Section 7: Conclusion

Deposit insurance reform merits consideration in the wake of bank runs in March 2023 and trends that may have increased the susceptibility of the system more broadly. This report assesses three options for deposit insurance reform, their efficacies to meet the objectives of deposit insurance in the current environment, their broader consequences, and tools that may be used along with each option to maximize their effectiveness. The primary options—ordered for expositional purposes only—are:

Limited Coverage, maintaining the current system of deposit insurance, potentially increasing the deposit insurance limit;

Unlimited Coverage, fully insuring all deposits; and

Targeted Coverage, substantially increasing coverage to business payment accounts, without significantly changing the limit for other deposits.

Financial stability is a primary objective of deposit insurance. Banks issue demandable deposits to fund long-term assets. When depositors withdraw their funds simultaneously, a bank may be forced to sell assets at a loss, leading to the bank's failure. One bank's failure may lead to contagion if depositors at other banks fear for their banks' solvency and withdraw funds, resulting in cascading bank failures. Depositors who lose access to their funds in bank failures may be unable to pay bills coming due, resulting in financial stress to firms and households and depressing credit and economic activity. Deposit insurance reduces these risks.

In addition to financial stability, deposit insurance objectives include depositor protection, consistency and transparency, and minimizing disruptions from bank resolution. Protecting small depositors has been an objective of the deposit insurance system since its founding, and more than 99 percent of deposit accounts were under the deposit insurance limit as of December 2022. Finally, deposit insurance coverage affects the ability of the FDIC to resolve institutions efficiently. Thus, objectives of deposit insurance reform include the minimization of disruptions associated with resolution.

Deposit insurance is associated with other consequences for the banking and financial system beyond its objectives. Because deposit insurance protects depositors from the consequences of bank risk-taking, they are less likely to withdraw their funds from a bank with poor risk management, allowing risks to build up in the system. However, other creditors and shareholders may continue to play an important role in constraining bank risk-taking in the presence of deposit insurance. Deposit insurance can also affect competition between banks, competition between banks and nonbanks, markets for deposit substitute products, and bank funding choices. Although some consequences are not inherently problematic, the implications should be understood in the context of deposit insurance reform decisions. In addition, increases to deposit insurance coverage affect the adequacy of the DIF and would require increased assessments to the banking industry.

Existing and new tools can complement deposit insurance reform to maximize its effectiveness in meeting its objectives and minimizing consequences deemed undesirable. Bank safety-and-soundness regulation and supervision can, in principle, constrain bank risk-taking and reduce the likelihood of uninsured depositor runs. Deposit insurance pricing promotes Fund adequacy and the fair allocation of the cost of deposit insurance across banks; to some extent, it also influences bank risk-taking. Requiring collateralization of large, uninsured depositors may reduce run incentives and promote monitoring. Limiting the convertibility of large, uninsured deposits may also reduce bank runs. Each tool has strengths and weaknesses.

This report indicates that Targeted Coverage—significantly increasing deposit insurance coverage to business payment accounts—is the most promising option to improve financial stability relative to its effects on bank risk-taking, bank funding, and broader markets. There are significant unresolved practical challenges to Targeted Coverage, however, including defining accounts for additional coverage and preventing depositors and banks from circumventing differences in coverage. Of the options considered, Unlimited Coverage provides the clearest solution to bank runs, at the expense of more significant implications for Fund adequacy and market disruptions, and the greatest potential of the options for increases in bank risk-taking. Limited Coverage fails to address the financial stability challenges associated with large concentrations of uninsured deposits but has the fewest implications for bank risk-taking and broader market disruptions. This report argues that Limited Coverage and Targeted Coverage may also benefit from simplification of the deposit insurance system but are unlikely to benefit from a voluntary excess deposit insurance system. The options and tools in this report may inform policies that can help the deposit insurance system best meet its objectives in the context of the current challenges.