FDIC: The Longest Running Bailout of American Banks

By Eric Nelson*

During the Great Depression, the American population lost faith in the banking industry out of fear that banks would lose their money. In response, the Federal Deposit Insurance Corporation (FDIC) was created to both ensure depositors that their money would be safe in the hands of banks and ultimately provide monetary stability to the United States.[1] The FDIC protects depositors by guaranteeing each depositor that, no matter what happens to a bank, he or she will be reimbursed the first $250,000, the current federal deposit insurance coverage limit, he or she deposited into the bank.[2] However, over the years, the FDIC has vastly overstepped its intended purpose by ensuring depositors that the FDIC will bail out the largest banks so that no depositor would ever suffer a loss, even if the amount were in excess of the $250,000 coverage limit.[3] This government-provided safety net has incentivized banks to engage in risky behaviors, since the banks are backed by the full faith and credit of the United States federal government.[4]

Due to the massive burden this assurance places on the federal government, there are several proposed alternatives and reforms to federal deposit insurance that could help reduce the incentive for bank's to take on excessive risk. Although there is no clear-cut solution, a system that would both lower the federal deposit insurance coverage limit and shift the onus of providing deposit insurance coverage to a private deposit insurance industry seems to be the most beneficial solution.

Solutions

In order to return to a sound banking system, avoid future economic downturns, help reduce the amount of government assistance associated with deposit insurance, and loosen the grasp of power that the federal government currently has over banks, it is essential to get banks off of the government's bankroll.[5] Because federal deposit insurance is not necessary to ensure a stable monetary system, scholars and experts have proposed several alternatives and reforms to federal deposit insurance.[6] As examined below, two of the more popular alternatives, or reforms, to federal deposit insurance are: 1) leave deposit insurance to the private sector and abolish the FDIC entirely; and 2) lower the amount of federal deposit insurance coverage to a more

---

* Eric Nelson is a recent graduate of Elon University School of Law. He completed his undergraduate work at the University of Texas at Austin, where he received a degree in Economics.

[1] Christine M. Bradley, *A Historical Perspective on Deposit Insurance Coverage*, 13 FDIC BANKING REV., no. 2, 2000, at 1, 5, *available at* https://www.fdic.gov/bank/analytical/banking/2000dec/brv13n2_1.pdf.

[2] *See* Frederic S. Mishkin, Evaluating FDICIA 3 (Dec. 19, 1996) (unpublished manuscript), *available at* http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.196.7072&rep=rep1&type=pdf; *see also* Marcie Geffner, *FDIC Insures Bank Deposits to $250,000*, BANKRATE, http://www.bankrate.com/finance/savings/fdic-insures-bank-deposits-to-250-000-1.aspx (last visited May 21, 2015).

[3] Mishkin, *supra* note 2, at 5–6.

[4] *Id.*

[5] PETER D. SCHIFF, THE REAL CRASH: AMERICA'S COMING BANKRUPTCY – HOW TO SAVE YOURSELF AND YOUR COUNTRY 84 (2012).

[6] GEORGE J. BENSTON ET AL., PERSPECTIVES ON SAFE AND SOUND BANKING: PAST, PRESENT, AND FUTURE 82 (1986).

reasonable amount. However, because both of these alternatives come with several regulatory impediments, a better and more likely option is to somehow combine the two alternatives.

Private Deposit Insurance

A popular alternative to federal deposit insurance amongst scholars and experts is to leave deposit insurance to the private sector and abolish the FDIC entirely.[7] Proponents of a private deposit insurance industry often point to a few crucial differences between federal and private deposit insurance that make the latter look much more preferable.[8]

One difference between today's mandatory FDIC and a competing private deposit insurance industry is that private deposit insurance would be optional.[9] "A bank could decide to eschew deposit insurance, and that bank's customers would receive the same disclaimer people receive when they invest in stock: your investment could go down to zero."[10] A bank that elects to forgo deposit insurance could be seen as a risky bank—making a deposit account similar to a stock investment, with the potential of high returns so long as they do not lose your money.[11] On the other hand, eschewing deposit insurance could be seen as a sign of complete confidence in that bank's soundness. In other words, the perception might be that such a bank only invests in the safest things and has such trust from its customers that it does not need to expend resources paying monthly deposit insurance premiums.[12]

Another difference between private and public deposit insurance is that risk would become more accurately priced.[13] "[P]rivate insurers would have their own money on the line, guaranteeing that they would be better at making accurate estimates of risk."[14] As Peter Schiff, author of *The Real Crash*, puts it, "government agencies will never be as effective watchdogs as the market."[15] In addition, customers themselves would become regulators.[16] Customers would conduct due diligence and figure out which bank is the safest place to store their money.[17] Fortunately for those trying to evaluate which bank is the safest, brand reputation and expert analysis would allow customers to make informed decisions—imagine a Consumer Reports for banks, studying the safety of their deposits and weighing safety against perks like free checking and waived ATM fees.[18]

---

[7] SCHIFF, *supra* note 5, at 84 (2012).
[8] *Id.*
[9] *Id.*
[10] *Id.*
[11] *Id.*
[12] *Id.* at 84–85.
[13] *Id.* at 84.
[14] *Id.* at 85.
[15] *Id.* at 81.
[16] *Id.*
[17] *Id.* at 79.
[18] *Id.* at 85.

Lower Coverage

Another proposed reform to federal deposit insurance is to reduce the amount of insurance coverage to a more "reasonable" amount—a limit of, say, $50,000.[19] Since federal deposit insurance was created in 1934, in constant dollars, the limit on insured deposits has risen by more than sixfold.[20] It is pretty evident that the FDIC has gone "from being a tool protecting the average depositor from poverty to a way of ensuring that depositors never have to worry about their banks' behavior."[21] "Another proposed reform would institute a system of *coinsurance* in which only a percentage of a deposit—say, 90%—would be covered by insurance."[22] "In this system, the insured depositor would suffer a percentage of the losses along with the deposit insurance agency."[23]

Combine the Two: The Ideal Solution

Currently, despite being charged for risk-based assessments, it seems that it is not enough of an incentive for banks to stop engaging in risky behavior. However, moving to a fully private deposit insurance industry may not be the best course of action, since it is risky to entrust private insurers with the responsibility of the FDIC, including the responsibility to decide whether to close risky or failing financial institutions.[24] Thus, it seems that the most ideal solution is to combine the two proposals discussed above—lower the amount of federal deposit insurance coverage to a more "reasonable" amount and transition, at least in part, to a private deposit insurance industry.[25]

By lowering the amount of federal deposit insurance coverage, the FDIC can return to serving its original purpose—protecting depositors from economic loss.[26] In addition, lowering the amount of federal deposit insurance coverage would also open up the door for a private industry.[27] Depositors who have deposits in excess of what is covered by federal deposit insurance, and who wish to insure that amount, could do so by purchasing additional coverage from a private insurer.[28]

In spite of this seemingly "ideal" solution for reform, it would be ignorant to not anticipate regulatory impediments or ramifications as a result of its implementation, as well. In reducing the federal deposit insurance deposit coverage limit, the power to close risky or failing financial institutions would remain with the FDIC.[29] Thus, for example, if the FDIC elected to close a failing bank and some of the deposits held at that bank were insured by private

---

[19] FREDERIC C. MISHKIN & STANLEY G. EAKINS, FINANCIAL MARKETS AND INSTITUTIONS app. to ch. 20 at W-49 (6th ed. 2008), *available at* http://wps.aw.com/wps/media/objects/744/761962/appendixes/ch11appendix.pdf.

[20] Bradley, *supra* note 1, at 1, 17.

[21] SCHIFF, *supra* note 5, at 80.

[22] MISHKIN & EAKINS, *supra* note 19, at W-49 (emphasis in original).

[23] *Id.*

[24] *See id.* at W-50, W-52.

[25] *See id.* at W-53; *see also* SCHIFF, *supra* note 5, at 85.

[26] SCHIFF, *supra* note 5, at 80.

[27] *Id.* at 84–85.

[28] *Id.* at 85.

[29] *See generally* MISHKIN & EAKINS, *supra* note 19, at W-49–W-53.

insurers, the FDIC would be causing the private insurer to cover the insured depositor's lost deposits. Disagreements would certainly arise if the private insurer in the above example thought the failing bank could otherwise be saved.

In addition, under this proposed, hybrid solution, it is fairly easy to see that that the problem of banks taking excessive risks would continue to be an issue. The difference would be that the banks would not only be putting the federal government's money at risk but also private insurers' money at risk, as well.

Conclusion

It is vital to the sustainability of the banking industry that the FDIC returns to serving its original purpose—restoring the public's faith in the banking industry. Although scholars and experts have proposed several alternatives and reforms to improve federal deposit insurance, the most appropriate solution is to combine the two most popular alternatives—lower the amount of federal deposit insurance coverage while shifting towards a private deposit insurance industry. This combination provides depositors with the confidence they need to trust banks with their money while also reducing banks' incentive to take unnecessary risks at the expense of the federal government.