

# Raising the Deposit-Insurance Limit: A Bad Idea Whose Time Has Come?

by James B. Thomson

*We at the FDIC are undertaking a comprehensive review of our deposit insurance system. I want to take a hard look at certain issues, including: (1) Does the deposit insurance system create the right incentives? (2) Is the system fair? (3) What is the right coverage level?*

Donna Tanoue, Chairman  
Federal Deposit Insurance Corporation<sup>1</sup>

*Is there any reason why the American people should be taxed to guarantee the debts of banks, any more than they should be taxed to guarantee the debts of other institutions, including the merchants, the industries, and the mills of the country?*

Senator Carter Glass  
Author of the Banking Act of 1933<sup>2</sup>

Less than a decade has passed since the enactment of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). FDICIA represented the final legislative response to the thrift debacle and regional banking problems of the 1980s. This statute enacted needed reforms to our system of bank supervision and regulation and to federal deposit insurance, including prompt corrective action, risk-adjusted deposit-insurance premiums, and discount-window-lending reforms. However, these provisions in FDICIA fall short of comprehensive reform of the intricate system of depository-institution regulations and financial-safety-net subsidies.

Since the passage of FDICIA, Congress has enacted two important pieces of financial sector legislation. In 1994 the Reigle-Neal Act removed most of the remaining restrictions to interstate consolidation of the banking system. Last

year the Financial Modernization Act of 1999 (FMA) was signed into law. Also known as the Gramm-Leach-Bliley Act, this statute represents the single most important set of regulatory reforms since the Glass-Steagall Act of 1933. The FMA repeals many of the provisions of the Glass-Steagall and Bank Holding Company acts that prohibit or limit the affiliation of banks with other nondepository financial firms.<sup>3</sup> The cumulative effect of these post-FDICIA statutes will be to accelerate the trend toward a financial system that is more integrated in terms of activities and products—a single financial firm will be able to provide commercial banking, investment banking, and insurance products. In addition, these reforms have resulted in a banking system that is more geographically integrated as the interstate consolidation of the banking system continues.

From the perspective of federal deposit insurance, the financial reforms of the 1990s were a mixed blessing. Lessons from banking history indicate that extending the geographic reach of banking organizations increases the stability of their funding and diversification of their assets, thereby reducing the need for federal deposit insurance.<sup>4</sup> On the other hand, the resulting consolidation of the financial sector is spawning larger and more complex banking organizations—ones that may be increasingly difficult to supervise adequately. If financial reform results in institutions too large or complex to effectively discipline, then an unintended effect of the post-FDICIA reforms will be the de facto extension of federal deposit insurance to a larger part of the financial system. As the involvement of the Federal Reserve Bank of New York in the privately funded rescue

**Federal deposit insurance protects the savings of small depositors, but it increases the likelihood that banks will take risks they otherwise would not have. Some bankers have suggested doubling the level of coverage, from \$100,000 to \$200,000. While such an increase may put smaller banks on a level playing field with larger ones, it exceeds the amount necessary to protect small savers and is unfair to taxpayers.**

of Long Term Capital Management in 1998 illustrates, policymakers may be reluctant to allow markets to fully discipline financial firms when the impact of the failure of a firm on the short-run stability of the financial system is uncertain.

There is little doubt that as regulators and policymakers work to implement the provisions of the FMA, reforms to the structure of financial regulation and to federal deposit insurance will be considered. One such reform, raising the federal deposit-insurance limit from \$100,000 to \$200,000 per insured account, has been proposed by the Independent Community Bankers of America.<sup>5</sup> This *Economic Commentary* examines the potential benefits and costs of doubling the deposit-insurance limit. Overall, there appears to be little justification for increasing the statutory size of the federal financial safety net.

## ■ Rationale for Deposit-Insurance Limits

Proponents of government guarantees of deposits typically justify them on the grounds of efficiency and equity. They

argue that the information costs to the economy are lower by having a single agency monitor banks than a large number of small depositors. Coordination problems among independent depositors largely preclude them from sharing information on their bank. This results in a duplication of efforts which requires depositors in the aggregate to use more resources in monitoring than the deposit-insurance agency would require. Therefore, delegating the monitoring function to the deposit insurer lowers information costs.

Concerns of equity—the widow and orphan arguments—center on the ability of small and presumably unsophisticated depositors to monitor banks. Proponents of deposit insurance argue that it is neither reasonable nor fair to expect unsophisticated individuals to monitor banks, whose portfolios of assets consist largely of information-intensive assets—loans. The costs of monitoring a bank for small depositors may outweigh the benefits, and therefore, it may be rational for them to not actively monitor the condition of their bank. Instead, rationally ignorant small depositors will seek to protect their interests by withdrawing their deposits whenever they are presented with information that causes them to question the solvency of their bank—that is, they will run on their bank. Rational ignorance by small depositors may prevent them from distinguishing between good information on the condition of their depository institution and false rumors; hence, they may participate in runs on solvent banks.<sup>6</sup>

On the other hand, 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.<sup>7</sup> It is, therefore, no accident that Congress sought to limit deposit-insurance coverage to modest levels: limits high enough to provide adequate protection for small depositors and low enough so that large depositors continue to act as a form of market discipline on depository institutions. Initially, the deposit-insurance ceiling was set at \$2,500 in the Banking Act of 1933. However, this limit was soon increased to \$5,000, effective June 30, 1934.

Any discussion of what the appropriate deposit-insurance limit ought to be going forward should consider what would be needed to protect small savers today. There are two approaches for doing this. One is to calculate the present-day equivalent of the original level of coverage by adjusting the 1934 limit for inflation. Another is to determine the level of coverage the average depositor would need to protect her savings.

### ■ How Does Coverage Today Compare with Past Levels?

Proponents of the proposal to adjust the current deposit-insurance ceiling to account for inflation point to the increases in the insured-deposit limit which have been made throughout the FDIC's 67-year history as justification. Congress increased the deposit-insurance limit to account for inflation in 1950, 1966, 1969, and 1974. These changes in the deposit-insurance limit are presented in table 1 with two inflation-adjusted limits. The fourth column in the table presents the \$5,000 limit in 1934 in current dollars in each of the years Congress raised the limit. In other words, column 4 shows the level of deposit insurance needed to keep the real level of coverage at the same level that existed when the FDIC began operations. The fifth column presents the amount of coverage needed to reset the deposit-insurance ceiling in real terms to the coverage afforded depositors at the last change in the insured-deposit limit. For example, the \$14,015 figure in column 5 for 1966 is the \$10,000 limit established in 1950, adjusted for changes in the implicit GDP deflator from 1950 to 1966.

The 250 percent increase in the deposit-insurance limit in 1980 was a jump of unprecedented magnitude that was opposed by the FDIC. Previous increases in the insurance limit could be rationalized as inexact inflationary adjustments aimed at restoring the real level of coverage previously established by the Congress. The 1980 current-dollar deposit-insurance limit based on 1934 coverage levels is \$28,880, and the inflation adjustment needed to reset the real coverage to 1974 levels is less than \$63,000. The motivation for the increase to \$100,000 was something other than the need to adjust deposit-insurance coverage for inflation.<sup>8</sup> In fact, it reflected an attempt by the Congress to slow the rate of disintermediation occurring because market interest rates had risen sharply above Regulation Q ceilings—the maximum interest banks

could offer on deposits. In addition, the Congress may have seen the increase as necessary to stabilize the funding sources for the savings and loan industry, which had been decapitalized by the interest-rate shock in late 1979 and early 1980.<sup>9</sup>

One measure of the adequacy of the current \$100,000 insured-deposit limit is to see if it affords the same coverage in real terms as it did historically. To examine this, the 1934 and 1974 limits are converted into 1999 dollars. The 1974 ceiling was used because it represents the last time that the deposit-insurance ceiling was raised primarily to adjust it for inflation. The \$5,000 limit in 1934 translates into a deposit-insurance ceiling of \$52,963 at the end of 1999, slightly more than half of the current limit. Converting the \$40,000 limit established in 1974 to 1999 dollars is equivalent to an insured-deposit ceiling of \$114,269. Therefore, a \$15,000 increase in the deposit-insurance ceiling would be needed to set the real coverage level to that established in 1974.<sup>10</sup>

It is clear that the current deposit-insurance limit provides coverage well in excess of the real coverage provided in 1934 and as such, one can argue that the insured-deposit limit should be reduced by \$40,000 to \$50,000. However, if the goal is to reset coverage to preserve the level of real coverage established at the last inflationary adjustment, then a small increase in the range of \$15,000 to \$30,000 could be justified—an increase well below the \$100,000 increase recently proposed.

### ■ How Much Coverage Do Small Savers Need?

*I think if anything, \$100,000 is too high. ... I'm not going to support raising them [coverage levels] under any circumstances.*

Honorable Phil Gramm, Chairman,  
United States Senate Committee on  
Banking, Housing, and Urban Affairs<sup>11</sup>

A simple comparison of real deposit-insurance coverage across time may not provide us with a relevant measure of the adequacy of the current deposit-insurance limit. After all, the financial system today is certainly more informationally efficient than in the 1930s, and the geographic consolidation of the banking system has increased the banking system's stability. In addition, deeper and more liquid capital markets and the proliferation of mutual funds have provided small

**TABLE 1 ACTUAL AND INFLATION-ADJUSTED INCREASES IN THE INSURED-DEPOSIT LIMIT**

Year	Old limit	New limit	Inflation-adjusted 1934 limit <sup>a</sup>	Inflation-adjusted previous limit	Reason
1950	5,000	10,000	8,834	8,834	Inflationary adjustment
1966	10,000	15,000	12,382	14,015	Inflationary adjustment
1969	15,000	20,000	13,968	16,922	Inflationary adjustment
1974	20,000	40,000	18,540	26,546	Inflationary adjustment
1980	40,000	100,000	28,880	62,310	Disintermediation

a. This is the \$5,000 limit in 1934, adjusted to current dollars using the implicit GDP price deflator from the Bureau of Economic Analysis.

SOURCE: Federal Deposit Insurance Corporation; Bureau of Economic Analysis; and author's calculations.

savers with low-risk alternatives to bank accounts that were not available to them in the 1930s. Finally, the proliferation of payments innovations—from credit cards to emerging electronic payments instruments—has likely changed the mix and level of deposits demanded by consumers. Consequently, a better way to judge the adequacy of deposit-insurance coverage is to assess the coverage needed by the average depositor. In other words, does the current limit of \$100,000 provide sufficient coverage for small savers today?

The answer to this question appears to be yes. Over 98 percent of all domestic deposit accounts in commercial banks are under the \$100,000 deposit-insurance limit, and the average deposit in these accounts is less than \$6,000.<sup>12</sup> If indeed the rationale for federal deposit guarantees is to protect small savers, the current deposit-insurance ceiling is more than adequate. In fact, these numbers are more consistent with the argument that the limit should be lowered—possibly to \$50,000, the current-dollar equivalent of the 1934 ceiling.

The Federal Reserve Board's 1998 Survey of Consumer Finances provides another perspective from which to assess the adequacy of current deposit-insurance coverage.<sup>13</sup> The results of that survey showed that 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 was \$15,000. These median deposit levels, taken individually or combined, are not high enough to warrant an increase in deposit-insurance coverage. Moreover, even the combined median checking-account balance of \$19,000 and the certificate-of-deposit balance of \$22,000 for households with incomes of \$100,000 or greater is nearly \$10,000 below the current-dollar equivalent of the FDIC's 1934 insured-deposit ceiling.

## Conclusion

During the height of the thrift debacle in the 1980s there were numerous calls for fundamental reform of federal deposit insurance. A number of the reform proposals called for substantially scaling back the insured-deposit ceiling to levels that reflected the needs of small depositors while reducing the moral hazard associated with guaranteeing the lion's share of bank liabilities.<sup>14</sup> It became clear, however, that irrespective of how strong the economic case for lowering the insured-deposit limit was, this reform was not politically feasible.<sup>15</sup>

It has been less than 10 years since the passage of FDICIA, legislation enacted by the Congress to reform those aspects of the government's involvement in the financial system seen as contributing factors to the banking- and thrift-industry problems of the 1980s. As such, FDICIA contained reforms for federal deposit insurance and the Federal Reserve's discount window aimed at reigning in the federal financial safety net. It is ironic, therefore, that in the face of major financial system integration, proposals have surfaced to further extend the federal financial safety net by doubling the statutory deposit-insurance limit.

From the standpoint of the average depositor there appears to be no need to increase the deposit-insurance ceiling. At current limits, depositors have nearly twice the coverage in real dollars than they had when federal deposit insurance was implemented. Moreover, \$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. There is no compelling reason to increase the insured-deposit limit at this time; in fact, it may be time to reconsider proposals for reducing it.

## Footnotes

1. Donna Tanoue, "Remarks," Annual Convention of the Independent Community Bankers of America, San Antonio, Tex., March 7, 2000, from <[www.fdic.gov/news/news/speeches/chairman/sp07Mar00.html](http://www.fdic.gov/news/news/speeches/chairman/sp07Mar00.html)>.

2. Quoted in Rixey Smith and Norman Beasley, *Carter Glass: A Biography*, New York: Longmans, Green and Co., 1939, p. 357.

3. Ironically, one of the major provisions of the Glass-Steagall Act that was not altered by the FMA is federal deposit insurance. Senator Carter Glass opposed federal deposit insurance but allowed its inclusion in the Banking Act of 1933 in order to garner enough votes to pass it. (See footnote 2.)

4. See George G. Kaufman, "The Truth About Bank Runs," in Catherine England and Thomas Huertas, eds., *The Financial Service Revolution: Policy Directions for the Future*, Lancaster and Dordrecht: Kluwer Academic, 1988, pp. 9–40.

5. The ICBA proposal for increasing the insured-deposit limit and indexing it to inflation can be found on the organization's Web site at <[www.ibaa.org/news\\_views/policy\\_resolutions\\_fr.html](http://www.ibaa.org/news_views/policy_resolutions_fr.html)>. This proposal is based on the perception by community banks that the too-big-to-let-fail doctrine provides large banks de facto 100 percent coverage of all their deposits. Hence, community banks argue that an increase in the deposit-insurance limit is needed to provide for a more level playing field between large and small banks. However, none of the proposals put forth by the banking trade groups considers the interests of the taxpayers. Any changes to the current system of federal deposit guarantees must be fair to large banks, small banks, and taxpayers.

6. George Kaufman distinguishes between bank runs on good information and those based on ex post false rumors. Kaufman labels runs based on good information as rational bank runs, which he argues are not contagious. He calls bank runs based on rumors which prove false ex post, irrational bank runs. According to Kaufman, irrational bank runs are potentially contagious and can lead to banking panics. However, in the presence of a properly functioning lender-of-last resort facility, irrational runs would be short-lived and, hence, should not have systemic ramifications. (See footnote 4.)

7. See Guy Emerson, "Guaranty of Deposits under the Banking Act of 1933," *Quarterly Journal of Economics*, vol. 48 (February 1934), pp. 229–44, and "The Guaranty of Bank Deposits," Association of Reserve City Bankers, Bulletin No. 3, A Report of the Commission of Banking Laws and Practice (November, 1933), Chicago, Ill.

8. See *Federal Deposit Insurance Corporation, The First Fifty Years: A History of the FDIC, 1933–1935*, Washington, D.C.: FDIC, 1984, pp. 69–72.

9. See Ramon P. DeGennaro and James B. Thomson, "Capital Forbearance and Thrifts: Examining the Costs of Regulatory Gambling," *Journal of Financial Services Research*, vol. 10, no. 3 (September 1996), pp. 199–211; Edward J. Kane, *The Gathering Crisis in Federal Deposit Insurance*, Cambridge, Mass.: MIT Press, 1985; and Edward J. Kane, *The S&L Insurance Mess: How Did it Happen?* Washington, D.C.: Urban Institute, 1989.

10. Assume that the Congress would have set an inflation-adjusted limit of \$70,000 in 1980—that is, half of the 1980 increase was for reasons other than inflation. The deposit insurance limit in 1999 dollars that corresponds to the hypothetical limit of \$70,000 in 1980 translates into \$128,372 at the end of 1999.

11. Quoted in Kevin Guerrero, "FDIC's Deposit Reform Plan Slowed by Politics," *American Banker*, vol. 165, no. 64 (April 3, 2000), p. 1.

12. 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 \$7,000. These numbers are calculated by the author using data from the June 30, 1999, 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.

13. The results of the 1998 Survey of Consumer Finances are summarized in Arthur B. Kennickell, Martha Starr-McCluer, and Brian J. Surette, "Recent Changes in U.S. Family Finances: Results from the 1998 Survey of Consumer Finances," *Federal Reserve Bulletin*, vol. 86 (January 2000), pp. 1–29.

14. See for example, James B. Thomson and Walker F. Todd, "Rethinking and Living with the Limits of Bank Regulation," *The Cato Journal*, vol. 9, no. 3 (Winter 1990), pp. 579–600, and James B. Thomson, "A Market-Based Approach to Reforming Bank Regulation and Federal Deposit Insurance," *Research in Financial Services: Private and Public Policy*, vol. 4, Greenwich, Conn.: JAI Press Inc., 1992, pp. 93–109.

15. This sentiment was clearly expressed by former FDIC Chairman Irvine H. Sprague in his 1986 book on the rescue of Continental Illinois Bank and Trust Company, where he concludes, "Rolling back the \$100,000 limit to a lesser figure has been proposed in many quarters. I agree this would be desirable, but my futile attempts to stop Congress from approving the \$100,000 limit suggest to me that there is no political possibility of a rollback." See Irvine H. Sprague, *Bailout: An Insider's Account of Bank Failures and Rescues*, New York: Basic Books, Inc., 1986, p. 261.

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*The views stated here are those of the author and not necessarily those of the Federal Reserve Bank of Cleveland or of the Board of Governors of the Federal Reserve System.*

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