FDIC’s Options for Deposit Insurance Reform

regulatory FDIC deposits

Summary: The FDIC has published a report outlining three possible options for deposit insurance reform — maintaining or increasing limited coverage for all depositors; implementing unlimited coverage for all depositors; or implementing targeted coverage for businesses. We provide details of the FDIC’s analysis of all three options.

On the long-running show, “Let’s Make a Deal” — co-created and hosted for decades by Monty Hall and now hosted by Wayne Brady, the final Big Deal could have been anything: A brand new SUV, an all-expenses-paid trip to Fiji, or tens of thousands of dollars’ worth of $20 bills floating down from the ceiling. Contestants would choose which of the three doors they thought hid the prize. Would the Big Deal reveal be behind Door No. 1, Door No. 2, or Door No. 3?

In May, the Federal Deposit Insurance Corporation (FDIC) published its own version of Door No. 1, Door No. 2, or Door No. 3 — Options for Deposit Insurance Reform, in light of March’s bank runs that shuttered several financial institutions. In the report, the FDIC details three options for the future of deposit insurance — increase the overall deposit insurance limit, fully insure all deposits of any amount, or provide extra insurance exclusively for certain business deposit accounts.

The report begins by placing the recent bank failures and the subsequent actions taken to protect uninsured depositors within the historical context that led to the FDIC’s creation in 1933. This background is important, as it provides the foundation for the FDIC’s proposal: changes to the FDIC’s insurance coverage.

The FDIC made an emergency, systemic risk exception both to protect the Silicon Valley Bank and Signature Bank depositors and to stem the flow of any other bank runs from uninsured depositors. By doing so, they fulfilled some of the FDIC’s primary objectives: upholding the financial stability of the US economy and fostering public confidence in the US banking system.

After these bank failures, however, the FDIC feels that it may be time for a reform in order to keep fulfilling those objectives. Deposits above the coverage limits lack the protection of the FDIC, and as of Q1 2023, S&P Global shows that uninsured deposits make up 42.2% of all total deposits in the US banking system — that amounts to $7.1T. The report notes that any future bank runs to retrieve uninsured funds would have “significant costs” on the financial industry and the economy, since bank runs and the alarms that they raise tend to be infectious. Deposit insurance prevents this, and with the growing number of uninsured deposits in the banking system, a reform is needed to reassure depositors that their funds are secure.

The FDIC outlined three options for deposit insurance reform: limited coverage, unlimited coverage, or targeted coverage.

1. **Limited Coverage.** This option maintains the current structure of deposit insurance in which there is a finite deposit insurance limit that applies across depositors and types of accounts — but the FDIC may consider increasing the limit above the current $250K per deposit account. While small- and medium-sized businesses that hold deposits at ranges modestly above the current limit may benefit from such an increase, it would be insufficient to prevent a bank run from those holding many of the largest uninsured

deposit accounts. Indeed, even increasing the limit to millions of dollars would still not cover those types of uninsured accounts, according to the report. As such, additional tools would need to be implemented to prevent bank runs and ensure financial stability within the system.

2. **Unlimited Coverage.** This option would fully insure all deposits. While unlimited coverage would effectively remove the risk of bank runs, it would also likely increase the level of risk for financial institutions because their funding for loans and investments would always be covered. Unlimited coverage would also remove depositor discipline as well, increasing the “moral hazard” within society. There would also be an enormous increase in premiums that would have to be paid by financial institutions to maintain a 70% to 80% increase in the overall deposit insurance fund to cover all deposits completely. Because it’s not strictly prohibited, some financial institutions may attempt to recoup that cost by charging customers an “FDIC fee,” which occurred after the limit increased from $100K to $250K in 2010.
3. **Targeted Coverage.** This option would provide substantial additional coverage to business payment accounts so that employees and suppliers could be paid and business operations would not be disrupted, without extending similar insurance to all business deposits — such as those used by businesses for investment purposes. A challenge to this is being able to delineate between business payment deposits and other business deposits, as well as between accounts for businesses and those for individuals or estates. For the latter challenge, eligible accounts would use a tax identification number (TIN) or employer identification number (EIN), rather than a social security number — but this could easily be exploited by individuals or estates adopting TINs or EINs. The FDIC would have to implement additional tools to maintain financial stability for this option. Moreover, premiums to cover an increase in the deposit insurance fund might have to be raised.

The FDIC concluded that targeted coverage is “the most promising option to improve financial stability relative to its effects on bank risk-taking, bank funding and broader markets.” Still, there are “significant unresolved practical challenges,” including defining accounts for additional coverage and preventing depositors and financial institutions from circumventing differences in coverage.

Though some aspects of the required changes lie within the scope of the FDIC’s rulemaking authority, choosing any of the proposed options would require congressional action and approval. Because of the need for Congress’ involvement, the FDIC has not yet recommended what a new insurance threshold might be.

FDIC reform of any kind will have a great impact on the financial industry. Check back with us for updates on which option the FDIC and Congress choose — and if there are changes, when the agency will seek public comment. In the meantime, it is important to consider how the selected deposit insurance reform option would impact your institution and your depositors, so that you can be prepared for one of the mentioned scenarios.

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ECONOMY & RATES

Rates As Of: 09/06/2023 08:00AM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	5.55	-0.01	1.13
6M	5.51	0.03	0.75
1Y	5.45	0.09	0.74

2Y	5.02	0.16	0.59
5Y	4.44	0.18	0.43
10Y	4.29	0.18	0.41
30Y	4.36	0.14	0.39

FF Market	**FF Disc**	**IORB**
5.33	5.50	5.40
SOFR	**Prime**	**OBFR**
5.31	8.50	5.32