ABATING MORAL HAZARD IN THE U.S. BANKING SECTOR

AN ANALYSIS OF CONGRESSIONAL LEGISLATION AMENDING FEDERAL DEPOSIT INSURANCE

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EXECUTIVE SUMMARY

On May 1, 2023, the Federal Deposit Insurance Corporation (FDIC) published a paper outlining potential policy proposals to amend the current structure for federal deposit insurance coverage.[1] The report was released in the wake of the failures of Silicon Valley Bank (SVB), Signature Bank (Signature), and First Republic Bank (FRB).

Under current law, the federal deposit insurance limit—or the standard maximum deposit insurance amount (SMDIA)—is $250,000 per depositor, per bank, per ownership category—as administered by the FDIC.[2] For credit unions, the standard maximum share insurance amount (SMSIA) is $250,000 per share owner, per insured credit union, for each account ownership category—as administered by the National Credit Union Administration (NCUA).[3]

The FDIC's report offers three proposals for alternative deposit insurance coverage: "Limited Coverage," "Unlimited Coverage," and "Targeted Coverage." All the options provided by the FDIC involve different degrees of increasing the threshold for federal deposit insurance. The FDIC's preferred option is to offer a new program of "targeted" deposit insurance coverage for business payment accounts while simultaneously requiring more regulation. The concept of increasing bank regulation along with deposit insurance coverage is mainly promoted by Democrats, such as Sen. Elizabeth Warren (D-Mass.).[4]

The FDIC's proposals would further entrench the federal government's foothold in the banking sector, restrict businesses and households' access to capital, significantly increase fees banks would have to pay into the Deposit Insurance Fund (DIF), enervate economic growth, exacerbate moral hazard,[5] and fail to fully stymie financial instability.

1. https://www.fdic.gov/analysis/options-deposit-insurance-reforms/report/options-deposit-insurance-reform-full.pdf
2. https://www.fdic.gov/regulations/resources/brochures/deposit_insurance_at_a_glance-english.html
3. https://ncua.gov/files/publications/guides-manuals/NCUAHowYourAcctInsured.pdf
4. https://www.bloomberg.com/news/articles/2023-03-21/warren-seeks-to-tie-higher-fdic-insurance-to-tighter-regulation
5. https://fortune.com/2023/03/21/what-is-moral-hazard-insurance-banking-risk-financial-recklessness/

The growth of uninsured deposits is a product of quantitative easing and over a decade of the Federal Reserve's (Fed) easy monetary policy that essentially created an artificial bubble of free financing.[6] Near-zero interest rates[7] also made it harder for banks to find higher returns in which to invest their deposits. As a result, banks, such as SVB, invested in long-dated Treasury bonds and mortgage-backed securities under the expectation that rates would be kept perpetually low and bond prices would not drop dramatically. SVB "held tens of billions of dollars in long-term government bonds" even when the Fed started to raise interest rates at an aggressive pace.[8] Deposit insurance allows banks to take these risks "because they can capture any profits but shift any losses to the government."[9] This is exactly what happened when the government assumed the risk for all depositors by invoking the "systemic risk exception."[10] Subsequently, the FDIC issued a "special assessment," or fee, on U.S. banks to recover the losses to the DIF for covering all uninsured deposits at SVB and Signature.[11] The FDIC estimates that 114 banking organizations, including some community banks with between $5 billion to $10 billion in assets, will have to pay a special fee to cover the losses.[12] The regulators are setting a dangerous precedent by generating moral hazard through their rescue of uninsured deposits.

Increasing the deposit insurance limit will allow bank managers to make riskier investments with deposits, knowing full-well that if the bank cannot meet a surge in deposit withdrawals and the bank goes under, the regulators will be there to support uninsured depositors.

Members of Congress have introduced legislation to increase the deposit insurance limit for banks and credit unions. This paper starts by analyzing the FDIC's proposal and then identifies and analyzes congressional legislation—pointing out their strengths and weaknesses. Ultimately, all the bills described in this paper are in the same vein—they raise the level of federal deposit insurance coverage, which will worsen moral hazard and cost American taxpayers more money down the road. The paper ends by offering free market alternative solutions that lawmakers can pursue, such as deregulating reciprocal deposits and enhancing accounting transparency for held-to-maturity (HTM) securities.

6. https://www.chicagobooth.edu/review/did-fed-contribute-svbs-collapse
7. https://fred.stlouisfed.org/series/FEDFUNDS
8. https://www.wsj.com/articles/how-svb-profited-from-interest-rate-risk-accounting-rules-deposit-fdic-federal-reserve-coupon-held-to-maturity-ec43418a
9. https://www.imf.org/external/np/seminars/eng/2006/mfl/pam.pdf
10. https://www.occ.gov/news-issuances/news-releases/2023/nr-occ-2023-43a.pdf
11. https://www.fdic.gov/news/press-releases/2023/pr23092.html
12. https://www.fdic.gov/news/fact-sheets/special-assessment-final-rule-11-07-23.html

I. THE FDIC'S PROPOSED REFORMS

A. BUSINESS PAYMENT ACCOUNTS

The FDIC's report envisions that business payment accounts could be covered under a program similar to the Transaction Account Guarantee (TAG) program, which was originally created in response to the 2008 financial crisis using the systemic risk exception.[13] The TAG program provided unlimited deposit insurance to noninterest-bearing transaction accounts. In 2012, however, Congress did not reauthorize the TAG program because Senate Republicans opposed it[14] for being the antithesis of free market policy.[15] The TAG program also reduced market discipline. If it had been extended, there would have been "less private sector control of bank risk-taking."[16] Now, the FDIC wants to introduce a new TAG program for business accounts. This program cannot be created unilaterally by the FDIC—it requires Congressional action. Congress would have to pass legislation. However, resurrecting TAG, or any programs like TAG, should be vehemently opposed by lawmakers. Any legislation that would increase federal deposit insurance, even for business accounts, would carry moral hazard risks and propagate future risk-taking.

Moreover, increasing deposit insurance above $250,000 for business accounts is not feasible. In the current deposit insurance system, there is no way to determine which deposits belong to consumers versus businesses, an issue the FDIC acknowledges in its May 2023 report. The agency specifically notes that just defining "business payment accounts" is a challenge.[17]

Even if there were a specific definition of a business account in place, knowledgeable depositors would find ways to get around a loose definition and take advantage of additional insurance coverage. More insured deposits will mean banks will have to pay more fees to shore up the DIF, which is required to maintain a statutory reserve ratio of 1.35 percent of all insured deposits.[18] If bank fees go up, bank customers will face higher costs, which means taxpayers will face higher costs.

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13. https://elischolar.library.yale.edu/cgi/viewcontent.cgi?article=1320&context=journal-of-financial-crises
14. https://www.congress.gov/bill/112th-congress/senate-bill/3637
15. https://cei.org/news_releases/tag-bank-bailout-fails-in-senate-taxpayers-win/
16. https://www.aei.org/articles/end-the-tag-program-it-puts-banks-and-the-economy-at-risk/
17. https://www.fdic.gov/analysis/options-deposit-insurance-reforms/report/options-deposit-insurance-reform-full.pdf
18. https://www.govinfo.gov/content/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf

Importantly, most small business accounts are already covered under the current deposit insurance framework. Fewer than one percent of bank accounts have more than $250,000.[19] A survey of 600,000 small businesses found that their median bank balance is $12,100—far below the current $250,000 threshold.[20] Additionally, Americans have a median savings account balance of about $5,300 while Black and Hispanic Americans have median savings account balances of approximately $1,500 and $1,900, respectively.[21] Any new increase in coverage for business accounts would only benefit the wealthy.

The FDIC acknowledges in its report that larger depositors are already covered because of "the presence of brokered deposits, sweeps, and reciprocal deposits."[22] If these techniques already allow depositors to effectively be insured above $250,000, then there is no reason to raise the SMDIA or SMSIA. Additionally, there are 14 different ownership categories, each of which gets insured up to $250,000.[23] Businesses can store deposits under different ownership categories and have more than $250,000 in deposits insured. The FDIC's proposal is a solution in search of a problem because businesses already have access to insurance above the $250,000 limit. The government should not create a new scheme simply because some depositors at regional banks did not take advantage of these readily available methods.

Although the FDIC leaves its proposed coverage of business accounts open-ended, Footnote 137 in its report suggests that limit could be $2.5 million.[24] But such a limit would fail to stop runs. Footnote 129 of the FDIC report acknowledges that even if the deposit insurance limit had been $2.5 million when SVB failed, it would not have made a material difference—a run still would have occurred.[25] This defeats the purpose for proposing a targeted increase in the deposit insurance limit. It also further shows that increases in the limit would only benefit the wealthiest Americans.

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19. https://www.cato.org/blog/less-one-percent-accounts-are-above-fdic-limit
20. https://www.jpmorganchase.com/content/dam/jpmc/jpmorgan-chase-and-co/institute/pdf/jpmc-institute-small-business-report.pdf
21. https://time.com/personal-finance/article/average-american-savings-account-balance/#:~:text=This%20content%20is%20created%20independently,Learn%20more.&text=American%20households%2C%20on%20average%2C%20have,according%20to%20the%20same%20data
22. https://www.fdic.gov/analysis/options-deposit-insurance-reforms/report/options-deposit-insurance-reform-full.pdf
23. https://www.fdic.gov/deposit/diguidebankers/documents/account-ownership.pdf
24. https://www.fdic.gov/analysis/options-deposit-insurance-reforms/report/options-deposit-insurance-reform-full.pdf
25. Id.

B. UNLIMITED COVERAGE

The worst concept in the FDIC's paper is providing unlimited federal deposit insurance. Providing unlimited coverage would effectively socialize the banking sector and subject it to government control. Sen. Warren has publicly stated that more federal deposit insurance for banks would have to be accompanied by "tighter regulation."[26] Ultimately, certain Democrats want the federal government to take over the banking sector. Sen. Warren cited an op-ed specifically calling for banks to be regulated like public utilities.[27]

Providing unlimited coverage also presents significant moral hazard concerns. According to one paper, "[u]nlimited deposit insurance increases moral hazard and represents a threat to the nation's long-term financial stability. History has shown that unlimited deposit insurance increases the likelihood of banking crises."[28]

C. REGULATION

More regulation of the banking sector is inextricably tied to an expansion of federal deposit insurance. The FDIC's report argues for more regulation at the expense of economic growth. For example, the report wrongly proposes regressive interest rate controls on deposits. The process of repealing Regulation Q, which took place from 1980 to 2011, removed distortive restrictions on the amount of interest rates banks can pay on certain deposits.[29] This deregulation has been a boon for consumers. The FDIC's proposal to turn back the clock would be a mistake.

The report also proposes requirements for banks to issue more long-term debt that can be converted into equity to cover losses in the event of a bank failure. This debt would increase leverage at banks—propagating instability[30] and exacerbating moral hazard.[31]

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26. https://www.bloomberg.com/news/articles/2023-03-21/warren-seeks-to-tie-higher-fdic-insurance-to-tighter-regulation
27. https://twitter.com/SenWarren/status/1704850132615811427?s=20 (tweeted favorably about *Make banks public utilities*, The Washington Post, Sept. 14, 2023)
28. https://elischolar.library.yale.edu/cgi/viewcontent.cgi?article=9314&context=ypfs-documents
29. https://www.investopedia.com/terms/r/regulationq.asp
30. https://www.finregrag.com/p/bank-resilience-equity-capital-versus
31. https://www.occ.treas.gov/news-issuances/federal-register/2023/88fr64524.pdf, 88 FR 64528

The Biden administration's overreach is nothing more than another avenue for the federal government to dictate how banks should finance themselves and prepare for difficult economic fluctuations.

More regulations to restrict risk-taking is a gross expansion of government power. This will only make the U.S. banking sector more dependent on government guarantees and financial backing.

D. MORAL HAZARD

In economics, the term moral hazard "refers to the tendency for insurance against loss to reduce incentives to prevent or minimize the cost of loss."[32] One study covering 118 countries from 1980-2004 found that when "interacting deposit insurance with credit to the private sector" there is "a positive and significant effect on bank insolvency and bank runs."[33] According to the paper, this suggests "that moral hazard outweighs the positive effect of deposit insurance on banking stability."[34]

Deposit insurance weakens banks' capital structure. According to Mark Calabria, "not only does the provision of deposit insurance reduce the cushion of equity in banks, it also increases the variance (risk) of their investments. Thus, both the asset and liability sides of the bank balance sheet are distorted in destructive ways by deposit insurance."[35] According to another paper, deposit insurance "reduces the marginal benefit of maintaining capital."[36] Moreover, Calabria points out that because of the reduced capital, "shareholders seeking greater returns on equity will shift toward banks with higher leverage." Greater leverage leads to more financial instability, not less.

The Fed has acknowledged that insuring all depositors at SVB and Signature worsened moral hazard. According to the Government Accountability Office's (GAO) preliminary report on the bank failures, Fed "staff raised concerns about exacerbating moral

32. https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?referer=&httpsredir=1&article=1870&context=faculty_scholarship#:~:text=In%20the%20nineteenth%20century%2C%20addressing,practices%20began%20to%20replace%20individual
33. https://www.sciencedirect.com/science/article/abs/pii/S1514032616300137
34. Id.
35. https://www.heritage.org/markets-and-finance/report/deposit-insurance-bank-resolution-and-market-discipline
36. https://files.stlouisfed.org/files/htdocs/publications/review/93/01/Dowd_Jan_Feb1994.pdf

hazard and potentially weakening the market discipline of many depository institutions."[37] Additionally, GAO pointed out that its report from 2010 showed that regulators' use of the systemic risk exception "may weaken market participants' incentives to properly manage risk if they come to expect similar emergency actions in the future." The 2010 report also states that expanded deposit insurance "could weaken incentives for newly protected, larger depositors to monitor their banks, and in turn banks may be more able to engage in riskier activities."[38] The GAO was incredibly prescient. If depositors are aware that the government will guarantee their deposits, it may lead "them to disregard the creditworthiness of their banks," and contribute to moral hazard.[39]

An empirical study conducted by the World Bank and International Monetary Fund (IMF) found that deposit insurance is a source of moral hazard and financial instability. The paper points out that:

> *Whether or not deposit insurance is the best policy to prevent depositor runs, all authors acknowledge that it is a source of moral hazard: as their ability to attract deposits no longer reflects the risk of their asset portfolio, banks are encouraged to finance high-risk, high-return projects. As a result, deposit insurance may lead to more bank failures and, if banks take on risks that are correlated, systemic banking crises may become more frequent.*[40]

If the FDIC's reforms were fully enacted by Congress, it would further subject the banking sector to government control and eventual nationalization. These policy proposals must be rejected by lawmakers. New legislation and regulation will not solve future bank instability. Regulators need to come to terms with their own supervisory failures and understand they already have all the tools they need. First, they need to figure out how to properly do their job. Fortunately, a coalition of over twenty free market organizations already conveyed their strong opposition to any enhancement to federal deposit insurance.[41]

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37. https://www.gao.gov/assets/gao-23-106736.pdf
38. https://www.gao.gov/products/gao-10-100
39. https://elischolar.library.yale.edu/cgi/viewcontent.cgi?article=9314&context=ypfs-documents
40. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=629183
41. https://www.atr.org/letter/atr-organizes-coalition-letter-in-opposition-to-enhanced-deposit-insurance/

E. PRIVATE INSURANCE

The FDIC's report discusses how private insurance for excess deposits coupled with federal deposit insurance could be another option to consider. While private insurance could be an option, lawmakers should think twice before mandating banks to offer it as a service. Introducing legislation to mandate private insurance could force banks of all sizes, including community banks, to pay exorbitantly higher assessment fees, which could result in consumers paying higher prices for bank services. Businesses "tend to pass on cost increases far more quickly than cost reductions."[42]

One opinion piece in the *Wall Street Journal* admitted that a new public-private insurance structure could potentially force banks to "pay a substantial premium."[43] This would ultimately raise costs for taxpayers. This hybrid structure would still largely rely on federal government support. Offering private insurance options should not be forced by the government, instead it should present itself organically and as an alternative to federal deposit insurance.

II. CONGRESSIONAL LEGISLATION

The failures of SVB, Signature, and FRB do not warrant the expansion of federal deposit insurance. Continuously expanding deposit insurance creates moral hazard among the management of insured depository institutions and their depositors, which catalyzes bank failures. Failure of regulatory supervision was another culprit.[44]

42. https://www.cuna.org/content/dam/cuna/advocacy/priorities/documents/True-Impact-of-Interchange-Regulation-CornerstoneAdvisors-June-2023.pdf
43. https://www.wsj.com/articles/the-private-market-can-add-discipline-to-deposit-insurance-svb-bank-run-crisis-f28a2c01?st=qv0tbqah98gnimp
44. https://www.atr.org/how-regulators-dropped-the-ball-on-silicon-valley-bank/

There is extensive academic research concluding that deposit insurance has resulted in systemic risk in the banking sector. One study by Charles Calomiris and Matthew Jaremski shows the historical failures of deposit insurance and how it "increased risk by removing market discipline that had been constraining erstwhile uninsured banks."[45] They also cited several papers "suggesting that the moral-hazard costs of deposit insurance have out-weighed its liquidity-risk-reduction benefits."[46]

Even former President Franklin Roosevelt felt that deposit insurance "would lead to laxity in bank management and carelessness on the part of both banker and depositor" and "would be an impossible drain on the Federal Treasury."[47]

At the time of the writing of this paper, there are five bills in Congress that would worsen bank stability, exacerbate moral hazard, and open the door for more regulation and government control of the banking sector. A description of the bills and analysis of their impact are outlined below in this paper.

F. DEPOSIT INSURANCE REFORM ACT OF 2023 (H.R. 3928)

H.R. 3928 Background

On June 7, 2023, Rep. Adam Schiff (D-Calif.) introduced the *Deposit Insurance Reform Act* (H.R. 3928).[48] At the time of this writing Rep. Donald Payne (D-N.J.) cosponsored the legislation. H.R. 3928 was referred to the House Committee on Financial Services.

The bill directs the FDIC and NCUA to establish multiple levels of insurance coverage. Depending on how the regulators set the coverage levels, banks and credit unions would be allowed to choose a higher level of deposit insurance with the caveat that higher fees would be assessed to banks and credit unions that elect to participate.[49] This would apply to both interest bearing and noninterest-bearing accounts for businesses, including sole proprietorships.

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45. https://www0.gsb.columbia.edu/faculty/ccalomiris/papers/Stealing%20Deposits.pdf
46. Id.
47. https://ari.aynrand.org/how-the-new-deal-made-the-financial-system-less-safe/
48. https://www.congress.gov/bill/118th-congress/house-bill/3928/text?s=2&r=1&q=%7B%22search%22%3A%22hr+3928%22%7D
49. https://www.congress.gov/bill/118th-congress/house-bill/3928/text?s=1&r=7&q=%7B%22search%22%3A%5B%22%22%5D%7D

H.R. 3928 Analysis

Rep. Schiff's bill establishes a permanent program that potentially offers unlimited levels of deposit insurance for any type of deposit account owned by a business entity. The bill effectively gives the FDIC and NCUA unlimited authority to set new deposit insurance levels. The primary differences between this bill and other bills that have been introduced is the extraordinary leeway it gives regulators to determine insurance coverage levels, and the fact that it covers both interest-bearing and noninterest-bearing accounts—instead of only noninterest-bearing. The accounts covered by this new level of insurance include, but are not limited to, demand deposits, money market deposit accounts, certificates of deposit, and high-yield savings accounts.

The regulators could theoretically place limits on which types of accounts could qualify. However, the new regulatory authority also allows the FDIC and NCUA to determine the SMDIA and SMSIA moving forward. Congress would be fully ceding its authority over the SMDIA and SMSIA to the executive branch. The moral hazard implications of this bill are extreme and would subject the banking sector to more regulation and supervision from the federal government.

G. SMALL BUSINESS STABILITY ACT (H.R. 3243)

H.R. 3243 Background

On May 11, 2023, Rep. Blaine Luetkemeyer (R-Mo.) introduced the *Small Business Stability Act* (H.R. 3243). At the time of this writing Rep. Dan Meuser (R-Pa.) cosponsored this bill. H.R. 3243 was referred to the House Committee on Financial Services.

The bill would grant the FDIC the authority to insure all noninterest-bearing transaction accounts for up to two months.[50] To kickstart this program, boards of the FDIC and the Fed would each need a two-thirds vote in favor of recommending this policy along with the approval of the Treasury Secretary, in consultation with the President. The regulators would have to determine that current statutory provisions aimed at minimizing losses to the DIF "would have serious adverse effects on the stability of the entire banking system" and the temporary guarantee would "avoid or mitigate such adverse effects."

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50. https://www.congress.gov/bill/118th-congress/house-bill/3243/text?s=1&r=4&q=%7B%22search%22%3A%5B%22%22%5D%7D

H.R. 3243 Analysis

Under the bill, the FDIC is allowed to disregard other provisions of statute that normally would require the agency to minimize the cost to the DIF. Not only will this bill result in increased assessment fees on banks, which the taxpayer will ultimately pay for, but this bill is a recreation of the TAG program, which was created in the wake of the 2008 financial crisis. TAG was initially created by federal regulators using the "systemic risk exception"[51] as authorized under the *Federal Deposit Insurance Corporation Improvement Act of 1991*.[52]

Subsequently, the big-government provisions of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* codified TAG's existence through 2012.[53] Former Sen. Harry Reid (D-Nev.) sponsored legislation to extend TAG through 2014, but it was subsequently quashed by Senate Republicans because of the significant moral hazard implications and the risk of further entrenching the federal government's foothold in the banking sector.[54]

If enacted, Rep. Luetkemeyer's bill will induce more moral hazard and increase systemic risk. Bank managers know that with more government insurance they can use more equity or deposits to make riskier investments—it is a classic safety net. Both individual and institutional depositors will ignore their bank's financial condition. The unlimited coverage in this TAG-like program "promotes moral hazard by weakening the incentives for large depositors to monitor the creditworthiness of their banks, and for banks to avoid excessive risks."[55]

The bill only adds coverage for noninterest-bearing accounts, and not interest-bearing accounts, which helps mitigate moral hazard. However, in times of distress, depositors could easily move their deposits to noninterest-bearing accounts that would qualify for the enhanced insurance, thus gaming the system to give themselves more coverage.

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51. https://www.gao.gov/assets/gao-10-100.pdf
52. https://www.congress.gov/bill/102nd-congress/senate-bill/543?q=%7B%22search%22%3A%5B%22cite%3APL102-242%22%5D%7D&s=1&r=1
53. https://www.govinfo.gov/content/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf
54. https://www.congress.gov/bill/112th-congress/senate-bill/3637
55. https://elischolar.library.yale.edu/cgi/viewcontent.cgi?article=9314&context=ypfs-documents

H. DEPOSIT SECURITY ACT (S. 3012)

On October 4, 2023, Sen. Joe Manchin (D-W.Va.) introduced the *Deposit Security Act* (S. 3012).[56] At the time of this writing Sens. John Hickenlooper (D-Colo.) and Mike Braun (R-Ind.) cosponsored the legislation. S. 3012 was referred to the Senate Committee on Banking, Housing, and Urban Affairs.

The bill raises the SMDIA and SMSIA to $10 million for noninterest-bearing transaction accounts at both insured banks and credit unions. Both banks and credit unions may opt-out of the increased coverage no later than one month after the program is established. Banks and credit unions may opt back into the program every five years. The bill also directs the FDIC and NCUA to jointly adjust the SMDIA and SMSIA every two years to reflect the percentage increase in inflation indexed to the Consumer Price Index For All Urban Consumers.

S. 3012 Analysis

Setting the SMDIA and SMSIA at $10 million is extraordinarily high and poses a significant expansion of moral hazard and government entrenchment in the banking sector. Considering that 99 percent of accounts are already covered under the $250,000 threshold it calls into question whether this drastic increase in the SMDIA and SMSIA is necessary.

The bill only adds coverage for noninterest-bearing accounts, and not interest-bearing accounts, which helps mitigate moral hazard. However, depositors could easily move their deposits to noninterest-bearing accounts that would qualify for the enhanced insurance in times of distress. Additionally, revaluating the SMDIA and SMSIA index every two years would result in an ever-increasing insurance coverage. The knock-on effects could perpetually increase bank and credit union assessment fees to keep up with the increases in the SMDIA and SMSIA. This would increase costs of services over time, which could ultimately contribute to inflation itself.

It is worth noting that the SMDIA and SMSIA are already indexed to inflation, but only evaluated every five years. The FDIC and NCUA maintain the discretion to adjust this by multiplying $100,000 by “the ratio of the published annual value of the Personal Consumption Expenditures Chain-Type Price Index (or any successor index thereto), published by the Department of Commerce.”[57]

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56. https://www.congress.gov/bill/118th-congress/senate-bill/3012/text?s=1&r=1&q=%7B%22search%22%3A%22s+3012%22%7D

57. https://uscode.house.gov/view.xhtml?req=(title:12%20section:1821%20edition:prelim)%20OR%20(granuleid:USC-prelim-title12-section1821)&f=treesort&edition=prelim&num=0&jumpTo=true

I. PAYROLL ACCOUNT GUARANTEE ACT (S. 2403)

On July 20, 2023, Sen. J.D. Vance, (R-Ohio), introduced the *Payroll Account Guarantee Act* (S. 2403).[58] At the time of this writing no senators have cosponsored the legislation. S. 2403 was referred to the Senate Committee on Banking, Housing, and Urban Affairs.

The bill establishes a new program to permanently insure all noninterest-bearing transaction accounts at all credit unions and any insured bank with less than $225 billion in assets. There is no limit to the dollar amount of deposits it would insure. No fees may be allowed to be imposed on banks or credit unions to fund the extra insurance provided under this program.

S. 2403 Analysis

The bill establishes a new version of the TAG program, which was rejected by Republicans in 2012 because of the substantial moral hazard implications that came with it. Under this bill there is no limit to the dollar amount of deposits that could be covered. The DIF would have to potentially cover billions of dollars in deposits. However, the program offers no way to fund the insurance it is providing, so the DIF could easily become insolvent. Additionally, it would make it nearly impossible for the DIF to stay above the statutorily mandated 1.35 percent reserve ratio.[59] The subsequent lack of solvency in the DIF could devolve into the FDIC borrowing cash or even direct appropriations from Congress and ultimately the taxpayer.

The bill only adds coverage for noninterest-bearing accounts, and not interest-bearing accounts, which helps mitigate moral hazard. However, depositors could easily move their deposits to noninterest-bearing accounts that would qualify for the enhanced insurance in times of distress.

58. https://www.congress.gov/bill/118th-congress/senate-bill/2403/text?s=2&r=1&q=%7B%22search%22%3A%22s+2403%22%7D

59. https://www.govinfo.gov/content/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf

J. DEPOSITOR PROTECTION ACT OF 2023 (S. 1572/H.R. 5845)

On May 11, 2023, Sen. Bill Hagerty (R-Tenn.) introduced the *Depositor Protection Act of 2023* (S. 1572).[60] At the time of this writing no senators have cosponsored the legislation. S. 1572 was referred to the Senate Committee on Banking, Housing, and Urban Affairs.

On September 29, 2023, Rep. David Kustoff (R-Tenn.) introduced the House version of the *Depositor Protection Act of 2023* (H.R. 5845).[61] At the time of this writing Rep. Erin Houchin (R-Ind.) cosponsored the legislation. H.R. 5845 was referred to the House Committees on Financial Services and the Judiciary. H.R. 5845 is identical to S. 1572.

For the duration of two years after its enactment, S. 1572/H.R. 5845 would raise the deposit insurance limit to $100 million "that any depositor at an insured depository institution maintains" in a noninterest-bearing transaction account.[62] A bank with less than $250 billion in total consolidated assets would not be required to participate in the increased deposit insurance coverage. The FDIC would also be prohibited from increasing assessments on banks that do not elect to participate in the program.

The bill simultaneously raises the dollar amount of reciprocal deposits that a bank may maintain on a non-brokered basis. Prior to 2018 all reciprocal deposits were considered brokered deposits.[63] Currently, there are regulatory restrictions on the level of brokered deposits a bank may hold and an institution that relies extensively on them will be subject to enhanced regulatory scrutiny. In 2018, the enactment of the *Economic Growth, Regulatory Relief, and Consumer Protection Act* (EGRRCPA) exempted reciprocal deposits from the definition of brokered deposits because reciprocal deposits acted like other relationship-driven core deposits.[64] Under current federal law, banks may hold reciprocal deposits on a non-brokered basis up to the lesser threshold of $5 billion or "20 percent of the total liabilities" of the bank participating in a deposit placement network.[65] S. 1572/H.R. 5845 would raise these thresholds to $10 billion and 25 percent, respectively. This would increase the number of reciprocal deposits that a bank would be able to hold on a non-brokered basis. This is a positive step forward.

60. https://www.congress.gov/bill/118th-congress/senate-bill/1572/text
61. https://www.congress.gov/bill/118th-congress/house-bill/5845/text?s=2&r=1
62. https://www.congress.gov/bill/118th-congress/senate-bill/1572/text?s=4&r=1
63. https://www.dallasfed.org/research/economics/2023/1128
64. https://www.congress.gov/115/plaws/publ174/PLAW-115publ174.pdf
65. https://uscode.house.gov/view.xhtml?req=(title:12%20section:1831f%20edition:prelim)%20OR%20(granuleid:USC-prelim-title12-section1831f)&f=treesort&edition=prelim&num=0&jumpTo=true

Reciprocal deposits are defined as "deposits received by an agent institution through a deposit placement network with the same maturity (if any) and in the same aggregate amount as covered deposits placed by the agent institution in other network member banks."[66]

The bill also adds a section to statute that would require the FDIC to consider non-systemic secondary costs to the DIF from the collapse and subsequent receivership of a bank with more than $100 billion in assets. The secondary costs could be a declination in the value of a bank's assets as a result of the liquidation of the bank, the liquidation of a bank that acquired another liquidated bank via the FDIC resolution process, or any other effect as a result of the least-cost resolution process. The FDIC may not organize a bank merger, sell bank assets, assume bank liabilities, or acquire stock in a bank under receivership until the FDIC has determined, while considering the secondary costs, that the actions would impose the least possible cost to the DIF. The FDIC board must make this determination based on a two-thirds vote.

The bill directs the GAO to review and report any FDIC determination to Congress. Additionally, not later than three days after a determination, the Secretary of the Treasury would be obligated to notify the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services that a determination has occurred—including a description of the basis for the determination.

Section five of the bill streamlines the regulatory approval process for bank holding companies interested in acquiring distressed banks. The bill stipulates that after the bank holding company acquires or merges with the distressed bank, it must be well-capitalized as determined by the Fed. The combined entity must not maintain more than double the amount of total consolidated assets as the bank holding company, and each insured bank owned by the combined entity must have a composite rating of 1 or 2 under the Uniform Financial Institution Rating System and maintain a rating of "outstanding" or "satisfactory" from the most recent Community Reinvestment Act examination.

Transactions must occur within 90 days after the bill is enacted. A transaction may not occur if the distressed bank becomes a subsidiary of an insured bank or is acquired or owned by an insured bank. The transactions are also exempt from the *Hart-Scott-Rodino Antitrust Improvements Act of 1976* premerger filing requirements, to speed up the process for bank holding company acquisitions.[67]

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66. https://uscode.house.gov/view.xhtml?req=(title:12%20section:1831f%20edition:prelim)%20OR%20(granuleid:USC-prelim-title12-section1831f)&f=treesort&edition=prelim&num=0&jumpTo=true

67. https://www.ftc.gov/legal-library/browse/statutes/hart-scott-rodino-antitrust-improvements-act-1976

S. 1572/H.R. 5845 Analysis

The bill would unnecessarily expand deposit insurance coverage—significantly increasing the detrimental effects of moral hazard. Under the current $250,000 limit, 99 percent of deposits are already covered, which calls into question the exorbitant increase of the SMDIA up to $100 million.

The bill is a temporary guarantee program, but like Rep. Luetkemeyer and Sen. Vance's bills, it is essentially a new TAG program, which has proven to promote bank risk-taking. The program is only supposed to last for two years, but there would be pressure on Congress to reauthorize it, just as what happened with the original TAG program until Republicans put a stop to it in 2012.

Section three of the bill increases the level of reciprocal deposits that would be considered as non-brokered. This is a positive step as reciprocal deposits have been shown to act like other core deposits, and should not be considered brokered. The provision would promote the use of programs that diversify deposits to other banks. This mitigates moral hazard. Deregulation of reciprocal deposits should be further pursued without expanding the deposit insurance limit.

The bill only adds coverage for noninterest-bearing accounts, and not interest-bearing accounts, which helps mitigate moral hazard. However, depositors could easily move their deposits to noninterest-bearing accounts that would qualify for the enhanced insurance in times of distress.

III. ALTERNATIVE FREE-MARKET SOLUTIONS

Lawmakers should oppose providing liberal amounts of federal deposit insurance. The bank failures of the 1980s and early 1990s were largely triggered by "an overly generous deposit insurance system."[68] A study looking at a sample of Texas state-charted banks in existence from 1919-1926 found "that the existence of deposit insurance for state-chartered banks increased their likelihood of failure."[69] The results "show a moral-hazard effect at work."[70]

Instead, lawmakers could look at other more tailored solutions to enable bank stability without ceding the sector to federal government manipulation. Below are free market solutions to consider.

K. FURTHER DEREGULATING RECIPROCAL DEPOSITS.

Reciprocal deposits implement a core function of deposit insurance since its inception in the U.S.—the ability to open multiple accounts to obtain higher levels of insurance. Rather than forcing depositors to manually undertake this task, reciprocal deposit networks utilize technology to make it easier for banks and their customers to employ a single banking relationship. By utilizing a reciprocal deposit network, a bank can take a customer's $1 million deposit and break it into equal pieces, sending some to other institutions in the network which "reciprocate" by placing their own deposits at the bank. This allows small businesses, nonprofits, and other large depositors to insure deposits above the current SMDIA without exacerbating moral hazard by raising the SMDIA.[71]

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68. https://www.imf.org/external/np/seminars/eng/2006/mfl/pam.pdf
69. https://www.jstor.org/stable/3132558
70. Id.
71. https://www.bankdirector.com/article/how-reciprocal-deposits-build-franchise-value/#:~:text=What%20are%20reciprocal%20deposits%3F,deposits%20at%20other%20network%20banks

EGRRCPA largely removed reciprocal deposits from the definition of a "brokered deposit" to unleash bank services that allow more deposits to be insured under the current deposit insurance limit.[72] Currently, reciprocal deposits are considered "non-brokered" if they amount to no more than $5 billion or 20 percent of a bank's total liabilities, whichever is less. These private sector alternatives protect depositors and avoid exacerbating moral hazard to the same degree as increasing the deposit insurance cap.[73] Since brokered deposits are subject to more regulatory scrutiny, allowing banks more leeway to pursue reciprocal deposits could benefit both household and business depositors. The portion of the Hagerty/Kustoff bill that raises the thresholds for holding reciprocal deposits on a non-brokered basis is a step in the right direction. Lawmakers should build on this provision without raising the deposit insurance limit.

Businesses and individuals can take advantage of these private sector alternatives. For example, some community banks[74] and regional banks[75] offer insured cash sweep programs that allow depositors to distribute their cash around to different accounts "to money market deposit accounts at other FDIC-insured financial institutions" to earn higher interest and stay under the insurance limit. A heightened government backstop is not needed because the private sector is already innovating new products to benefit individuals and businesses.

Additionally, the Federal Reserve Bank of Dallas cited research suggesting that "reciprocal deposits reduce a bank's probability of default and are associated with lower resolution costs in case of bankruptcy."[76]

The Fed's paper also shows how small and midsize banks can benefit from reciprocal deposits. For midsize banks with between $10 billion and $100 billion in assets, reciprocal deposits grew by about 170 percent from "fourth quarter 2022 to second quarter 2023."[77] For banks with between $1 billion to $10 billion in assets, reciprocal deposits grew by about 65 percent. Banks with less than $1 billion in assets saw reciprocal deposits grow by about 51 percent over the same time period. Removing regulatory restrictions on reciprocal deposits would help promote further use of this product.

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72. https://www.congress.gov/115/plaws/publ174/PLAW-115publ174.pdf
73. https://www.wsj.com/articles/the-fdic-should-act-like-a-real-insurer-reciprocal-deposit-arrangement-spreading-risk-svb-moral-hazard-dac7e312
74. https://www.bankofutah.com/business/treasury-management/sweep-accounts
75. https://www.usbank.com/financialiq/improve-your-operations/investments-and-controls/protecting-cash-balances.html
76. https://www.dallasfed.org/research/economics/2023/1128, (referencing *Reciprocal brokered deposits, bank risk, and recent deposit insurance policy,* https://www.sciencedirect.com/science/article/abs/pii/S1062940815000534)
77. Id.

Lawmakers could also introduce legislation to prohibit the Fed from including non-brokered reciprocal deposits in the calculation for the global systemically important bank holding company (GSIB) surcharge.[78] Currently, the Fed's proposed regulatory capital rule would include non-brokered reciprocal deposits in the short-term wholesale funding indicator.[79] These products should be removed from the short-term wholesale funding indicator because they are fundamentally different from brokered deposits.

L. ENSURE MARK-TO-MARKET ACCOUNTING FOR ALL BANK SECURITIES.

Accounting tweaks, such as mark-to-market accounting of a bank's HTM securities portfolio, can offer transparency to bank shareholders, bondholders, and depositors. Charles Calomiris and Phil Gramm have proposed this idea.[80] Some banks and investors have also decided that some changes need to be made to accounting designations.[81]

SVB's foibles, such as a high-level of venture capital and tech startup depositors and borrowers, and poor risk management led to its demise. SVB's high concentration of HTM securities and failure to hedge interest rate risk as the Fed raised interest rates also largely contributed to its downfall. Disclosure of mark-to-market accounting for HTM securities would enhance transparency for shareholders and bondholders without the need to change capital calculations for all banks with more than $100 billion in assets.[82]

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78. https://www.govinfo.gov/content/pkg/FR-2023-09-01/pdf/2023-16896.pdf
79. 88 FR 60395, https://www.federalregister.gov/documents/2023/09/01/2023-16896/regulatory-capital-rule-risk-based-capital-surcharges-for-global-systemically-important-bank-holding
80. https://www.wsj.com/articles/in-todays-banking-crisis-echoes-of-the-80s-thrift-delayed-recognition-risk-taking-deposit-insurance-svb-signature-cfdd2b37
81. https://www.wsj.com/articles/banks-investors-revive-push-for-changes-to-securities-accounting-after-svb-collapse-99caa9ce
82. https://www.federalreserve.gov/newsevents/speech/barr20230710a.htm

IV. CONCLUSION

The implications of raising the SMDIA and SMSIA will exacerbate moral hazard and substantially enfeeble the U.S. banking sector by subjecting banks to further government control of deposit insurance.

Increasing government-backed insurance coverage without consideration of moral hazard is a facile and exigent solution that has not proven to end bank failures. Moreover, it does not analyze how the banking sector would react to higher assessments. More than likely, costs for providing checking and savings accounts would go up, the cost of allocating credit could increase, and ultimately American taxpayers would be paying those price increases.

Lawmakers should instead pursue free market policies that would improve the safety of depositors while also preventing the federal government from increasing its foothold in deposit insurance. Further deregulating reciprocal deposit programs can insure deposits by spreading them around to participating depository institutions. Specifically, significantly increasing the amount of reciprocal deposits depository institutions are allowed to hold on a non-brokered basis would especially benefit small and midsized banks.

Moreover, transparent disclosure of mark-to-market accounting of HTM securities is a light-touch approach to ensure shareholders, depositors, and bondholders are fully aware of a bank's financial condition.

The free market has the tools to enable more bank stability, but policymakers must understand why slapdash proposals to increase and enhance federal deposit insurance is a step in the wrong direction.

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