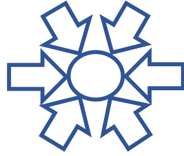

FedFin Client Report

Tuesday, May 2, 2023

FedFin Analysis: FDIC Presses Targeted Coverage; Open to Excess Coverage, Collateralization, MBRs

Client Report: DEPOSITINSURANCE119

Executive Summary

In this report, we follow our initial assessment of the FDIC's deposit-insurance reform report with an in-depth analysis of its recommendations and their prospects. Aspects of this report reiterate conclusions initially noted in the agency's Friday report on Signature Bank's failure (see *Client Report* **REFORM222**), noting in particular the sharp growth of uninsured deposits at larger banks and the growing risk of social-media runs. The new report also states that FedNow is likely to exacerbate run risk which increases if open banking advances.

The report also describes changing deposit composition, a key point lying behind its principal recommendation that Congress should consider higher or even unlimited FDIC coverage for business payment accounts to prevent the payroll and related disruptions evident in recent failures. The FDIC rejects like kind protection for other accounts on moral-hazard grounds, but it is open to bank, FDIC, or private-sector insurance providing excess coverage, an option explored in a recent Petrou client memo. Deposit collateralization and run-risk buffers such as minimum balance at risk is also possible. In his comment on this report, HFSC Chairman McHenry (R-NC) applauded the FDIC for noting coverage trade-offs, committing only to assessing this issue as the Committee works through the implications of recent bank failures.

Analysis

Much in the paper leads to the recommendation rejecting broad or unlimited deposit coverage in favor of protecting business payment accounts (e.g., payroll, trade finance) above the limit while maintaining the $250,000 threshold for other bank deposits. The FDIC believes limited coverage accomplishes the numerous objectives essential for effective deposit-insurance coverage detailed in this lengthy report but says that some additional coverage is required given the credibility challenges resulting from recent rescues. The principal challenge to this targeted approach is effective identification of business-payment accounts to prevent depositor abuse. Unlimited coverage is said to pose the risk of significant financial-market dislocation and require untenable premiums.

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However, voluntary excess coverage by which bank, FDIC, or other providers add coverage above the FDIC threshold is said to be worth considering if the entity offering the coverage can absorb it and need to address concentrated uninsured-deposit liabilities at a few large banks. Accurate pricing is also said to be problematic and the consequences for moral hazard are uncertain.

Other options more clearly rejected are forcing short-term liabilities to fund only short-term assets (a threat to financial intermediation). The FDIC is more open to requiring security for some uninsured deposits (e.g., funds used for investment purposes) as is now done for municipal accounts or certain other accounts. Limiting deposit convertibility above the insurance ceiling along the minimum balance at risk idea recently floated by FRB-NY staff; the FDIC is also open to this idea.

The report describes the macroeconomic impact of widespread runs that destroy business accounts essential for company survival, also noting the importance of deposit insurance to liquidity and maturity transformation and thus to economic growth. The report also describes resolution implications such as adversely affecting franchise value or hiking cost. The paper also endorses the idea of using long-term debt to reduce resolution costs, an idea proposed by the FDIC and FRB for large regional IDIs (see FSM Report **RESOLVE48**).

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