Options for Deposit Insurance Reform to Stabilize
Our Banking System and Protect Depositors

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Testimony before the
United States Senate Committee
on Banking, Housing, and Urban Affairs

July 20, 2023

Chair Brown, Ranking Member Scott, and Members of the Committee: Thank you for inviting to testify at this hearing. My name is Emily DiVito, and I'm the Senior Program Manager of the Corporate Power program at the Roosevelt Institute, an economic think tank. I'm here to discuss the slate of potential reforms to federal deposit insurance that have emerged following recent bank failures.

Recent Bank Failures Highlight the Importance—and Potential—of Deposit Insurance

Since the banking panics of the early 1930s, the US has offered federal deposit insurance (FDI) on eligible deposit accounts up to a statutory limit, currently set at $250,000. In addition to protecting small depositors' money, FDI has been remarkably successful in preventing bank runs and mitigating financial panic—until recently. Though FDI's current cap well exceeds the account balances of most Americans, banking system reliance on uninsured deposits has been increasing in recent years, especially as economic inequality has worsened (Vuillemey 2023). The collapses of Silicon Valley Bank (SVB), Signature Bank, and First Republic Bank (FRB) have exposed vulnerabilities in—or at the very least cast doubt on—FDI's current terms and structure. Is FDI protecting the "right" depositors at the "right" coverage threshold? Is it maximizing the government's ability to avert a financial crisis and, if one occurs, contain it with minimal contagion to the rest of the US economy? And finally, because FDI applies to individual and institutional depositors alike, who is the banking system *for* and what does that imply about the government policies and practices in place to serve them? The answers to all of those questions carry policy implications for depositor confidence, US financial stability, and bank industry concentration.

Taking lessons from the bank failures that happened in the spring of 2023, many experts have outlined their preferred ways to reform FDI. These proposals vary widely, but all reckon with similar themes: financial stability, depositor protection, market discipline, and moral hazard. I synthesize the bevy of proposals below (and in a recent brief for the Roosevelt Institute)[1] in an effort to better understand the policy trade-offs to our banking system and the individuals, families, and businesses that rely on it.

[1] More information on FDI and the various reform proposals offered in the wake of the financial crises this past spring can be found in my brief for the Roosevelt Institute, "Options for Deposit Insurance Reform to Stabilize Our Banking System and Protect Depositors" (DiVito 2023).

FDI's Purpose and Pitfalls in Light of Recent Bank Failures: Depositor Discipline, Market Discipline, and Moral Hazard

FDI is situated within a network of economic conditions and depositor instincts, both visible and invisible. Bank runs are an inherent vulnerability in banking, since deposits can be redeemed for cash at virtually any time. Most of the time, deposits are stable and banks are able to reliably use them to finance riskier longer-term activities—like issuing personal and business mortgages, credit, and loans. But if many of a bank's depositors (or simply a handful of large ones, as we saw with SVB) ever want to withdraw at the same time, a bank might not be able to meet all its obligations. This built-in fragility means that if depositors merely *suspect* a problem with a bank, they're incentivized to withdraw funds, which in turn inspires other depositors to withdraw funds—sparking a bank run.

The existence of FDI—and the Federal Deposit Insurance Corporation (FDIC) that administers it—prevents this cycle from occurring by offering eligible bank customers peace of mind so that they are not inclined to withdraw their deposits en masse. It thus acts as a stabilizing force to the banking system as a whole. But deposit insurance can also introduce moral hazard (i.e., when a bank or financial institution lacks the incentive to guard against risk). In theory, without FDI, incentives are low for banks to take risk as depositors are inclined to monitor their bank's behavior. When it works, depositor discipline is one type of market discipline: To attract and retain client deposits, a bank's management may avoid excessive risk before a run could occur. Not all depositors can—or even should—monitor their banks' risks. Most individual depositors and many small businesses aren't positioned, resourced, or knowledgeable enough to do so effectively. Deposit insurance intervenes to protect those depositors that cannot encourage market discipline.

But this effect only extends as far as the reach of deposit insurance coverage, and only works if depositors can reasonably expect to take a loss in the event of a bank collapse. More fundamentally, after the recent bank collapses, many experts are questioning the extent to which depositor discipline exists at all, and the extent to which it has a measurable effect on a bank's risk-taking. In theory, any change to the FDI cap also changes the existing balance of these disciplining forces and moral hazard. The FDIC receives no appropriations from Congress, and instead is primarily funded via the Deposit Insurance Fund (DIF), into which banks pay quarterly risk-priced premiums.

The Spectrum of Approaches to FDI Reform

Recent bank collapses cast doubt on the foundational assumption that some of FDI's efficacy rests on large depositors providing a disciplining effect to banks. On paper, many of SVB's clients were large businesses and organizations with the staff and resources to be able to keep an eye on their bank's risks. However, their frenzied withdrawals of nearly $42 billion in deposits after SVB publicly announced it was struggling suggest they weren't monitoring its ongoing activities closely enough, if at all. The collapse proved that even banks *not* previously designated systemically important can jeopardize broader US financial stability.

Following these crises, financial systems and banking experts have offered various proposals to reform FDI to better achieve the interconnected aims of depositor protection and financial stability. I categorize these proposals into three schools of thought on potential FDI expansion:

1) Preserve the current system as is;
2) Expand insurance for certain accounts; and
3) Enact universal and unlimited coverage.

Approach 1: Preserve the Current System

One approach to the deposit insurance reform debate concludes that the current system is working mostly as intended and for whom it's intended. It therefore doesn't need much reforming—if any. Indeed, FDI has been historically successful in preventing banking panics, and for the vast majority of individual and small business depositors, the current coverage threshold is sufficient (FDIC 2023a; JP Morgan Chase Institute 2016). Even the recent bank failures likely had specific non-FDI vulnerabilities—like poor interest rate risk management and supervisory shortcomings—that were significant factors in their respective collapses (Board of Governors of the Federal Reserve System 2023).

This approach to FDI reform also ascribes value to the existing balance of market discipline and bank risk-taking. Arguing that any significant changes to the FDI status quo would also disrupt the moral hazard-market discipline status quo, experts in this school of thought conclude that expanded FDI coverage could engender more harm than good (Wessel et al. 2023; Demirgüç-Kunt and Detragiache 2002; McCoy 2007). Moreover, some experts assert that bank failures provide a form of market discipline of their own, and are inevitable, if expensive, in a competitive and innovative private market for depositors' businesses (Klein 2023).

To the extent that experts within this school of thought agree that reform is necessary, they tend to advocate for highly focused improvements to inject resiliency into the current system. One such approach would be to index the coverage cap to inflation to help it keep pace with the price level. Economists at the International Association of Deposit Insurers find evidence that rising inflation can erode insurance coverage and lead to a decrease in the real terms of otherwise unchanged nominal coverage levels (Van Roosebeke and Defina 2022). This tweak would eliminate the need to continually legislate individual increases to coverage.[2] Another similarly motivated refinement would be to bake in automatic emergency provisions to allow agencies greater authority to quickly intervene in financial crises.

On the whole, because this approach is relatively non-interventionist, its weaknesses mirror those of the current FDI system, in which uninsured depositors still pose some threat to US financial stability. It also largely preserves existing tools authorities have to address failing financial institutions—including the possibility of hurried bank mergers following crises. Critics of this approach argue that the recent bank failures *do* expose structural vulnerabilities to the FDI status quo that jeopardize US financial stability if not addressed.

[2] The coverage cap largely kept pace with the price level until 1980, when it was increased to $100,000 (or, 2.5 times the previous limit of $40,000) (Robinson 2013). The next—and as of this writing, most recent—increase came during the financial crisis of 2007-2008 when Congress raised it to $250,000 (Aronczyk and Fountain 2023).

Approach 2: Expand Coverage for Certain Accounts

A second approach to FDI reform argues that the current system fails to strike the right balance between market discipline and moral hazard—but believes that such a balance is possible via a coverage cap. If depositors (one in a triad alongside regulators and shareholders that keep banks in check) fail to provide discipline to banks, a key industry-balancing mechanism is out of whack. By leveraging the cap to tease out which depositors can (and can't) bring market discipline to bear, this approach targets them (and only them) for expanded coverage. This is the approach favored by the FDIC (FDIC 2023b). Such an approach to reform could be made permanent, or fashioned as an automatic and temporary emergency provision in times of crisis.

One avenue to achieving differential treatment of accounts is to lift the upper limit on all "transaction accounts," or those that individuals use to make financial transactions and that businesses and organizations use to make payroll and conduct other basic business activities. These accounts, though potentially large, don't turn a large profit and thus aren't likely to provide any market discipline. However, they often contain the deposits on which other people—namely workers—depend for their livelihoods, and thus their exposure can trigger wide consumer panic. For example, when SVB failed, Roku's ability to make payroll was put into jeopardy, which likely helped intensify and spread the panic (May 2023). Other similarly motivated reforms within this approach include lifting the cap only for all non–interest bearing accounts, or using employment as a proxy for targeting small and medium-sized enterprises (SME) for expanded coverage (Phillips 2023b; Conti-Brown 2023).

Critiques to this kind of differential treatment of depositors include that it could be difficult to come to consensus on how to define the types of accounts deserving of additional coverage. This approach could also add a degree of complexity to FDI that could be difficult for the FDIC-insured banks to communicate about to their clients and and for the FDIC to enforce. It could also make bank reporting relatively more complicated (FDIC 2023b). Any increase to the FDI cap would also require more funding to the DIF, though how much depends on the precise changes to the deposit base and cap.

Approach 3: Enact Permanent Universal and Unlimited Coverage

A third approach to FDI reform ultimately weighs the benefits of unlimited, universal deposit insurance—including the elimination of the threat of bank runs—over the potential for increased moral hazard. This conclusion itself is predicated on the belief that the US has a broad system of *implicit* deposit insurance—established through the tacit knowledge that policymakers will always err on the side of caution to intervene in financial crises the way the Treasury Secretary did to invoke the systemic risk exception for SVB—which has already fostered moral hazard and neutralized any depositor disciplining potential. Moreover, experts within this approach argue that the presence of an FDI cap pushes large depositors toward the megabanks that would be most likely to be backstopped in a crisis via the FDIC's systemic risk exception (Hockett 2023; Labonte 2023).

There are two distinct policy tracks within this approach that differ in scope, though not in spirit: One would remove the FDI cap without necessarily modifying the rest of existing banking infrastructure, and one would eliminate the cap on deposits as part of a much more expansive slate of reforms to transform private financial infrastructure into public. On the first, experts argue that the current cap can be lifted permanently and for all depositors without necessarily requiring broader reform to the rest of banking.[3] Proponents of this reform generally seek to better align the law with current practice by making the system of *implicit* universal deposit insurance that they argue already exists *explicit* (Menand and Ricks 2023; Wessel et al. 2023). Others argue that the cap should be lifted because it is already superfluous—a vestige of the earlier iteration of deposit insurance in which assessments were levied pro-cyclically and without risk sensitivity (Hockett 2023).

On the second, several experts advocate ambitious alternative banking models that would eliminate defaultable money in the long term by either regulating banks explicitly as investor-owned public utilities or elevating the role of the Federal Reserve as the primary platform for generating and managing financial resources (Menand and Ricks forthcoming; Omarova 2021; Ricks et al. 2018). Part of the inspiration for these sweeping proposals comes from a reassessment of the fundamental role, purpose, and efficacy of financial institutions in the economy and society. These reforms would necessitate broad changes to the US financial system—such as bank chartering, share ownership, portfolio constraints, supervision, and capital requirements (Menand and Ricks forthcoming).

By far the most prevalent public critique to this approach is that it would eliminate any potential market disciplining force an FDI cap provides and therefore could encourage greater risk-taking by banks. Critics also highlight the potentially large costs of this reform to the DIF. If the existing size requirement that the DIF be a percentage of total insured deposits remained in place, mandating coverage for at least an additional $8 trillion in currently uninsured deposits would make it the most financially expensive of the reforms included in this analysis, and would necessitate much larger assessments on banks. Moreover, critics assert that this approach could provoke widespread disruptions to the business of banking and related financial markets like those for deposit substitutes (though proponents see this as a feature rather than a bug). Because some of these reforms imagine transformed financial and banking systems, implementing them could be politically challenging, technically complex, and require a relatively long time horizon.

Stronger Institutions and Regulations: Other Considerations for FDI Reform

Any deposit insurance scheme can only be maximally successful if it coexists with complementary policies to encourage financial systems oversight and accountability. Strong institutions generally—and strong bank regulation and supervision specifically—are requisites to a safe and sound banking system. Research shows that countries with strong institutional environments are less likely to suffer from concerns around moral hazard due to deposit insurance (Demirgüç-Kunt and Detragiache 2002; Hovakimian et al. 2003).

[3] However, many of the experts who support lifting the cap independent of broader reforms to the rest of US banking underscore the importance of doing so with consideration for how broadly deposits are defined (for instance, lifting the cap for all transaction account balances, but not for all time deposits)—thus aligning somewhat with approach two (US House Committee on Financial Services 2023; Menand and Ricks 2023).

Strong institutions and regulations are both tools to support financial stability objectives on their own and tools to address possible consequences of FDI reform. All of the following should be considered independent of any particular FDI reform proposal:

- Reversing recent regulatory rollbacks that allow for supervisory discretion—like those pursued through the Economic Growth, Regulatory Relief, and Consumer Protection Act in 2018 (S.2155). Though S.2155 allowed for the Fed's discretion in imposing additional requirements on banks between $100–$250 billion—the size of SVB, Signature, and FRB at the time of their respective collapses—it does not allow for such authority for banks under that $100 billion threshold. Moreover, experts warn that the law itself signified a "stand down" order to bank regulators (Phillips 2023a). This and other culture changes at oversight agencies in recent years have loosened regulatory requirements and constrained bank examiners, resulting in laxer supervision (Board of Governors of the Federal Reserve System 2023).
- Enhancing liquidity requirements designed to mitigate stability risks associated with banks' funding long-term assets with short-term liabilities, to help ensure that banks hold enough liquid assets to compensate for any hypothetical future sudden outflows. For example, as the FDIC notes in its investigation report on the recent failures, SVB and Signature weren't subject to either of the two primary liquidity requirements, the Liquidity Coverage Ratio (LCR) or the Net Stable Funding Ratio (NSFR), which exacerbated the crisis when large depositors sought simultaneously withdrawals (FDIC 2023b; Labonte 2021).
- Enhancing capital requirements, or the limitations placed on banks' reliance on deposit financing for their other activities, which can help make shareholders more sensitive to risk-taking, thereby theoretically reducing moral hazard incentives. Limits on uninsured depositor funding for banks and requirements on liquid assets can both reduce the risk of bank runs *and* provide depositors confidence that their banks hold sufficient liquidity to meet withdrawals. If any changes to deposit insurance erode depositor discipline, stronger capital requirements can help mitigate moral hazard (FDIC 2023b).

Conclusion

The precipitous failures of SVB, Signature, and FRB shook the US banking industry—as well as the millions of depositors that hold money in the wider financial sector—and unearthed questions about who FDI serves and why. While the FDIC has been extraordinarily successful in preventing bank panics or containing them when symptoms have flared up in the past, the recent crises have revived debate about FDI's continuing ability to protect individual and institutional depositors and stabilize the US financial system. In the weeks after the recent banking crises, experts offered a broad range of reforms to FDI. Though recommendations span from nonintervention to differential account treatment to permanent universal and unlimited coverage, each aims to maximize financial stability and depositor protection. Independent of achieving political passage for any of the proffered proposals, policymakers would do well to wrestle with questions about the current system's purpose and efficacy—and the implications that each potential reform carries. The federal government, banking and depository institutions, and most importantly, depositors, will be better for it.

Appendix I. The Range of Federal Deposit Insurance (FDI) Reforms

	Approach 1: Preserve the Current System	**Approach 2: Expand Insurance for Certain Accounts**	**Approach 3: Enact Universal and Unlimited Coverage**
Proposals Within each approach	● Don't touch the current system at all ● Index the coverage cap to inflation ● Integrate automatic temporary emergency expansion powers and provisions	● Lift or remove the coverage cap for transaction/business payment accounts, but preserve it for others ● Lift or remove the coverage cap for all non-interest-bearing accounts, but preserve it for others ● Use employment as a proxy to lift the coverage cap for all small businesses and organizations	● Remove the coverage cap for all accounts, without broader structural changes to the banking/financial sectors ● Overhaul the US financial system to replace private money and banking infrastructure with public, thereby making all deposits non-defaultable
Strengths to each approach	● Maintains existing balance of market discipline and moral hazard ● Would have little—if any—cost to the Deposit Insurance Fund (DIF)	● Targets coverage to meet operational needs of certain large uninsured depositors ● Preserves a degree of depositor discipline	● Virtually eliminates the risk of bank runs ● Could eventually result in more accessible public-interest banking and financial infrastructure
Weaknesses to each approach	● Doesn't significantly improve upon existing system ● Retains risks related to panicked withdrawals by uninsured depositors	● Makes defining the accounts eligible for expanded coverage difficult ● Adds a layer of complexity to FDI ● Results in some cost to the DIF	● Eliminates existing depositor discipline and increases moral hazard ● Potentially disrupts related markets ● Potentially results in large costs to the DIF
These lists are non-exhaustive. See also Table 1.1 in FDIC 2023b.			

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