Raising Federal Deposit Insurance Coverage

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Preface

This Congressional Budget Office (CBO) paper examines the implications for banks and depositors of raising the limit on federal deposit insurance coverage. The paper supplements CBO's analysis of the federal cost of raising deposit insurance coverage (reported in CBO's cost estimate for H.R. 3717, the Federal Deposit Insurance Reform Act of 2002) by taking a broader economic perspective. The paper was prepared at the request of the Ranking Member of the Senate Committee on Banking, Housing, and Urban Affairs. In keeping with CBO's mandate to provide objective, impartial analysis, it contains no recommendations.

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Introduction and Summary

The Congress is considering legislation to increase federal insurance of deposits in banks, savings and loan associations, and credit unions. Currently, the first $100,000 in an account is covered. Legislation recently passed by the House would raise that limit to $130,000 for most accounts, to $260,000 for retirement accounts (such as individual retirement accounts and Keogh accounts), and to as much as $2 million for in-state deposits by state and local governments. Those increases are being considered as part of a package of changes that include merging the Bank Insurance Fund with the Savings Association Insurance Fund and altering the conditions under which banks and savings associations pay premiums for deposit insurance. This paper, however, focuses primarily on the effects of increasing the level of insurance coverage.

When deposit insurance was established by the Federal Banking Act of 1933, its purposes were to prevent mass panicked withdrawals, or "bank runs," and to protect unsophisticated depositors with few financial assets from the loss of their deposits. In recent years, however, raising deposit insurance coverage has been viewed mainly as a way to help banks and savings associations attract more deposits.[1]

Advocates cite at least four reasons to increase deposit insurance coverage. First, the limit on insured deposits has not risen since 1980 (when it was raised to $100,000). During the past 22 years, inflation has eroded the value of coverage. Second, increasing the coverage limit would afford greater convenience to depositors who now divide their funds into multiple accounts to get full insurance coverage of deposits in excess of $100,000. Third, boosting deposit insurance coverage could serve to attract more deposits to all banks and thrifts. To the extent that small banks are more dependent on deposits than large banks are, increased deposits could improve the competitiveness of small banks. Fourth, raising the coverage limit for in-state municipal deposits could reduce costs for banks, which now must hold collateral for municipal deposits in excess of the federal insurance limit.

Opponents counter those arguments and offer reasons to retain the current limit. They maintain that raising the ceiling on coverage is unnecessary to meet the original goals of deposit insurance: to prevent bank runs and protect the savings of most depositors. Although inflation has reduced the value of coverage in the past two decades, today's ceiling of $100,000 is still more than 70 percent higher than the original limit of $5,000 (set in 1934) adjusted for inflation. Indeed, only about 1 percent of all accounts exceed the current ceiling. And

1. See, for example, Independent Community Bankers of America, *Federal Deposit Insurance: Time for Reform and Increased Coverage* (Washington, D.C.: ICBA, Fall 2000), available at www.icba.org/deposit_insurance/depinsbrochure.pdf.

although some of the accounts below the ceiling belong to people who divide their deposits among multiple accounts of $100,000 or less in order to insure large sums, the majority belong to depositors who hold amounts well below the insurance limit. Even families at the highest income level in 1998 had a median checking account balance of $19,000, less than one-fifth of the current insurance ceiling.[2]

In addition, opponents contend that boosting deposit insurance coverage would raise insurance costs without achieving the key benefits that supporters claim. Historical data do not show a consistent connection between increases in deposit insurance coverage and increases in total bank deposits. Thus, it is not certain that raising deposit insurance would help banks of any size. Nor is it clear that small banks need special help, since they have been experiencing historically high levels of profitability in recent years. Finally, some analysts argue that if higher insurance coverage was important to banks or depositors, banks could choose to purchase additional deposit insurance privately.

The one certain result of raising deposit insurance coverage is increasing the costs of insurance. Even if total deposits did not grow, the increase in insured deposits from boosting the coverage limit would raise the federal government's potential liability, the insurance premiums paid by financial institutions, and ultimately the cost to those institutions' customers.

The government's potential liability would rise because some of the deposits that are now uninsured would become insured. The Congressional Budget Office (CBO) estimates that the higher coverage proposed in the House legislation would increase insured deposits by about 10 percent—and raise federal outlays to cover losses of failed depository institutions by a total of about $2.8 billion over the 2003-2012 period.[3]

Higher deposit insurance coverage would also require depositories to pay greater premiums, for two reasons: to cover the higher expected losses resulting from increased coverage, and to restore the government's deposit insurance funds to the required level of reserves. Currently, the deposit insurance funds for banks and savings associations must maintain reserve balances equal to 1.25 percent of insured deposits; the insurance fund for federally insured credit unions maintains a ratio equal to 1.3 percent of insured deposits. With a greater volume of insured deposits, depositories would have to pay more into the insurance funds to main-

2. 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, no. 1 (January 2000), p. 11.

3. Congressional Budget Office, *Cost Estimate for H.R. 3717, Federal Deposit Insurance Reform Act of 2002* (May 16, 2002).

tain those ratios. In all, CBO estimates that depository institutions would be required to pay $3.5 billion more in deposit insurance premiums over the 2003-2012 period under the House legislation.[4]

That $3.5 billion rise in costs to the banking system over 10 years would most likely be passed on to consumers through a combination of increased service charges and lower interest rates on bank deposits. Any attempt to reduce that financial burden on banks and their customers would be likely to result in higher costs to the government and to taxpayers.

The Current Deposit Insurance System

Federal deposit insurance protects the balances of depositors up to $100,000.[5] The insurance system is flexible, affording virtually unlimited coverage even if people have total deposit holdings greater than $100,000. The limit on deposit insurance applies per type of account, per insured institution, so people who want more coverage can get it in two ways: by maintaining accounts at different insured depositories, and by maintaining accounts with different types of legal ownership. Three common types of accounts that are insured separately are individual accounts, joint accounts, and individual retirement accounts (IRAs). Thus, a couple could have $600,000 in fully insured deposits at a single institution—two individual accounts of $100,000 each, two IRAs of $100,000 each, and one joint account of $200,000.

The growth of bank holding companies and increased affiliation among banks, securities firms, and insurance companies have made the $100,000 ceiling on deposit insurance even less binding. Financial firms that own more than one bank can now offer their customers the service of dividing large deposits into multiple accounts of $100,000 so customers do not have to do it themselves.[6]

Insurance gives depositors the benefit of a riskless asset. At the same time, it increases the likelihood that banks will use deposits to take risks they would not otherwise have taken because some of the losses from doing so would be borne by

4. The $700 million difference between the additional amount that depositories would have to pay over the 2003-2012 period ($3.5 billion) and additional federal outlays ($2.8 billion) is the amount that CBO estimates would be needed to keep the depository insurance funds from falling below the required levels of reserves.

5. Deposits in commercial banks and savings associations are insured by the Federal Deposit Insurance Corporation. The deposits in federally chartered (and most state-chartered) credit unions are insured by the National Credit Union Administration.

6. "Deposit Insurance Overhaul Proposals Lack Support from Key Members," *CQ Weekly*, March 2, 2002, p. 589.

the insurer—a problem known as moral hazard. Lawmakers therefore face a trade-off in determining the limit on deposit insurance: setting the ceiling high enough to protect small depositors and prevent bank runs, but low enough that a number of uninsured depositors remained who would have an incentive to monitor, and impose some discipline on, the risks that banks assume.

Proposed Changes in Deposit Insurance Coverage

The current system sets the same limit on virtually all types of insured deposits. Two pieces of legislation—the Federal Deposit Insurance Reform Act of 2002 (H.R. 3717), which the House passed on May 22, and the Safe and Fair Deposit Insurance Act of 2002 (S. 1945), introduced in the Senate—would initiate a system with different ceilings for different types of accounts. The standard limit on insured deposits for most accounts would rise from \$100,000 to \$130,000 (with that amount adjusted for inflation every five years and rounded up or down to the nearest \$10,000). The ceiling for retirement accounts would more than double: to \$260,000 under H.R. 3717 or to \$250,000 under S. 1945. In either case, that ceiling would be adjusted for inflation in step with the standard limit.

The ceiling on deposits by state or local governments held at insured depositories in their state would rise even higher. Such in-state municipal deposits would be covered to the lesser of either \$5 million or the sum of the standard limit (initially \$130,000) plus 80 percent of any deposits above that limit. (In the version of H.R. 3717 passed by the House, that \$5 million figure was lowered to \$2 million.)

Possible Effects of Raising the Coverage Limit

Increasing the current cap on deposit insurance would be likely to have the following effects:

- Provide modest benefits to a small number of depositors,
- Prompt a small increase in the total volume of bank deposits and a larger increase in the amount of insured deposits,
- Raise the effective interest rates paid on municipal deposits,
- Deliver few benefits to small banks, and
- Raise the cost of insurance significantly for depository institutions and depositors.

Table 1.
Actual and Inflation-Adjusted Increases in the Limit on Insured Deposits (In dollars)

	Previous Limit	New Limit	1934 Limit Adjusted for Inflation[a]	Previous Limit Adjusted for Inflation
1950	5,000	10,000	9,384	9,384
1966	10,000	15,000	12,758	13,596
1969	15,000	20,000	14,208	16,706
1974	20,000	40,000	18,672	26,283
1980	40,000	100,000	29,336	62,846
2001	100,000	130,000[b]	58,199	198,388

SOURCE: Congressional Budget Office based on data from the Federal Deposit Insurance Corporation and the Bureau of Economic Analysis.

a. The 1934 limit of $5,000, adjusted to current dollars using the chain-type price index for personal consumption expenditures.

b. Legislation before the Congress would raise the current $100,000 limit to $130,000 for regular accounts, to at least $250,000 for retirement accounts, and even higher for in-state municipal deposits.

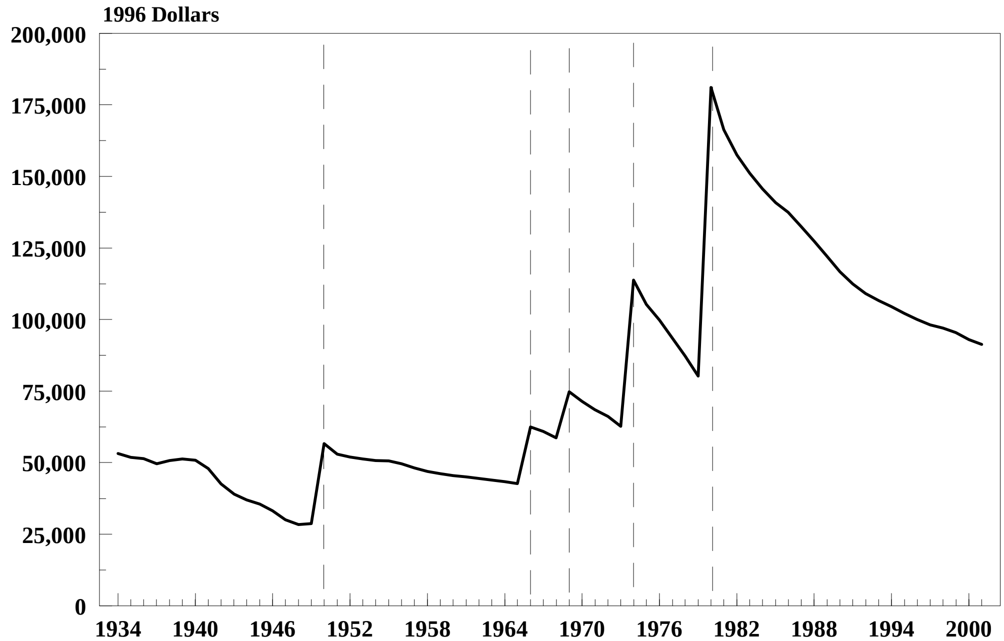
Would Higher Coverage Benefit Depositors?

Advocates of increasing the coverage limit argue that inflation erodes the real value of depositors' insurance coverage. The ceiling was set at $5,000 when deposit insurance took effect in 1934 and has been raised five times since then (see Table 1). The most recent increase occurred in 1980, when the limit was boosted to $100,000. People who argue that the ceiling needs to be raised to maintain the real value of insurance tend to use that most recent increase as a base. The $100,000 limit would need to be roughly doubled to adjust for inflation since 1980. But using the original limit on deposit insurance as a base, the $5,000 ceiling set in 1934 is now equivalent to less than $60,000—well below the current ceiling.[7] Raising that limit to $130,000 would more than double the original real level of coverage. In inflation-adjusted terms, the ceiling on deposit insurance coverage has been above the original level since 1966 and is now more than 70 percent higher than that level (see Figure 1).

More important, the real level of deposit insurance coverage may not be a useful measure of the adequacy of the current limit. The U.S. financial system is

7. Statement of Alan Greenspan, Chairman, Board of Governors, Federal Reserve System, before the Senate Committee on Banking, Housing, and Urban Affairs, April 23, 2002.

Figure 1.
The Inflation-Adjusted Value of Deposit Insurance Coverage, 1934-2000



SOURCE: Congressional Budget Office based on data from the Federal Deposit Insurance Corporation and the Bureau of Economic Analysis.

NOTE: Dashed lines indicate years in which the limit on deposit insurance coverage was raised.

more stable today than it was in the 1930s, because of such factors as greater asset diversification through interstate banking. Also, depositors have more low-risk alternatives to bank accounts (such as money market mutual funds) today than they did in the 1930s. Furthermore, payment innovations such as credit cards and automatic teller machines may have changed the level and mix of deposits required by consumers. Consequently, a better way to judge the adequacy of the current limit on deposit insurance coverage may be to assess whether that limit is sufficient to cover typical depositors today.

As of June 2001, 98.8 percent of all domestic deposit accounts (including IRAs, Keogh accounts, and the accounts of businesses and municipalities) in commercial banks were $100,000 or less. The typical household's deposit account was far below that limit. The median balance in checking accounts was about $3,100, and in certificate of deposit (CD) accounts, about $15,000.[8] Even for families in the highest income bracket ($100,000 or more in 1998), the median

8. Kennickell, Starr-McCluer, and Surette, "Recent Changes in U.S. Family Finances," p. 11.

checking account balance was $19,000, and the median CD account balance was $22,000.

Thus, only 1.2 percent of deposit accounts in U.S. commercial banks would gain additional coverage if the ceiling was raised above $100,000. However, depositors who now divide their funds among banks or accounts to maximize insurance coverage would be able to consolidate their accounts for greater convenience.

Would Higher Coverage Attract More Deposits?

Proponents also maintain that raising the limit on coverage would increase the total volume of bank deposits. However, no close association is evident between the growth of deposits and increases in insurance coverage. Total domestic deposits in insured banks (adjusted for inflation) have grown by an average of 3.2 percent per year since 1934. Real deposits fell from 1989 through 1994, a period in which a large number of U.S. banks failed. Since then, deposits have risen; they reached their highest real level in 2000 (see Figure 2).

Deposit growth has not been especially large immediately following most of the increases in deposit insurance coverage (which occurred in 1950, 1966, 1969, 1974, and 1980). In real terms, total deposits declined in the first year after three of the five increases in coverage, including after the limit rose from $40,000 to $100,000 in 1980 (see Figure 3). The biggest jump in real deposits following an increase in coverage occurred after 1969, when the limit was raised from $15,000 to $20,000.[9] In 1980, the year of the largest rise in deposit insurance coverage, real total deposits fell by 2.6 percent. Deposits did grow faster than average from 1982 through 1986. But one of the largest real increases since 1980 (6.6 percent) occurred in 2000—20 years after the last rise in deposit insurance. It appears that increased deposit insurance coverage is neither necessary nor by itself sufficient for above-trend growth in deposits. (An exception may be municipal deposits, as explained in the next section.)

Among the many reasons why the ceiling on insurance coverage is not a key driver of the growth of deposits is that balances in most accounts are well below that ceiling, and depositors already have almost unlimited coverage with the current system. Inasmuch as the ceiling plays a small role in the growth of deposits, an increase is unlikely to be of much consequence for the total volume of deposits.

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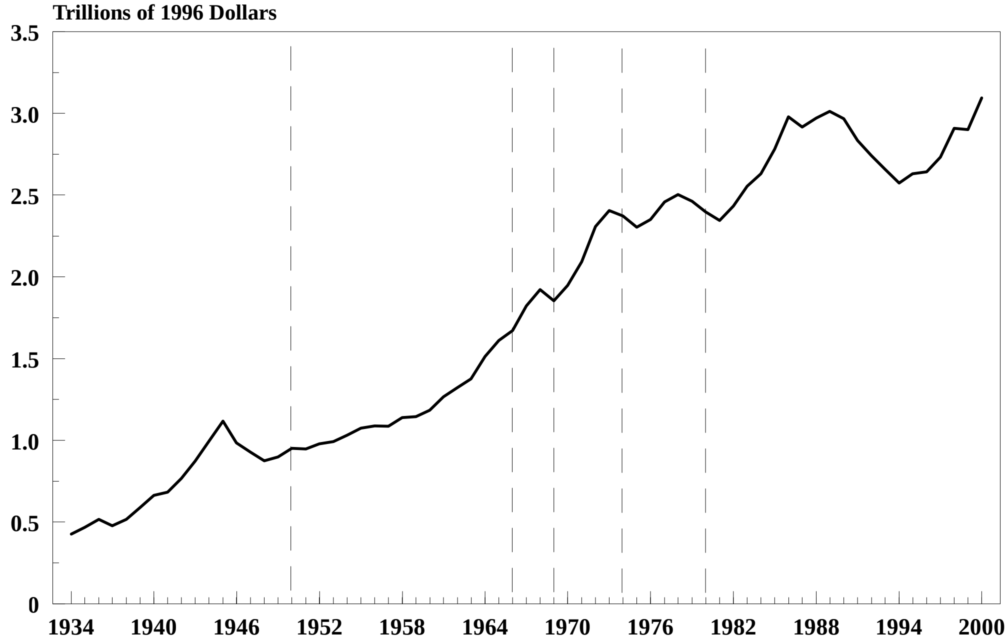
9. However, that jump may have had more to do with the removal in June 1970 of interest rate ceilings on deposits of $100,000 or more.

Figure 2.
Total Inflation-Adjusted Domestic Deposits in Insured Banks, 1934-2000



SOURCE: Congressional Budget Office based on Federal Deposit Insurance Corporation, *2000 Annual Report* (May 31, 2001), p. 97, and data from the Bureau of Economic Analysis.

NOTES: Domestic deposits are all deposits made in a branch or subsidiary of a reporting bank located in the 50 states or the District of Columbia or at a U.S. military facility (regardless of the country). Starting in 1990, deposits in insured banks exclude deposits held by Bank Insurance Fund members that are insured by the Savings Association Insurance Fund and include deposits held by Savings Association Insurance Fund members that are insured by the Bank Insurance Fund.

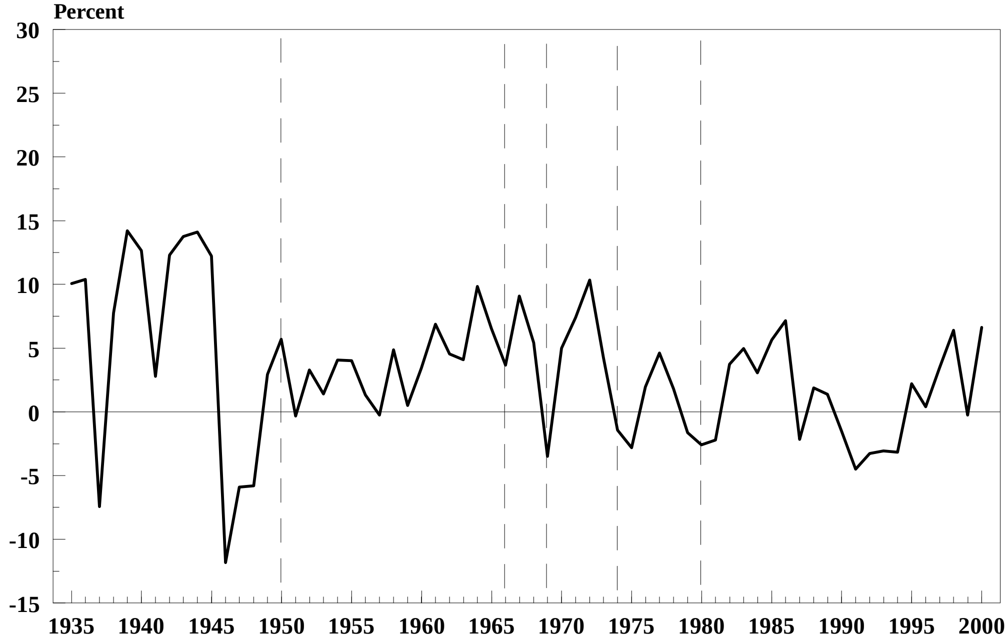
Dashed lines indicate years in which the limit on deposit insurance coverage was raised.

The interest rates offered on deposits (compared with those on alternative assets) have a more reliable effect on deposit growth. The Depository Institutions Deregulation and Monetary Control Act of 1980, which raised the deposit insurance limit to $100,000, also removed the ceilings on interest rates that banks could offer depositors with balances under that amount. Subsequently, bank deposits became competitive with other investments, such as money market mutual funds, and the growth of deposits accelerated.

Would Higher Coverage Benefit Municipalities?

Banks stand to benefit initially from higher coverage for municipal deposits because most states require banks to collateralize (pledge assets to ensure payment of) any municipal deposits above the insurance limit. Holding high-quality, low-

Figure 3.
Annual Percentage Change in Inflation-Adjusted Domestic Deposits in Insured Banks, 1935-2000



SOURCE: Congressional Budget Office based on Federal Deposit Insurance Corporation, *2000 Annual Report* (May 31, 2001), p. 97, and data from the Bureau of Economic Analysis.

NOTES: Domestic deposits are all deposits made in a branch or subsidiary of a reporting bank located in the 50 states or the District of Columbia or at a U.S. military facility (regardless of the country). Starting in 1990, deposits in insured banks exclude deposits held by Bank Insurance Fund members that are insured by the Savings Association Insurance Fund and include deposits held by Savings Association Insurance Fund members that are insured by the Bank Insurance Fund.

Dashed lines indicate years in which the limit on deposit insurance coverage was raised.

yield collateral is costly for banks because it reduces their capacity to hold riskier, higher-yielding assets. Raising the insurance limit for municipal deposits would free banks to shift their collateral into securities and loans that have higher risk and higher expected returns. (Risk-based capital requirements could restrain that shift, however.)

In a competitive banking environment, the additional benefit provided by the higher insurance limit on municipal deposits should be expected to accrue primarily to municipalities and only secondarily to banks. As banks benefited from the lower cost of securing municipal deposits, they would have an incentive to attract more of those deposits by offering municipalities higher interest rates or additional services. Of the more than $1.4 trillion in financial assets owned by state and local governments at the end of 2001, only $153 billion was in CDs, savings accounts, and checking accounts. Municipalities held roughly the same amount of assets—about $159 billion—in risky corporate stocks and mutual fund shares. Another $662 billion was invested in U.S. government and agency securities and in repurchase agreements for government securities, which typically offer higher yields than bank deposits do. The remaining roughly $400 billion was invested in corporate debt and mortgage securities. Municipalities' demand for financial assets, therefore, appears to assign substantial importance to yield as well as to a federal guarantee of safety. Thus, if banks offered higher interest rates on municipal deposits because of their lower costs, they might attract some of the funds that municipalities now hold in other forms.

Municipal depositors could benefit from an increased coverage limit in two ways. Besides earning higher yields on their deposits as banks passed through cost savings in the form of higher interest rates, they might gain more-secure protection for their deposits. When a bank fails because of fraud, the collateral intended to back municipal deposits may be missing. With federal deposit insurance, there is no risk of loss.

Would Higher Coverage Help Small Banks?

Proponents argue that increased deposit insurance coverage would be particularly helpful to small banks, which are more dependent on "core" deposits than large banks are. (Core deposits are those deposits that provide a relatively stable, long-term funding source for banks. They include demand deposits, even though holders of such accounts have the right to withdraw cash at any time.) As noted above, there is scant evidence to suggest that raising the ceiling on coverage would significantly increase total deposits at banks, but it might help small banks attract a larger share of deposits, by appealing to investors who are looking to deposit more than $100,000 but less than $130,000. CBO has no information about the possible number of such investors. However, any benefits of higher coverage to small banks would be multiplied for large financial services firms that have multiple affiliated banks.

It is not clear that small banks need special help. For more than a decade, small banks have been outperforming large ones: from 1985 to 2000, the growth rate of both total deposits and uninsured deposits at small banks consistently exceeded the growth rate of such deposits at large banks. At the same time, profitability of small banks has risen to historically high levels.[10]

10. William F. Bassett and Thomas F. Brady, "The Economic Performance of Small Banks, 1985-2000," *Federal Reserve Bulletin*, vol. 87, no. 11 (November 2001), pp. 719-728.

Some advocates of increased coverage suggest, on the basis of high bank loan-to-deposit ratios, that small banks are restricted in their ability to lend by a shortage of funds.[11] But a recent study of small-business lending by community banks (those with $500 million or less in assets) headquartered in nonmetropolitan counties found no statistically significant relationship between small-business lending and deposits.[12] Evidently, that result reflects the fact that community banks have sources of funds besides insured deposits, including advances from Federal Home Loan Banks.[13]

Would Higher Coverage Be Costly?

Raising deposit insurance coverage would simultaneously increase the federal government's potential liability and depositories' insurance premiums while reducing incentives for depositors to constrain risk taking by insured institutions.[14]

A higher coverage limit would expand the government's liability for insured deposits in the event of bank failures. Although only about 1 percent of accounts contain balances of more than $100,000, those accounts constitute roughly 40 percent of total bank deposits. CBO estimates that the coverage increases envisioned in H.R. 3717 (as reported out of committee) would raise the total amount of deposits insured by the Federal Deposit Insurance Corporation by about $325 billion—an increase of approximately 10 percent.

CBO also estimates that insured institutions would pay about $1.5 billion in additional insurance premiums in the first year after enactment of H.R. 3717 and a total of $3.5 billion more over the 2003-2012 period. Most of that increase in premiums would result from the higher coverage limit. However, some would reflect the requirement that the deposit insurance funds for banks, savings associations, and credit unions maintain reserve balances equal to a fixed percentage of

11. Independent Community Bankers of America, *Federal Deposit Insurance*, p. 15.

12. Ben R. Craig and James B. Thomson, "Federal Home Loan Bank Lending to Community Banks: Are Targeted Subsidies Desirable?" *Journal of Financial Services Research* (forthcoming).

13. Collateralized advances from Federal Home Loan Banks to member institutions rose by 8 percent in 2001, to $473 billion. For an analysis of the effect on deposit insurance of collateralized Federal Home Loan Bank advances, see Congressional Budget Office, *The Federal Home Loan Banks in the Housing Finance System* (July 1993).

14. See, for example, remarks by Alan Greenspan at the 37th Annual Conference on Bank Structure and Competition, held at the Federal Reserve Bank of Chicago, May 10, 2001, available at www.federalreserve.gov/boarddocs/speeches/2001/20010510/default.htm.

insured deposits.[15] With more deposits insured, depository institutions would have to pay more in premiums to keep the insurance funds at the required ratios. The difference between depositories' $3.5 billion in additional premiums over 10 years and the $2.8 billion in additional federal outlays over that period—or $700 million—is the amount that CBO estimates would be needed to build up and then maintain the depository insurance funds at or above the required levels of reserves.

In a competitive industry such as banking, cost increases that affect all firms tend to be passed through to consumers. Thus, the extra $3.5 billion burden on depository institutions over 10 years would end up being an added cost to users of depository services. That cost might take the form of increased service charges or lower interest rates on deposits.

Finally, another result of raising the insurance limit would be to encourage risk taking by banks. Financial institutions, especially those threatened by insolvency, have an incentive to undertake riskier investments with depositors' funds when those funds are insured, primarily because they do not have to compensate depositors for the increased risk. CBO had no basis for estimating the size of the effects of increased moral hazard on insurance costs; therefore, it did not include such costs in its estimate of H.R. 3717.

15. Currently, the deposit insurance funds for banks and savings associations must maintain reserve balances equal to 1.25 percent of insured deposits, and the fund for federally insured credit unions must maintain a balance of 1.3 percent of insured deposits.