

Federal Reserve Bank of Cleveland

Who Benefits from Increasing the Federal Deposit Insurance Limit?

by James B. Thomson

Spawned by a compromise to ensure passage of the Glass-Steagall Act in 1933, federal deposit insurance is one Depression-era program that is likely to remain part of the financial landscape for the foreseeable future. But pressure to reconsider its role in the U.S. financial system is mounting. The Gramm-Leach-Bliley Act (GLBA) is dismantling many of the statutory limits on financial consolidation that were the heart and soul of Glass-Steagall, altering the face of the financial services industry. GLBA and the Reigle-Neal Act (1994), which dismantles interstate branching restrictions, promise increased integration of financial markets and more competition among financial firms. Heightened competition in funding markets has prompted some banking associations and policymakers to recommend raising the deposit insurance limit to \$200,000.

In March 2000, the Federal Deposit Insurance Corporation (FDIC) began to formally consider this proposal and other reforms. It issued an options paper in August 2000, whose purpose was “to frame the issues confronted by the FDIC and begin the discussion of options for addressing those issues.”¹ Any discussion of federal deposit insurance and the proposed reforms to the current system needs to address two basic questions. First, what are the net social benefits of providing federal guarantees for bank and thrift deposits? Second, given that we have decided a system of federal deposit insurance improves social welfare, how can we structure the system of guarantees to deliver the benefits most effectively—that is, at the lowest cost to society?

To answer these questions, we must first clarify our motives for providing deposit guarantees. In other words, we must understand why the market outcome is deemed unsatisfactory and what the social objectives we hope to achieve through government intervention are. Such an analysis is important because the structure of our system of federal deposit guarantees is likely to be different if the social objective is to protect small savers, subsidize the funding of bank assets, or stabilize the banking system. In addition, identifying and understanding the social objectives for deposit insurance is essential for assessing the net social benefits of the various reform proposals, including changes in the insured-deposit limit.

This *Economic Commentary* seeks to shed light on the issue of deposit insurance coverage by examining who would benefit from increases in the insured-deposit limit.² Potential benefits to three sets of stakeholders—depositors, community banks, and taxpayers—are discussed. Understanding who stands to gain from increases in the insured-deposit limit helps to ascertain whether such an increase is consistent with the social welfare objectives we establish for federal deposit guarantees.

■ Benefits to Small Savers

Proponents of federal deposit insurance argue that it provides two social benefits. First, they claim it improves economic efficiency. With deposit insurance, the deposit insurer can monitor the condition of banks more cost-effectively than many small depositors, spread out around the country, can. Second, they claim that deposit insur-

Who might stand to benefit from doubling the insured-deposit limit to \$200,000, and are such benefits consistent with the social objectives of federal deposit insurance?

ance creates a more equitable banking market for small savers. Proponents of deposit insurance argue that it is neither reasonable nor fair to expect small savers to monitor banks. After all, it is common to presume, correctly or not, that small savers are financially unsophisticated and lack the ability to assess the condition of a firm whose portfolio of assets consists largely of information-intensive assets—loans. Moreover, even if small savers are financially savvy, the costs of monitoring a bank for them may outweigh the benefits and therefore, it may be rational for them to not actively monitor the condition of their bank.

Is the current \$100,000 per account limit sufficient to protect small savers? The answer appears to be yes. After all, the average deposit in these accounts is less than \$6,000.³ Close to 99 percent of all domestic deposit accounts in commercial banks are under the \$100,000 deposit-insurance limit. This breadth of depositor coverage compares favorably to depositor coverage historically. For example, when the Congress established our system of federal deposit guarantees in 1934, the initial insured-deposit ceiling was \$2,500. It is estimated that the \$2,500 limit afforded full coverage to 96.5 percent of depositors in FDIC-insured banks.⁴

According to Federal Reserve Board figures, the median balance in transaction (checking) accounts for all families is only \$3,100, and the median value of certificates of deposits held by households is \$15,000⁵ (see table 1). These median deposit levels, taken individually or combined, are well under the current \$100,000 insured-deposit limit. Moreover, even the combined median checking account balance of \$19,000 and the certificate-of-deposit balance of \$22,000 for households with the highest incomes (more than \$100,000) is less than half of the current insured-deposit limit.

The current \$100,000 ceiling is even more generous when one considers that it applies to a single deposit account at a single insured institution. Depositors have two ways they can increase their coverage above \$100,000. First, a depositor can maintain accounts at multiple insured depositories. With around 9,800 FDIC-insured banks and thrifts, there is almost unlimited coverage available to even the most well-heeled depositor. Second, FDIC rules treat individual accounts and joint accounts as separate accounts for insurance purposes. For example, through a combination of individual and joint accounts, a family of four can have \$3.2 million in fully insured deposits in a single institution.⁶ The current deposit insurance ceiling of \$100,000 appears to exceed what is required to protect small savers.

■ Benefits to Community Banks

Community banks and thrifts continue to lobby for increases in the insured deposit limits on different grounds of equity. These institutions argue that the liabilities of large banks carry a conjectural guarantee of the government—often referred to as the too-big-to-let-fail doctrine. In other words, community financial institutions maintain that too-big-to-let-fail puts large institutions at a competitive advantage in deposit markets, and an increase in the insured deposit ceiling is needed offset this.⁷

Community financial institutions neglect three important considerations from their equity arguments. First, the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 eliminates the too-big-to-let-fail doctrine by explicitly prohibiting forbearance to uninsured depositors and

creditors of any failed bank or thrift institution unless the FDIC seeks and is granted a systemic risk exemption. Moreover, the prompt corrective-action provisions of FDICIA apply equally to all banks and thrifts, irrespective of size. Second, Congress appears to have leveled the playing field between large and small depository institutions in the GLBA. This legislation provides community financial institutions with superior access to funding from the Federal Home Loan Banks by allowing them to borrow against their small business, small farm, and small agricultural lending portfolios. Finally, any changes to the current system of federal deposit guarantees must be fair to large banks, small banks, and taxpayers.

Ideally, to identify and measure the benefits of increasing the insured-deposit limit for community banks, we would examine changes in funding costs and deposit growth resulting from raising the ceiling. However, arriving at such estimates using past increases in the insured deposit limit is problematic given the lack of available data. Moreover, even if such estimates were possible to construct, the quantum differences between the structure of our banking system today and the attendant regulatory system vis-à-vis 1981—the last time the deposit insurance limit was changed—raise serious questions as to the applicability of those estimates to today.

An alternative way to identify potential benefits to banks of increasing the deposit insurance ceiling is to project the impact of this change on the current levels and mix of deposit funding. Presently, over 59 percent of all domestic deposit balances are in fully insured accounts, and 72 percent of deposits are insured. For banks as a whole, about 1.14 percent of their accounts exceed the current ceiling—that is, around only 1 percent of all depositors would benefit from an increase in the insured-deposit limit. However, these depositors' uninsured balances make up around 28 percent of total domestic deposits. For community banks (banks with assets less than \$500 million) close to 70 percent of their deposit balances are under \$100,000 and nearly 83 percent are insured. Around 1.4 percent of community bank depositors have deposits that exceed \$100,000. The average deposit in accounts exceeding \$100,000 is

around \$356,000 for all banks and close to \$233,000 for community banks.

To examine the implications of doubling the insured-deposit limit for community banks, we focus on how such a change in coverage could affect their deposit mix. To do this, we need to assume that a change in the insured-deposit limit does not affect the total amount of deposits a bank has.⁸ Second, we need to make some assumptions about what percentage of currently uninsured balances would be covered by the higher limit. Including a small number of very large deposits in the uninsured deposit totals significantly skews the mean. Therefore, while we cannot observe the distribution of uninsured deposits, it is reasonable to presume that the majority of partially insured deposits have balances that are less than the mean of the distribution and that the bulk of partially insured accounts are less than \$200,000. Moreover, the presence of these jumbo deposits makes it likely that the preponderance of uninsured balances will remain uninsured even if the insured-deposit ceiling is raised to \$200,000. As a result, our analysis focuses on what changes in the deposit mix could occur when 20 to 50 percent of previously uninsured balances become insured. The results are reported in table 2.

For community banks, we see that if one-fifth of their uninsured deposits become insured, the percent of insured deposits increases from 83 to 86 percent. If half of uninsured deposits are affected by the change, the deposit mix shifts to 91 percent insured. For large banks the impact is even more dramatic, principally because they have a higher percent of deposit balances in partially insured accounts, and a greater proportion of these carry very large balances—including large certificates of deposit, which are typically issued in denominations of \$1,000,000 and higher.

The benefits to a bank of increasing the insured-deposit limit to \$200,000 depend on how big a fraction of its uninsured deposits become guaranteed under the higher ceiling. At the lower end of the range considered, community banks appear to gain little from doubling coverage. However, as the share of uninsured deposits shifting to insured status moves toward

TABLE 1 FAMILY HOLDINGS OF BANK DEPOSITS

Income (1998 dollars)	Checking Accounts		Certificates of Deposit	
	Median value*	% of families	Median value*	% of families
Less than \$10,000	0.5	61.9	7.0	7.7
\$10,000 to \$24,999	1.3	86.5	20.0	16.8
\$25,000 to \$49,999	2.5	95.8	14.5	15.9
\$50,000 to \$99,999	6.0	99.3	13.3	16.4
\$100,000 or more	19.0	100.0	22.0	16.8
All families	3.1	90.5	15.0	15.3

*Thousands of dollars.

SOURCE: Arthur B. Kennickell, Martha Starr-McCluer, and Brain J. Surette, "Recent Changes in U.S. Family Finances: Results from the 1998 Survey of Consumer Finances," *Federal Reserve Bulletin*, vol. 86 (January 2000), p. 11, table 5B.

TABLE 2 POTENTIAL IMPLICATIONS OF AN INCREASE IN THE DEPOSIT INSURANCE CEILING TO \$200,000

Uninsured balances	Percent of Deposit Balances Insured		
	Large banks	Community banks	All banks
Base case	69.18	82.76	71.95
20% become insured	75.34	86.21	77.56
30% become insured	78.43	87.93	80.36
40% become insured	81.51	89.66	83.17
50% become insured	84.59	91.38	85.97

SOURCE: Federal Financial Institutions Examination Council, *Reports of Condition and Income*, June 2000; and author's calculations.

50 percent, there do appear to be economically significant benefits accruing to depository institutions.

■ Benefits to Taxpayers

Taxpayers would stand to benefit from an increase in the insured-deposit limit if this policy intervention improved the efficiency and stability of the financial system. Some level of deposit guarantees can enhance the stability of the banking system by removing the incentives for rationally ignorant small depositors to run on depository institutions.⁹ Moreover, as discussed earlier, the deposit guarantor can monitor banks more effectively and at total lower resource costs than would be incurred collectively by small savers. However, given that there appear to be few benefits to small savers from increasing the insured-deposit ceiling, it is unlikely that such a policy action will enhance the stability and efficiency of the financial system.

To the contrary, economic theory and recent financial history show that de-

posit insurance levels above what is required to protect small depositors is counterproductive. The banking literature has long recognized the moral hazard associated with federal deposit guarantees. Contemporary writers criticized the deposit insurance provisions of the Banking Act of 1933, correctly pointing out the dangers of removing depositor-based market discipline from the banking system.¹⁰ Studies of the 1980s thrift debacle show that the previous increase in the deposit insurance ceiling from \$40,000 to \$100,000 contributed to the losses suffered, losses that averaged nearly 35 percent of assets for thrifts resolved over the decade.¹¹ Increasing the insured-deposit limit may be setting the stage for another crisis, not financial stability.

■ Conclusion

As with any governmental intervention into private markets, the case for raising the deposit-insurance limit needs to be examined in terms of social welfare—that is, a comprehensive cost-benefit analysis needs to be

conducted. Cost-benefit analysis requires a careful consideration of the overriding social objectives for deposit insurance and the consequent costs associated with its unintended effects.

If the social rationale for federal deposit insurance is the protection of small savers, there appears to be little justification for increasing the deposit insurance ceiling. After all, \$100,000 in deposit insurance coverage is well in excess of what the average depositor requires, and less than two percent of depositors would benefit from an increase in coverage. However, to the extent that increases in the percentage of deposits explicitly insured levels the playing field between small and large banks, it is possible that such an increase may be consistent with social welfare. On the other hand, there is little evidence that taxpayers would benefit from raising the deposit insurance ceiling and in fact, the lessons of the 1980s suggest the opposite is true. Since any deposit insurance reform needs to be fair to depository institutions of all sizes and to taxpayers, a more comprehensive welfare analysis needs to be done before one can argue for an increase in the insured-deposit limit on equity grounds.

Finally, any discussion of deposit insurance reform needs to consider the following question. Have the advances in information and communications technology and the financial market reforms enacted during the 1990s changed the market's structure in such a way that government intervention is no longer even necessary? To the extent that increased market efficiency emanating from innovations and reforms may have reduced the benefits associated with the current level of federal deposit guarantees, it is less likely social benefits associated with an increase in the insured-deposit limit exceed the costs of providing the additional coverage.

■ Footnotes

1. The options paper can be found on the FDIC's web site at <<http://www.fdic.gov/deposit/insurance/initiative/OptionPaper.html>>.
2. The focus is on coverage increases because many view current coverage levels as an entitlement and, hence irrespective of economic considerations, reductions in nominal deposit insurance coverage do not appear to be politically feasible.

3. Other average deposit measures support this conclusion. For instance, the average domestic deposit in commercial banks is less than \$10,000 and the average insured deposit is around \$7,190. These numbers are calculated using data from the June 30, 2000, FFIEC, *Reports of Income and Condition*. Note that these mean deposit levels are a high-biased estimate of the balances held by the typical small depositor, being skewed by a small number of high-balance accounts.

4. See "The Guaranty of Bank Deposits," *A Report of the Commission of Banking Laws and Practice*, Bulletin No. 3 (November 1933), Chicago, IL.: Association of Reserve City Bankers, p. 7.

5. See <<http://www.fdic.gov/deposit/deposits/insured/yourid.pdf>>

6. For a family of four there are four unique single accounts, six unique two-person joint accounts, four unique three-person joint accounts, and one unique four-person account, for a total of fifteen distinct accounts for deposit insurance purposes. Each depositor named on an account is covered up to the \$100,000 limit, so the total possible coverage for this family of four is \$3.2 million.

7. See ICBA, *Report On Federal Deposit Insurance Reform*, <http://www.icba.org/deposit_insurance/depositins_report_fr.html>.

8. Simple examination of the potential shifts in deposit mix may understate potential benefits to community banks from increasing the insured-deposit limit. To the extent that the migration of accounts in excess of \$100,000 from community banks to large banks is affected by the level of explicit coverage, raising the ceiling could slow this migration of deposits from small to large banks and possibly even reverse this deposit flow.

9. While the fragmented unit banking system of the nineteenth and early twentieth centuries in the United States was susceptible to runs, the increased geographic integration of the U.S. banking system and a properly functioning lender-of-last resort facility pretty much eliminate the need for deposit insurance to contain runs on solvent banks.

10. See Guy Emerson, "Guaranty of Deposits under the Banking Act of 1933," *Quarterly Journal of Economics*, vol. 48 (February 1934), pp. 229-244 and "The Guaranty of Bank Deposits," *A Report of the Commission of Banking Laws and Practice*, Bulletin No. 3, (November 1933), Chicago, IL.: Association of Reserve City Bankers.

11. See table 1 and *The FDIC and RTC Experience: Managing the Crisis*, Washington, D.C.: Federal Deposit Insurance Corporation, 1998, charts C.35, C.36, and C.37.

James B. Thomson is a vice president and economist at the Federal Reserve Bank of Cleveland.

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**Federal Reserve Bank of Cleveland
Research Department
P.O. Box 6387
Cleveland, OH 44101**

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