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ECONOMIC Synopses

The FDIC Studies "Options for Deposit Insurance Reform"

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A bank run is an attempt by large numbers of depositors to simultaneously withdraw their deposits. A run can cause a bank to fail if it is unable to meet redemption requests. *Deposit insurance* protects bank depositors against the loss of their deposits in the event of bank failure. In the United States, the Federal Deposit Insurance Corporation (FDIC) insures commercial bank deposits up to $250,000 per depositor per institution. Deposit insurance mitigates the risk of bank runs by removing the incentive to withdraw one's money from a troubled bank. But uninsured deposits have increased in recent years, reaching 46% of all deposits in 2021 (FDIC, p. 1). Recent runs on Silicon Valley Bank, Signature Bank, Silvergate Bank, and First Republic Bank have led to the failure of these banks and have put deposit insurance back into the headlines. In response to these events, the FDIC recently put together and published a document describing potential ways to reform deposit insurance. This essay briefly summarizes and explains the conclusions of the FDIC document, "Options for Deposit Insurance Reform."

Bank runs can be self-fulfilling because all uninsured depositors have an incentive to withdraw their money in the event of a run on a bank. Therefore, even a rumor of trouble at a bank can cause a run, which might cause even a sound, solvent bank to fail. Runs at globally systemically important banks are particularly important because they could trigger contagion in the whole financial system.

While deposit insurance mitigates the risk of bank runs, its provision also removes the incentives from insured depositors to monitor the state of their bank's financial health so that they can remove deposits in case of trouble. Such monitoring is known as "market discipline." Of course, such monitoring is well beyond the capability of the vast majority of individuals, but it is not beyond the capability of corporations.

The current system of limited deposit insurance coverage protects accounts up to $250,000. Depositors with more than $250,000 may split up money between accounts at multiple institutions to obtain complete coverage. This can be costly and inconvenient, however, particularly for some types of business accounts that are used for payments purposes.

The bank runs and financial stress of March 2023 motivated the FDIC to consider and explain options for deposit insurance reform. Recent technological advances have increased the risk of bank runs by making it easier to get and spread information about a bank's problems or potential problems through social media and to withdraw one's money very quickly from a troubled bank with online banking.

The FDIC document sensibly emphasizes that deposit insurance should be considered as one type of policy in a portfolio of policies, particularly bank regulation and supervision, to promote financial stability (FDIC, p. 40). The FDIC laid out three options to reform the deposit insurance system: *limited coverage*, *unlimited coverage*, and *targeted coverage*.

The FDIC refers to *limited* coverage as the "best tested" model of insurance and points out that no incremental increase in coverage will much decrease uninsured deposits because much of the total value of currently uninsured deposits is in very large deposits that would remain uninsured (FDIC, pp. 49-51). Therefore, any limited coverage—excluding extremely high limits—will not much mitigate the problem that uninsured depositors retain the incentive to withdraw their money if their bank gets in trouble. And an increase in limited coverage will also not remove much "market discipline" from banks (FDIC, p. 52).

The FDIC writes that "Extending *unlimited* deposit insurance coverage to all deposits…would directly and effectively address financial stability concerns" (FDIC, p. 53).[1] That is, unlimited coverage would remove the incentive to run on a bank and would also simplify the resolution process, although it would require a much larger insurance fund. The FDIC criticizes the unlimited-coverage option, however, for increasing "moral hazard"; that is, it would provide incentives for depositors to put their deposits at increased risk of loss, and it would artificially increase the attractiveness of holding bank deposits versus other instruments.

The FDIC's favored solution is to *target* coverage of large accounts used for business payments, which are hard to break up into multiple, insured accounts. Such accounts were important features of the recent runs on Silicon Valley and First Republic banks. This would foster financial stability by reducing incentives for bank runs by reducing large, uninsured deposits. The FDIC emphasizes that an important challenge in implementing targeted deposit insurance would be to ensure that depositors understand the criteria by which accounts qualify for deposit insurance and whether their accounts do qualify (FDIC, p. 60). As with any extension of deposit insurance, one must accept some loss of market discipline on banks. The FDIC argues, however, that such a targeted approach would create fewer distortionary incentives by depositors to choose bank deposits over other instruments (FDIC, p. 59). ■

Note

[1] On March 12, 2023, Treasury Secretary Yellen approved an extension of deposit insurance to all deposits of Silicon Valley Bank after receiving recommendations from the FDIC and Federal Reserve (Department of the Treasury, 2023). That is, the deposit insurance was made unlimited for Silicon Valley Bank. The same extension was later taken for deposits at Signature Bank.

References

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