require that banks hold high-quality short term assets against very large deposits. And this would impose some kinds of cost on the banks and on these very large depositors from maintaining these very large accounts that pose the risk of bank runs. And we

also talk about limited withdrawal capacity. So for a very large depositors, requiring that they cannot withdraw everything at a moment's notice and we require to have some of that account remain in the bank and that would increase their incentives to monitor the bank and increase their incentive…the risk-bearing capacity that those account holders have.

BRIAN SULLIVAN: Well, that's a lot. And all this to say is that this is food for thought, right? Any of the ideas that are embodied in this report are being put out there for discussion purposes. Ross, now what?

ROSALIND BENNETT: Well, we continue to have discussions. People approach us and ask us to talk about the report, and we continue to talk people about the report.

BRIAN SULLIVAN: But there's a lot of people talking out there about deposit insurance and how it might be reformed in order to fit today's market. Jon, any final thoughts about this report and where we go from here?

JONATHAN POGACH: It's been a great experience to think through these issues and I'm hoping that we can inform the outcome, inform the conversation that policy makers nationally are having about these issues.

BRIAN SULLIVAN: Right. Well, Rosalyn Bennett and Jonathan Gersh of the FDIC Center for Financial Research, thank you so much for joining me.

ROSALIND BENNETT: Thank you.

JONATHAN POGACH: Thanks for having us.