FRBSF Weekly Letter

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Changing the $100,000 Deposit Insurance Limit

Recent deterioration in the financial condition of the Federal Deposit Insurance Corporation (FDIC) has raised doubts about its ability to meet the goals of protecting small depositors and preventing bank runs. Several recent proposals discuss reducing the level of deposit insurance coverage to provide more "depositor discipline." The notion is that at-risk depositors would monitor the condition of their banks, reining in bank risk-taking; as a consequence, the banking system would become less risky, and the federal deposit insurance liability would decline.

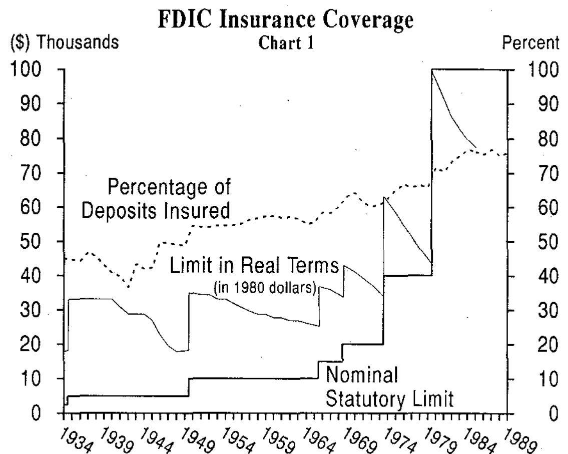
This *Letter* argues that current FDIC treatment of failed banks makes changes in the coverage limit more symbolic than effective. Little additional discipline would be introduced, and small banks and their depositors would bear a disproportionate burden. Moreover, even if depositor discipline could be introduced through a reduction in coverage, it probably is undesirable. Hence, while market discipline in banking is a worthy goal, deposit markets may be the wrong place to seek that discipline.

Current limits

Currently, the coverage limit for deposit insurance is $100,000 per individual per category of account per institution. Chart 1 plots the nominal coverage limit, the limit adjusted for inflation, and the percentage of deposits insured by the FDIC.

Proposals to reduce coverage are founded on a belief that coverage has increased to a higher level than is necessary to achieve the goals of deposit insurance. Many of these proposals have focused on the nominal level of coverage when justifying decreases in the coverage limit. However, changes in the nominal coverage limit can be deceptive because they do not account for inflation. In real terms—that is, in terms of the purchasing power of the insured amount—current coverage is little more than that in 1974 and

FDIC Insurance Coverage
Chart 1



only twice that of 1935. Furthermore, given the high inflation rate over the last 25 years, it may be appropriate that the most dramatic changes to the nominal coverage limit have taken place during this period.

Failure resolution policies and the coverage limit

FDIC treatment of failed banks has made the legal coverage limits of little practical importance. In 861 of the 1,086 bank failures during the 1980s, the FDIC either found another institution to take over the operations of the failed bank through a "purchase and assumption," or provided financial assistance to allow the bank time to recover or arrange a merger. In such cases, no depositors lost, regardless of whether their balances exceeded the $100,000 limit. These depositors have little incentive to impose discipline, regardless of statutory coverage.

In the remaining 225 failures, insured deposits were transferred to another bank, or were paid off up to the $100,000 coverage limit. Depositors with balances above the limit may have suffered losses in these cases. Almost all of these were small banks under $100 million in deposits.

Despite a number of large-bank failures, no failed commercial bank with more than $500 million in deposits was resolved through an insured deposit transfer or payoff during the decade. Thus, it is not surprising that small banks derive less than 10 percent of their deposit funding from accounts with balances above $100,000, while large banks have over 30 percent of deposits in such accounts.

As a result, without a change in the treatment of failures, small banks probably would bear the brunt of any adjustment to a lower insurance limit. Any increase in depositor discipline resulting from reduced coverage would have to be provided by depositors at these banks, where total protection is least likely. Depositors who were less than fully insured would demand higher interest rates, or would shift their deposits to larger banks where complete protection is more likely.

Although the impact on small banks might be substantial, the overall effect on depositor discipline would be slight, because a change in the limit would be irrelevant to depositors at all but the smallest banks. Hence, changes in the limit (in the absence of changes in the treatment of large bank failures) are unlikely to affect the propensity of most depositors to impose discipline.

Should we want depositor discipline?

If the burden of increased depositor discipline could be spread equitably, would it be desirable? To answer this, it helps to look at the goals of deposit insurance. One goal is to protect the economy from the effects of deposit runs.

Are deposit runs harmful? An important body of economic literature suggests that the answer lies in an understanding of bank "uniqueness." Specifically, when the flow of credit is impeded by unequal (or "asymmetric") information between potential lenders and potential borrowers, banks are uniquely qualified as intermediaries. Because they can serve as superior monitors of the financial condition of borrowers, banks allow more funds to flow to more productive uses, thereby raising national income. Of course, loans made when information is asymmetric are necessarily illiquid (that is, the price they bring if sold on the open market is less than their full value), but this illiquidity presents no problem if banks are certain that loans can be held to maturity.

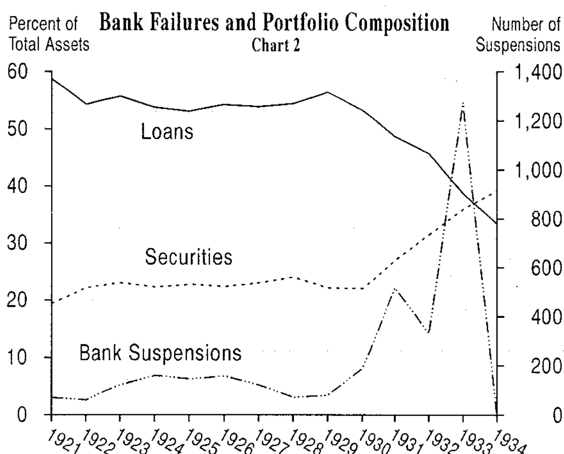
However, bank deposits are generally short-term, and most are payable on demand at a fixed value independent of the bank's assets. Unusually high rates of deposit withdrawals can force banks to sell illiquid loans at a loss, possibly leaving the bank without sufficient resources to pay all depositors. With depositor discipline, even a suspicion that this might happen can cause a rush to withdraw—depositors naturally want to be first in line at the bank rather than last, knowing that bank assets are fundamentally illiquid —and depositors' expectations become self-fulfilling. Thus, the same information asymmetry that provides the reason for the existence of banks also makes deposit runs likely.

The broader economic costs

The unique character of banks and bank loans, combined with the unavoidable difference in liquidity between loans and deposits, creates a "market failure," in which the free market outcome (including depositor discipline and actual or threatened deposit runs) is not optimal. Diamond and Dybvig (1983) demonstrated that the cost of runs exceeds the cost to the directly affected banks. Costs to the whole economy arise because, if banks protect themselves from the threat of runs by switching to liquid assets (for example, securities), loans may be unavailable for productive investments.

This type of portfolio shift in the face of runs is evident in pre-FDIC banking data. Chart 2 shows the rise in bank failures prior to establishment of the FDIC in 1934, a period in which banks faced frequent runs as a result of depositor discipline. Coincident with the increase in failures, banks adjusted their portfolios: relative to total assets, loans fell by half while holdings of securities doubled. The funds tied up in securities were not available for the unique (but illiquid) lending that is the primary function of banks. Bernanke (1983) has argued that this shift deepened and prolonged the depression of the 1930s.

Some research does suggest that the costs historically associated with bank runs are minimal. As cited in a recent *Weekly Letter* (April 12, 1991), these studies show that the frequency of actual runs was low, and that direct losses to depositors were small relative to total deposits. However, such measurements ignore the more important point that it is the *threat* of runs in the system—regardless of whether or not runs



actually occur —that causes banks to protect themselves by curtailing lending. The most important economic costs stem from this reduction in bank intermediation. The direct losses suffered by depositors in actual runs may be a trivial component of the loss to the entire economy.

Insurance coverage as a solution

One legitimate role of government in a free market economy is to solve such problems of market failure. The solution in this case is deposit insurance, which eliminates deposit runs. The drawback of insurance is that it removes depositors as a potential source of discipline to restrain bank risk-taking. Hence the government, as insurer of deposits, must provide the missing discipline through a combination of prudential regulation and deposit insurance pricing.

Many economists have argued that regulation never adequately replaces market discipline, because regulators lack appropriate incentives. However, the issue is not whether regulatory discipline is inferior to depositor discipline, but whether the disciplinary gains from forcing depositors to monitor banks outweigh the social costs of instability in the banking system. More depositor discipline means more potential for bank runs. To argue that depositors should provide discipline is really to argue that bank runs are not very costly because banks play no special role in the economy—the more special banks are, the less desirable depositor discipline.

Choosing the coverage limit

Setting any particular coverage limit involves a tradeoff between the benefits of protection from bank runs and the costs of reduced market discipline. In principle, the chosen limit should balance the gains and costs at the margin. But if banks are indeed "unique," full insurance for *all* deposits that are likely to run might be desirable. This would require substituting regulatory discipline for depositor discipline even more widely than is now done. A case even could be made for coverage of the liabilities of intermediaries such as certain private insurance companies, if changes in the structure of the financial system lead them to provide bank-like services in the face of asymmetric information.

This does not argue against all forms of market discipline. Longer-term debt and other types of claims can and should provide a brake on bank risk-taking, but deposit markets present special problems. Depositor discipline should be a last resort, unless it is far superior to other forms of market discipline. A case might be made for depositor discipline at the very high end of the deposit market, where the size of a typical institutional deposit exceeds $1 million: these large depositors might run, but at least their behavior is likely to be based on better information.

In sum, there is probably little to gain from reducing the deposit insurance coverage limit from its current $100,000 level. A lower limit buys little additional depositor discipline, given current policy toward failures, except possibly at small banks. Recommendations for lower coverage appear to overlook one of the major benefits of deposit insurance: the elimination of the threat of destabilizing bank runs. Since instability in the banking system is potentially very costly, the case for lower coverage is weak.

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