

The Daily Dish

Facts on Deposit Insurance

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Fun fact: While nobody was looking, a bank failed in the United States. On January 30, the Metropolitan Capital Bank & Trust in Chicago closed its doors (and, as is typical, another bank – the First Independence Bank of Detroit – assumed substantially all the deposits and assets). Bank failures, while headline-grabbing, are a natural part of a functioning financial system, not a flaw in the system itself. They reflect market discipline at work, where poorly managed institutions exit and resources are reallocated. While bank failures are a feature, not a bug, this is not a very common event. Over the past five years, bank failures have numbered between zero and five per year, and averaged just under two.

Weird fact: Despite the paucity of bank failures, there is legislation aimed at establishing expanded Federal Deposit Insurance Corporation (FDIC) insurance for all noninterest-bearing transaction accounts. Under this proposal, the FDIC would raise the guarantee on these accounts from $250,000 to $10 million, with the stated objective of preventing bank runs and failures.

Background fact: Deposit insurance is a government guarantee that protects depositors against losses if their bank fails. The FDIC was created in 1933 in the aftermath of widespread bank runs during the Great Depression and the amount of deposits guaranteed was raised from $2,500 in 1934 (about $65,000 in today's dollars), to $100,000 in 1980 (during the S&L crisis), and eventually to $250,000 in 2008 (as part of the Emergency Economic Stabilization Act in response to the global financial crisis).

But not all deposits are guaranteed. The limit is designed to protect the average depositor while preserving market discipline for large depositors who, in theory, have both the resources and the incentive to monitor bank risk. By number of accounts, FDIC deposit insurance covers 99 percent of all accounts in the United States. By dollar value, the 1 percent uninsured represents roughly 60 percent of the total.

Eakinomics “fact”: Expanding deposit insurance does not make sense. A proposed expansion might reflect the desire to avoid financial instability, but could backfire because of the reduced incentive to monitor banks’ riskiness. It could favor depository institutions over other financial services firms, thus upsetting competitive balance. And it could end up with the taxpayer holding the bag on a costly financial sector policy.