A Better Approach to Deposit Insurance*

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Bert Ely and Alex Pollock are correct — the deposit insurance changes made in the Dodd-Frank bill have raised a serious question that probably should have been raised before now. Should there be more than one deposit insurance fund? Pollock suggests there should be two funds; Ely, that at a minimum there must be separate accounting for large and small banks.

They are on to something, in my judgment, but I don't think that additional insurance funds are necessary to resolve the problems they raise. What does seem clear is that there are good reasons to remove the largest institutions from DIF and leave the smaller ones as the only participants in DIF.

Turn the Deposit Insurance Fund over to the smaller banks. Let them be the only banks to fund it, let losses from it come from banks other than the systemically risky banks, isolate it from losses that the resolution of a large bank might create, and require the largest banks to clean up their own mess, should they have any. Here's one way that could work without creating multiple funds.

Require all of the institutions in any systemic risk holding company to be resolved under the systemic risk resolution language of Dodd-Frank. That is, should one of the biggest banking companies fail, the depository institution affiliate and the rest of the company would be resolved under the Dodd-Frank resolution authority and not the FDI Act. Mandate that the domestic deposits in the insured depository institution be paid up to the same levels as would be the case if the institution were insured. Those payments on deposits, however, would not come from the DIF but from advances from Treasury. The sign at the teller windows of such depository institutions would say the deposits are insured by the U.S. government under the Dodd-Frank Act. The rules for coverage of deposits would be identical with those of deposits insured under DIF.

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In the resolution of the institution, payments on deposits would be an expense of the receivership, and their cost would be recovered just as all other expenses of the receivership are recovered — that is, from liquidation of assets and assessments on covered institutions. Under depositor preference law, repayment of the Treasury would have preference in the liquidation. Dodd-Frank has made it clear that Treasury will not lose money on any resolution, and has established a system that mandates repayment by other systemically significant institutions of any losses Treasury might incur. Therefore, Treasury loses no money should there be a failure of a depository institution subsidiary of a large systemic risk institution.

DIF would be limited to resolving institutions that are not subsidiaries of systemic risk holding companies, and payment for any losses, or for building that fund to the desired level through assessments, would be limited to those institutions that are covered under that Act. If the smaller banks are right in the lobbying they have done over the years, they soon will find it unnecessary to pay any deposit insurance assessments since the overhang of the largest institutions will have been eliminated.

If larger banks felt that was unfair, too bad. They would be stuck under Dodd-Frank. If smaller banks thought that was unfair, then they would have to explain why, since their complaint has been that they have been subsidizing the largest banks and that life would be more pleasant if they didn't have to do so.

This would be a major change in deposit insurance in the U.S., and those recommending it would be asked to articulate some good reasons to make the changes. Here are some good reasons to do so; I'm sure there are many more.

1. The FDIC and Congress no longer would have to be concerned that the failure of one of the largest banks would bankrupt DIF. The failure simply would not have any impact at all upon DIF.
2. The federal budget would not have to factor in losses from the failure of the largest banks when considering the impact of deposit insurance operations; they would also not be able to add the revenues from assessments on the largest banks to help balance the federal budget. Part of the politicalization of the FDIC that has begun in Dodd-Frank would be diluted. Deposit insurance funding would be removed from politics.

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3. Resolution of the largest institutions was exhaustively considered in this Congress and the solution Congress chose is laid out in Dodd-Frank. The biggest institutions are resolved under that language, and that logically should include their insured depository institution subsidiaries and affiliates. Currently, it is not clear that this would be the case. In fact, if the depository institution affiliate fails, it would probably be deemed a failure that could cause a systemic risk under the FDI Act and be resolved under the systemic risk resolution techniques in that Act, not Dodd-Frank. Hence, two systemic risk resolutions would be carried on at the same time — one of the parent and one of the subsidiary. A better result would be one in which both institutions were resolved under Dodd-Frank, probably under the techniques that have been in place in the FDI Act for years.

4. Other than possibly Continental Illinois 26 years ago, there have been no really large banks that have failed, so none of the payments made to DIF by Chase, Citi, BAC, Wells, United Bank, BONY, etc. over all of these years have ever been drawn upon to resolve failures of any large institution. What they have paid for, on the other hand, are thousands of failures of smaller institutions. On the surface at least, this has been an unfair subsidization of smaller banks' reckless banking by larger banks.

5. Should one of these giant banking institutions fail, it is better public policy to isolate DIF from the effects that follow, thereby putting large institutions on notice that should their peers fail, they, not the smaller banks, will pay for it. That will encourage the largest banks to ride herd on their peers, something that would be less important if the cost of the failure remains under DIF and thus is shared by the smaller institutions.

6. There are technical problems that have arisen that support such a change. As Bert Ely has pointed out, with the convoluted assessment system adopted at the last minute in order to get the necessary votes for Dodd-Frank, the FDIC may have to keep separate books for large banks and for small ones. This change would simply build upon that.

7. For 75 years the assessment system of the FDIC worked fairly well, and while the losses almost exclusively have come from banks that would not be considered in the list of systemic risk banks, the amount of assessments for insured deposits roughly corresponded to the amount

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of insured deposits covered by those paying those assessments. The rule of thumb in the legislative consideration of options under Dodd-Frank mandated that the bill punish the big banks whenever possible, and so that accommodation was abandoned, and a process adopted that is not in balance. Moving to this new approach would put things back in balance.

8. This change would stimulate the economy just at the time stimulation is needed. Since the DIF would be covering only about half as many insured deposits, the reserve ratio would immediately at least double in size and small banks would not be required to make contributions to the DIF for years, assuming there wasn't a massive run of small bank failures. That money could be used for lending. Similarly, large banks would not have to pay assessments, and that would free up additional funds for lending at large banks. It's a win-win.

Currently, the resolution of large systemic institutions is out of balance in that the largest subsidiary for those that have depository institution subsidiaries is the depository institution itself, and it probably is not covered under the Dodd-Frank resolution procedures. Similarly, the DIF burden is out of balance in that the bulk of losses are caused by failures of smaller banks, and the bulk of assessments come from the largest banks. Consideration of the proposal outlined above has the merit, at least, of addressing both of those situations and perhaps bringing both of them more closely into balance with reality.

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