Perspectives on Deposit Insurance Reform after Recent Bank Failures
Senate Committee on Banking, Housing, and Urban Affairs
July 20, 2023

Opening Statements

Chairman Brown (D-OH) said that reforms need to be focused on protecting consumers and the American taxpayers. He pointed to how the Committee held multiple hearings on the recent bank failures and it is their job to hold executives accountable. Brown said that the Committee advanced the RECOUP Act, and it will ensure that Wall Street executives will not be able to cash out on their bad decisions. He said that we also need better protections, stronger capital liability standards, tougher stress tests, and more rigorous enforcement and supervision. Brown turned to deposit insurance and how SVB and Signature ignored liquidity risk given their concentration of deposits in the same industry. He said that when these banks failed, they impacted small businesses across the country who just wanted to make payroll. Brown said that this crisis was not the first time that we have covered uninsured deposits and they understand the need to protect depositors and promote stability in the banking system. He pointed to the pivotal role of community banks in the banking system, but decades of consolidation and concentration has led to deposit flight to the big banks, which has stripped the wealth of local communities. Brown said if customers move deposits to megabanks for deposit safety, this will impact rural economies and their communities. He said that we cannot allow these big banks to keep growing unchecked. Brown said that today's hearing is to look at the FDIC's deposit insurance framework and he looked forward to hearing what, if any changes, need to be made. He said that changing deposit insurance is not a cure all and other reforms need to be made as well. Brown said that workers are the ones who face the consequences when Wall Street fails, then Congress implements safeguards and lobbyists work to roll them back.

Ranking Member Scott (R-SC) said that he looked forward to hearing from Mr. Olmem, given his prior service on the Committee. He said that deposit insurance is an important issue that impacts the financial stability of our system. He said that over 99% of all deposit accounts are insured under the FDIC and not a single penny of insured deposits has been lost at all. Scott pointed to how the government took extraordinary steps to cover unprecedented amounts of uninsured deposits in the recent crisis and they are here today to look at the current deposit insurance regime and see if it needs to be changed. He pointed to how none of the proposals today come without a cost and most of them will be borne by small businesses and everyday consumers. Scott said that they have a responsibility to deliver safety and soundness for the American people. He added that they must also take into account the other factors that caused the recent banking crisis, such as social media and online banking. Scott said that they should consider whether a system created in the 1930s still works for the 2020s.

Witness Testimony

Ms. Emily DiVito Sr., *Program Manager For Corporate Power, The Roosevelt Institute,* pointed to how deposit insurance helps maintain stability in the banking system, but there can still be panic as we saw with the recent banking crisis. DiVito then provided an overview of each of the proposals, including preserving the current system, expanding deposit insurance for certain accounts, and enacting universal and unlimited coverage. She provided the arguments for and against each approach and closed by saying that policymakers would do well to wrestle with questions about the current system's purpose and efficacy—and the implications that each potential reform carries.

Mr. Thomas J. Fraser, *CEO, First Mutual Holding Co.,* said that deposit insurance is an important part of the banking system and ensures depositor confidence. Fraser noted that since the 2008 crisis, risks facing banks have expanded, including things like the nonbank shadow market, and these issues should be considered. He then turned to deposit insurance reform proposals, saying that any reform should remain centered on the impacts it has on consumers and the stability of our banking system. Fraser closed by noting that no insurance scheme can fully account for all risks, and no legislative or regulatory solution can be expected to solve all the problems or prevent all bank failures.

Mr. Andrew Olmem*, Partner, Mayer Brown,* said that deposit insurance is one of the key pillars of the US banking system and any reforms need to balance two competing policy issues. He said that the reforms need to prevent bank runs but also prevent moral hazard. Olmem pointed to the FDIC's report on deposit insurance reform and said that the target approach suggested in the report merits the most attention from the Committee. He added that giving small businesses the option to purchase more deposit insurance could also make sense. Olmem cautioned the Committee about increasing the overall level of insurance and if there is an increase for some accounts, it should be offset by other accounts. He noted that increasing deposit insurance would also decrease the effectiveness of the least cost-resolution test. Olmem pointed to the use of SRE and how the treatment of uninsured depositors here needs to be examined. He added that the impact of social media and digital banking also needs to be considered and deposit insurance needs to keep up with technological change.

Member Questions

Chairman Brown (D-OH) turned to DiVito on how we have seen systemic risk events in the recent banking crisis and during the 2008 crisis. He asked what these events reveal about the strengths and weaknesses of our banking system and our deposit insurance system. DiVito pointed to how depositors are incredibly flighty, and this can threaten financial stability. She added that these events also seem to be exacerbating concentration in the larger banks. DiVito said that bank supervision and regulation plays an important role in ensuring the banks operate safely and soundly. Brown asked how deposit insurance is critical for small businesses and consumers. Fraser said that it encourages banks to operate in a safe manner, protects consumers and ensures that consumers have access to credit. He said that he is concerned about the rise of bank services from bank like entities that create consumer confusion. Brown asked what the benefits of expanding deposit insurance coverage for all demand deposits are and what are the downsides that we need to account for. DiVito said that expanding deposit insurance would help reduce the likelihood of bank runs and minimizing the number of depositors who would initiate a bank run would decrease financial stability risks, but there is also the issue of moral hazard and coming to consensus on eligibility. Brown said that uninsured deposits have been trending upward and there is more migration to nonbanks and shadow banks. He asked what risks this poses to consumer and financial stability. Fraser said that there is a question of what is insured and not insured and there are risks for customers to suffer adverse behavior because of the lack of supervision and regulation in the system. He questioned what policymakers would do if a nonbank, like a payment processor, failed. Fraser said that one of their customers went to the payment type processor and they expected to be bailed out if things went wrong.

Ranking Member Scott (R-SC) said that increasing benefits is always good and if you increase the number of deposits covered by insurance, you have to increase the number of deposits exposed to the FDIC. Scott said that it seems to him that there is no increase without an expense and asked Olmem if the benefits outweigh the downsides. Olmem said that deposit insurance provides some financial stability and can increase confidence in the banking system, but the other side is the costs. He pointed to the additional insurance premiums and how they need to be priced according to the risks and for some banks, that cost is not worth it for their business model. Olmem added that there is also the issue of moral hazard and people not doing their due diligence which can result in banking crises. Scott said that he has received hundreds of phone calls on scenarios to increase deposit insurance and some may even merit consideration. He then asked about the commercial exposure versus the individual and how some have suggested bifurcating deposit insurance and if this is smart. Olmem said that we kind of have this already since most Americans do not have $250,000 in their account. He said that large corporations and other banks can monitor their deposits and said that good bankers have the reputation of good risk management, which attracts these customers. Olmem said that increases in deposit insurance can also create competitiveness issues in the market, as there can be perverse incentives. Scott said that the bank run was created in part by social media, which we have never seen before, and he wanted them to contemplate the changes that are necessary given the technological evolution in our nation.

Sen. Menendez (D-NJ) said that the FDIC favors a targeted approach to deposit insurance, but the issue of this is defining the accounts that get this coverage. He asked DiVito how they tailor this coverage and what types of accounts should be included. DiVito pointed to expanding deposit insurance for noninterest bearing accounts or transaction accounts, like business payment accounts. She said that the definition of transaction accounts would have to be teased out. DiVito said that she has also heard about expanding it to small businesses with 200 or so employees. Menendez said that we do not want to increase moral hazard and if this term of business account is not defined properly, moral hazard could be an issue. Menendez asked how Congress can ensure that a targeted coverage increase is properly tailored and if the FDIC would need additional flexibility to implement this type of tailoring. DiVito said that getting clear definitions is the real way to enhance financial stability objectives. Menendez said that he was concerned about the impact of increased deposit insurance on smaller banks. He asked if DiVito would expect deposits to concentrate at a small number of banks if Congress increased deposit insurance. DiVito thought that raising insurance would allow community banks to compete better since they do not enjoy the same bailout privileges of too big to fail (TBTF) banks. Menendez asked what impact increased deposit insurance would have on small banks. Fraser said that they would have to think through the costs and noted that there has been a shift to investing in T-Bills and that corporate treasurers are being more active. He said that for their banks, they do not see too many corporate accounts beyond the $250,000 threshold. Menendez said that while increasing deposit insurance may be necessary for financial stability, consolidation presents its own risks.

Sen. Vance (R-OH) wanted to ask how the recent banking crisis affected Main Street banks and said that he has highlighted the importance of the three tier banking system since these bank failures. He asked Fraser who they compete with on deposits. Fraser said that they have always competed with community banks and regional banks, saying that they have a healthy three-tiered system, but they are seeing a flight of deposits to nonbank services, as well as T-bills and MMFs, which he is concerned about. Vance said that we have seen some flight of deposits to the bigger banks as well and his fear is that if you are a local business, you will put deposits in big banks because of the implicit unlimited deposit insurance. He asked Fraser to speak to the importance of the three tier banking system. Fraser said that the three tiered system is critical as they can provide better tailored services to different individuals and different businesses of different sizes. Vance pointed to how they introduced the Payroll Account Guarantee Act, which would increase deposit insurance for non-interest bearing business transaction accounts. He said they are not penalizing businesses for using a bank as a bank. Vance asked if extending the Transaction Account Guarantee Program (TAG) would help Fraser's bank and the banking system in Ohio. Fraser said that targeted insurance is worth considering and he thought this was a good place to begin the deeper dive. He added that the nine new risk factors in his testimony should also be considered when evaluating reform proposals.

Sen. Smith (D-MN) said that her state has a lot of small community banks, and she was pleased to see that many of them were excluded from the DIF special assessments. She asked Fraser why it's important to ensure that small banks are not burdened by this special assessment. Fraser said that this is very important, and they were pleased to be excluded since they were not involved in the root cause of this, but he worried about the next event where they may have to bear this burden. Smith said that it is complicated because we do not want to create a moral hazard with unlimited deposit insurance. She turned to DiVito and noted how SVB and Signature treated risk management like an afterthought and the DIF assessments are based on risk. Smith asked if SVB and Signature contributed less to the DIF than they should have and how supervision is essential in maintaining the DIF. DiVito said that she did not have the figures on this, but experts are concerned about banks being underassessed. She thought there could be ways to more progressively assess based on risk, like looking at the concentrations of uninsured depositors. Smith said that this would ensure that community banks are not paying more than their fair share. DiVito agreed. Fraser commented that it is important for risk management practices to be included in any assessment.

Sen. Warner (D-VA) said that it seems to him that a lot of energy around deposit insurance reform has dissipated. He asked the panel if there is any kind of reform system that benefits all institutions, if better use of the Fed discount window could be encouraged, and if informal exchanges or networks for deposit insurance, which raise deposit insurance beyond $250,000, could be strengthened. Fraser referred to the informal exchanges, saying that banks are creative, and they will swap deposits so customers can remain protected, but there are some costs in doing this especially if they become more reliant on it. Warner said that this does not burden the overall system. Fraser agreed and said that it is generally a safe practice. Fraser said that on liquidity tools, removing stigma is important and the Fed Facility in the wake of the SVB crisis has been useful. Olmem thought he was right on the discount window and said that the Fed should not need to use Sec. 13(3) in a banking crisis. He said that there is some balancing that needs to be done in the supervisory process. Warner said that internet driven runs cannot be prevented with higher capital.

Sen. Cortez Masto (D-NV) wanted to focus on deposit swaps and said we know that any person or business with more than $250,000 has the option to open accounts at multiple banks. She continued that they have the ability to have that covered by the FDIC and said that banks can easily move deposits above the $250,000 to other accounts through deposit swaps, using companies like IntraFi. Cortez Masto said that if SVB used deposit swap companies, the run may not have occurred, and she asked what the bank is responsible for here, what the role of cash dispersal and sweep account options is, and if we should be relying on the private sector to engage in this. DiVito pointed out that this indicates that there are categories of sophisticated depositors who are able to access more insurance than is in statute and this has created a tiered system that they should look to clarify so everyone can get the same degree of coverage. Fraser said that his banks use these facilities, but they are usually initiated by customers, adding that they do not charge more for this. He said that over time this could be part of deposit insurance reform or solutions. Fraser said that given the scope of the bank run that occurred, he questioned if IntraFi or a similar entity could have absorbed that kind of shock to the system. He added that this underscores that if banks have a high number of uninsured deposits, then its liquidity risk and interest rate risk management practices need to be front and center. Cortez Masto turned to shadow banking and asked how they should be looking at this system and what can be done. Fraser said that they do play a role and they raise technological innovation, but they are not under the regulators and are outside many consumer laws. He said that this does not mean they are reckless, but they are outside of the regulatory perimeter. Cortez Masto asked if he agreed that when looking at consumer protection and financial stability, then it should apply to banks and nonbanks. Fraser said that the question is how they absorb loss and are held accountable for behavior.

Sen. Sinema (I-AZ) said that today's conversation on deposit insurance is an important piece of the puzzle and noted that a UPenn professor proposed increasing deposit insurance for small businesses with less than 200 employees. She asked how this would apply to pass through entities and how banks can distinguish between these. Fraser said that this is the most complex element of targeted deposit insurance, and it was difficult to determine under TAG. Olmem agreed and said that the definition and monitoring is very important as some could game the system. He pointed to how depositors could do some verification before opening accounts, but this would be an administrative burden and he was unsure how effective it would be. DiVito agreed that this could be a feasible approach. Sinema asked if they think that depositor discipline exists right now and if people think they will lose money beyond the FDIC guarantee, and if so, why or why not. Fraser said that it depends on the customer and the depositor, noting that some are concerned about deposit insurance. Olmem said that depositor discipline exists as evidenced by the runs, but he was not sure if it was as effective as it should be. DiVito said that the limit exists for those depositors who are incapable or uninterested in providing that depositor discipline, but some are monitoring for risk and can still participate in runs.

Sen. Warren (D-MA) said that throughout history, when rumors circulate about banks not being able to cover deposits, depositors pull their money. She asked DiVito if a crisis hits the banking system, does history suggest that depositors need to worry about their money at community banks. DiVito said that usually depositors are made whole, but this can take time and this length of time can be harmful. Warren said that since 2007, 7% of failed banks had uninsured depositors who had not recovered their money. She asked if depositors at TBTF should worry about deposits over $250,000 at those big banks. DiVito said no, the government has shown that they will cover these deposits, and this leads to higher assessments. Warren said that when depositors trigger a run and go to big banks, they are acting rationally. She said businesses flee to the place where they know money will be ready for them whenever they need it, adding that the government will always throw the unlimited insurance life vest to bigger banks. She asked Fraser if TBTF banks are paying for this extra measure of insurance. Fraser spoke to what his bank pays into the system and said that all institutions are subject to the schedule of calculations based on risks. Warren said that these banks are getting unlimited insurance without paying for it and asked how they make sure that FDIC insurance is not structured to provide a bonus to these big banks. She asked if we could provide a little more reassurance to the business depositors that their money will be protected by raising the insurance caps at the smaller banks and if they would be less likely to flee those smaller banks whenever consumers hear about stress in the banking system. DiVito agreed. Warren said that they need to reform the deposit insurance system by raising the FDIC limits so businesses can bank with community banks without the threat of interruption; make the TBTF banks and banks with high levels of uninsured deposits cover more of the costs of ensuring the stability of the banking system and DIF; and exhibit tougher oversight to ensure that banks do not take advantage of additional insurance and engage in riskier behavior.