WRITTEN TESTIMONY OF

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HEARING ON *PERSPECTIVES ON DEPOSIT INSURANCE REFORM AFTER RECENT BANK FAILURES*

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Chair Brown, Ranking Member Scott and the members of the Committee, thank you for the opportunity to testify today on potential options for reforming the federal deposit insurance program.[1] I commend the committee for taking up this important issue as deposit insurance is one of the key pillars of the U.S. banking system and its continued operation is critical to maintaining a vibrant and stable U.S. economy.

My testimony will first present a brief history of federal deposit insurance to provide important context for the Committee's consideration of potential reforms. I will next discuss the Deposit Insurance Corporation's (FDIC) recent report, *Options for Deposit Insurance Reform* (FDIC Report), and its main reform options. I will conclude by identifying several issues that the Committee should examine as it considers potential reforms of the FDIC's deposit insurance program.

## 1. The History of Federal Deposit Insurance.

The federal deposit insurance program was created by the Banking Act of 1933 to restore confidence in the banking system in the midst of the Great Depression.[2] During the debate over the legislation, Congress wrestled with the same central issue that this Committee will also have to address as it considers potential reforms: How to provide federal deposit insurance in a manner that prevents bank runs but does not create moral hazard that over time reduces incentives for

[1] The views expressed in my testimony are my own. I am appearing before the Committee in my personal capacity and not on behalf of Mayer Brown LLP, or any client or organization with which I have been affiliated.

[2] The Federal Savings and Loan Insurance Corporation, which provided deposit insurance to thrifts, was created by the National Housing Act of 1934. Under the Federal Deposit Insurance Reform Act of 2005, the separate deposit insurance funds for banks and thrifts were merged to create the Deposit Insurance Fund (DIF).

proper risk management and, thereby, increases losses for banks, depositors, the federal government, and taxpayers.[3]

Although deposit insurance became a central component of the New Deal, it is worth noting that President Franklin D. Roosevelt opposed the creation of federal deposit insurance.[4] He contended that federal deposit insurance would encourage a "laxity in bank management and carelessness on the part of both bank and depositor."[5] In his view, when banks suffered losses, "it is better to have that loss taken than jeopardize the credit of the United States Government or to put the United States Government further in debt."[6] Although President Roosevelt underappreciated the benefits of deposit insurance, his recognition of the risks involved remains timely.

Despite his initial opposition to deposit insurance, President Roosevelt still signed the Banking Act of 1933 into law after Congress agreed to limit the amount of deposit insurance protection. This ensured that uninsured depositors (corporations, investment firms, high-net-worth individuals) would still monitor the risks their banks assumed. The FDIC was also established to administer the program. The deposit insurance limit was initially set at $2,500, but increased to $5,000 in 1934.

The creation of federal deposit insurance has been widely viewed as critical to stabilizing the banking system during the Great Depression and preventing bank runs in the ensuing decades.[7]

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[3] *See* Carmen M. Reinhart & Kenneth Rogoff, *This Time is Different: Eight Centuries of Financial Folly* (2009), p. 144-145.

[4] Sara Jane Gates, *More Lives Than a Cat: A State and Federal History of Bank Deposit Insurance in the United States, 1829-1933*, The University of North Carolina Greensboro (2017). *See* Alan Meltzer, *A History of the Federal Reserve: Volume I, 1913 – 1951,* The University of Chicago Press (2003), p. 432 – 434; Adam Cohen, *Nothing to Fear: FDR's Inner Circle and the Hundred Days That Created Modern America*, The Penguin Press (2009), p. 278; *See also* Aaron Klein, *Why FDR Limited FDIC Coverage*, *The Wall Street Journal* (April 9, 2023).

[5] Franklin D. Roosevelt, Letter to *The New York Sun* (October 10, 1932).

[6] *Gates* at 310.

[7] Milton Friedman and Anna J. Schwartz, *A Monetary History of the United States 1857-1960* (1963), *p. 440.*

It also provided a means for resolving banks, setting the stage for future economic growth unencumbered by banks saddled with losses. Nevertheless, the tension that emerged during the creation of the deposit insurance program between the competing policy goals of (1) preventing bank runs, and (2) mitigating moral hazard risk has endured and influenced each of Congress's subsequent deposit insurance reform efforts.

After a period of relative stability in the 1950's and 1960's, the banking system came under pressure in the 1970's from rising interest rates, economic shocks, outdated regulations (particularly interest rate caps), and marketplace and technological innovations. These forces combined with misguided regulatory policies that exacerbated moral hazard risks to ultimately produced the savings and loan crisis. To start, Congress initially sought to strengthen the banking system by increasing deposit insurance from $40,000 to $100,000 to help banks compete against new, nonbank investment options, particularly money market mutual funds.[8] This increase in deposit insurance – which far exceeded the average amount of deposits held by individual depositors – significantly increased moral hazard risk by encouraging more funds to flow to banks without any risk assessments, and increased the federal government's exposure to liabilities arising from bank failures. During this period, the FDIC also began to use open bank assistance to provide financial support to failing institutions it deemed systemic.[9] As mounting losses threatened to exhaust the deposit insurance funds, the FDIC also engaged in regulatory forbearance, allowing failing institutions to remain open with the hope that changing market conditions would restore the institutions back to health. However, regulatory forbearance only caused losses to grow and

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[8] *The Depository Institution Deregulation and Monetary Control Act of 1980.* In 1974, Congress increased deposit insurance to $100,000 for deposits of federal and state entities.

[9] The Federal Deposit Insurance Corporation, *The Federal Deposit Insurance Corporation: The First Fifty Years* (1984), p. 94-95.

make the final costs to resolve institutions far higher than if they had been closed earlier.[10] In the final tally, more than 2,000 banks and thrifts failed, causing the insolvency of the Federal Savings and Loan Insurance Corporation, and requiring taxpayers to pay more than $132 billion to resolve failed institutions.[11]

In response to the savings and loan crisis, Congress passed the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) to reform the deposit insurance program and address what this Committee identified at the time as significant moral hazard created by the FDIC's resolution process. In particular, the Committee sought to end the FDIC's policy of "too big to fail," which the Committee identified as the provision of assistance to protect uninsured depositors of both banks deemed by the FDIC as systemically important, and non-systemic banks.[12] It was this Committee's view that uninsured depositors, not taxpayers or other banks, should bear the losses arising from the failure of any bank.[13] Accordingly, in FDICIA Congress expressly prohibited the FDIC from taking any action to protect uninsured depositors from incurring losses if such action would increase losses to the deposit insurance fund.[14] In addition, Congress included in FDICIA the least-cost resolution requirement, which prohibits the FDIC from providing assistance to failed institutions to protect uninsured depositors unless the cost of such assistance is less than the amount the FDIC would incur in paying out deposit insurance.[15]

[10] Congressional Budget Office, *Report on the Economic Effects of the Savings and Loan Crisis* (1992).

[11] The Federal Deposit Insurance Corporation, *An Examination of the Banking Crises of the 1980s and Early 1990s Vol I.* (1997), p. 187; The Federal Deposit Insurance Corporation, *Managing the Crisis: The FDIC and RTC Experience* (1980), p. 4-5

[12] The U.S. Senate Committee on Banking, Housing and Urban Affairs, *Report of the Senate Committee on Banking, Housing, and Urban Affairs to accompany S. 543 together with additional views* (1991), p. 45-46

[13] *Id.*

[14] 12 U.S.C. § 1823(c)(4)(E).

[15] 12 U.S.C. § 1823(c)(4)(A).

Although Congress sought to address moral hazard in FDICIA, it also recognized that imposing losses on uninsured depositors can, in some cases, spark a bank run by uninsured depositors. To address this systemic risk, Congress also included in FDICIA the systemic risk exception (SRE) to the least-cost resolution requirement.[16] The SRE allows the FDIC to provide assistance without considering the least-cost resolution requirement, including providing assistance to protect uninsured depositors. However, Congress did not want the SRE to be used to routinely evade the least-cost resolution requirement. To avoid this result, FDICIA imposed a heightened approval process for its use. The SRE can only be used upon the written recommendation of each of the FDIC Board and the Federal Reserve Board of Governors (upon a two-thirds vote of each), and then the Secretary of the Treasury (in consultation with the President) must determine that compliance with the least-cost resolution requirement "would have serious adverse effect on economic conditions or financial stability" and that taking other action could "avoid or mitigate" such adverse effect.[17] The FDIC was authorized to recoup any losses it incurred due to the use of the SRE from assessments on the banking industry.[18]

In FDICIA, Congress also adopted the prompt corrective action mandates, which require banking regulators to take increasingly stringent actions with respect to undercapitalized institutions.[19] The goal of prompt corrective action was to have the FDIC close institutions while they still had positive capital and, thereby, prevent bank failures from resulting in losses to the deposit insurance fund. FDICIA also authorized the FDIC to charge risk-based assessments for deposit insurance.[20] By making assessments risk sensitive, Congress sought to mitigate moral

[16] 12 U.S.C. § 1823(C)(4)(G)(i).
[17] *Id.*
[18] 12 U.S.C. § 1823(C)(4)(G)(ii).
[19] 12 U.S.C. § 1831o.
[20] 12 U.S.C. § 1817(b).

hazard by imposing higher assessments on banks that posed greater risks to the deposit insurance fund.

The passage of FDICIA was followed by another period of relative stability for the banking industry, which lasted until the 2008 financial crisis. The 2008 financial crisis not only severely tested the reforms implemented by FDICIA, but also threatened the solvency of the deposit insurance fund. Initially, the FDIC sought to comply with FDICIA and allowed uninsured depositors to incur losses in the resolution of IndyMac. However, as the crisis continued, the FDIC took more aggressive action. First, the SRE was used to provide open bank assistance. Second, the FDIC obtained a temporary increase in the deposit insurance limit to $250,000. Third, the FDIC used the SRE to establish the Temporary Guaranty Liquidity Program (TGLP), which provided guarantees for (1) noninterest-bearing transaction accounts, and (2) newly issued senior secured debt of insured depository institutions and their holding companies and affiliates. At its peak, the TGLP guaranteed more than $1 trillion in liabilities. Fortunately, these and other emergency measures to dramatically expand the federal safety net stemmed the runs on the banking system and stabilized the overall financial system.

Recognizing that this expansion of the federal safety net – even if necessary in the short run to combat the financial crisis – created serious long-term moral hazard risk for the U.S. banking system, Congress included in Dodd-Frank several reforms of the deposit insurance program designed to help restore market discipline to the banking system. With respect to the SRE, Congress clarified that the SRE could only be used to provide assistance to an insured depository institution for which the FDIC had already been appointed receiver.[21] In effect, this reform

[21] The Government Accountability Office (GAO) questioned the legal basis for using the SRE for the TGLP, determining that "the overall legislative history of FDICIA also suggests Congress did not intend the exception to provide the breadth of new authority claimed by the agencies." GAO, *Federal Deposit Insurance Act: Regulators' Use of Systemic Risk Exception Raises Moral Hazard Concerns and Opportunities Exist to Clarify the Provision*

prevents the FDIC from using the SRE to provide assistance to banks outside of receivership and to non-bank companies as had been done with the TGLP. This reform sought to restore the boundary of the federal safety net to again exclude non-banks. For banks, Congress required certain banking organizations to prepare resolution plans to help facilitate their resolution and mitigate spill-over effects.

Although Congress sought to address moral hazard with the Dodd-Frank amendments to the SRE, it also provided in Dodd-Frank new authorities that expanded the FDIC's capabilities to respond to future financial crises. These new authorities included (1) the orderly liquidation authority (OLA), which provides a new mechanism for the FDIC to resolve systemically significant nonbank financial companies, including bank holding companies, (2) new authority for the FDIC to guarantee the debts of insured depository institutions and their holding companies and affiliates,[22] and (3) a permanent increase in the deposit insurance limit to $250,000. While OLA and the FDIC debt guaranty authority both provide new tools to combat financial crises and create new moral hazard risks, they also both have heightened approval processes to minimize their use outside of a crisis. However, the permanent increase in the deposit insurance limit to $250,000 has had an immediate effect of not only increasing the deposit insurance fund's liability, but also of effectively allowing a *de facto* expansion of the federal safety net to uninsured depositors.

The FDIC Report revealed that since the deposit insurance limit was increased to $250,000 in 2008, the percentage of bank failures where uninsured depositors suffered losses was only 6%.[23]

(2010), p. 53. With its subsequent amendments to the SRE, Congress sided with GAO's assessment. *The Dodd-Frank Wall Street Reform and Consumer Protection Act*, Section 1004.

[22] The CARES Act expanded the scope of the debt guarantee program authority to allow the FDIC to also guarantee noninterest-bearing transactional accounts, thereby allowing the FDIC to establish another TGLP, subject to obtaining the requisite statutory approvals. Section 4008(a), *Coronavirus Aid, Relief, and Economic Security Act (CARES Act)*.

[23] The Federal Deposit Insurance Corporation, *Option for Deposit Insurance Reform* (2023), p. 22.

In contrast, for the period from in 1992 (the year after FDICIA was enacted) until 2007 that percentage was 43%.[24] What accounts for the exceptionally sharp decline in market discipline for uninsured depositors? According to the FDIC, the increase in the deposit insurance limit to $250,000 has significantly increased the amount of funds that the FDIC can use under the least cost-resolution requirement to resolve a bank.[25] Indeed, the FDIC was able to provide $13 billion to facilitate the sale of First Republic Bank, which protected both insured and uninsured depositors, without invoking the SRE. In retrospect, the use of the SRE to protect the uninsured depositors of Silicon Valley Bank (SVB) and Signature Bank (Signature) was only exceptional because it was the first time since Dodd-Frank that the SRE had been employed. However, the protection of the uninsured depositors of SVB and Signature was consistent with how the FDIC has treated uninsured depositors in 94% of bank failures.

This brings us to the current state of deposit insurance. The recent use of the SRE for SVB and Signature reveals that several of the post-2008 reforms achieved their objectives of restoring more market discipline. In particular, the requirement that the SRE can only be used to provide funding to banks for which the FDIC has been appointed receiver resulted in shareholders and unsecured creditors bearing their full losses. However, as the statistics cited above demonstrate, regulators have been very reluctant to impose losses on uninsured depositors even outside of resolutions involving the SRE, contrary to the policy set by FDICIA. Whether and when losses can be imposed on uninsured depositors are the great unanswered questions about the deposit insurance program.

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[24] *Id.*

[25] *Id.*

## 2. The FDIC's Options For Deposit Insurance Reform.

The FDIC Report provides a well-reasoned, thoughtful discussion of three main potential approaches to deposit insurance reform. The FDIC Report is an excellent starting point for the Committee's consideration of whether any reforms are necessary and, if so, the potential best approach.

### a. Current System.

The first option is to preserve the current system. For most Americans and banks, the current deposit insurance system works very well. Accordingly, following the adage "don't fix what isn't broken" could be an appropriate approach. The downside of this approach is that it forgoes an opportunity to proactively strengthen the deposit insurance system to account for changes in the marketplace, particularly the growth of digital banking (as discussed below). As noted, it is far better to address up front potential challenges to the deposit insurance program than to allow them to grow into serious problems.

### b. Targeted Expansion of Deposit Insurance Coverage.

The second option is to expand deposit insurance coverage for particular types of accounts. The FDIC suggests expanding deposit insurance to business payment accounts on the grounds that depositors of such accounts provide little market discipline but have high incentives to run.

One factor to weigh when considering any increase in deposit insurance coverage is that any increase will further reduce the effectiveness of the least cost-resolution test. As discussed above, Dodd-Frank has already significantly undermined the least-cost resolution test by permanently increasing the deposit insurance limit to $250,000. Additional increases in the deposit insurance limit without other offsetting statutory restrictions could encourage more aggressive use of assistance by the FDIC to protect uninsured depositors contrary to the intent behind FDICIA.

In addition, increasing the amount of deposit insurance would likely require higher deposit insurance premiums on banks. Given that banks, particularly smaller and regional banks, are already dealing with significant regulatory costs, higher assessments would only further increase the costs of banking, pushing more activity outside of the banking system.

If the Committee does want to consider a targeted approach, one interesting proposal is to expand deposit insurance for certain small business accounts, but then reduce the overall amount of deposit insurance.[26] The average deposit balance by Americans is approximately $42,000, so a reduction in the $250,000 deposit insurance limit would not impact the vast majority of Americans. However, a reduction in the deposit insurance limit could potentially offset increased deposit insurance for small business accounts so that there is no net expansion of deposit insurance coverage. If structured properly, this might help preserve the effectiveness of the least-cost resolution test and prevent a net increase in assessments on banks. Nevertheless, it is critical to strike the right balance in any adjustments to the deposit insurance cap, and the Committee would be well-advised to carefully study potential unanticipated consequences. For example, if there are not clear lines on the types of deposits that qualify for enhanced deposit insurance, it could open the door to depositors gaming the system to increase their deposit insurance coverage.

Another option worth the Committee's consideration is allowing banks to buy additional deposit insurance from the FDIC. This could be a means for small businesses to obtain deposit insurance for their payroll accounts, but it is critical that such insurance be properly priced to avoid adverse selection problems.

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[26] *See* Peter Conti-Brown presentation at The Brooking Institution's *A Debate: Should the US Raise the $250,000 Ceiling on Deposit Insurance?* (2023).

### c. Unlimited Deposit Insurance Coverage.

The third option is to provide unlimited deposit insurance. I strongly caution the Committee against adopting this approach. It is my view that the adoption of an unlimited deposit insurance program would be a profound policy error. Most importantly, as the FDIC recognized in its report, an unlimited deposit insurance system would entirely eliminate depositor discipline. Removing the incentive for sophisticated depositors to monitor their banks and reward well-managed banks with their deposits would create a far riskier banking system. Although the FDIC Report suggests that regulators might be able to offset this risk by imposing higher capital and long-term debt requirements and interest rate caps, such reforms would undermine the competitiveness of the banking system and lead to a further outflow of activity from the banking system. Further, most of the 4,600 insured depository institutions would be unable to either secure the necessary long-term debt or prudentially manage their risks subject to interest rate caps, especially during surges in inflation. The lessons of the 1970's should be instructive on this point. In addition, unlimited deposit insurance could place well-managed banks at a competitive disadvantage against poorly-managed banks as depositors would no longer care about the quality of their bank. Indeed, it may be that the biggest beneficiaries of unlimited deposit insurance are sophisticated investors who place deposits in troubled banks to secure higher returns knowing that they will be rescued by the FDIC if a bank fails.

### 3. Issues for the Committee's Consideration.

As the Committee examines potential deposit insurance reforms, I recommend that it consider the following issues:

#### a. The Impact of Technological Change.

One of the most notable facts around the collapse of SVB was the apparent speed at which significant deposits were withdrawn from the bank. According to the California Department of Financial Protection and Innovation, SVB received deposit withdraw requests of approximately $42 billion in an eight-hour period through the use of digital banking, fueled by commentary about SVB on social media.[27]

Although SVB may have had a more technologically-savvy depositor base than most banks, it is only a matter of time before digital banking becomes even more pervasive. The advent of digital banking certainly promises great benefits for consumers in terms of efficiency, convenience, and cost. However, it is critical that the deposit insurance program keeps pace with this ongoing technological change. This is therefore an apt time for Congress and the FDIC to conduct a reassessment of assumptions about the stickiness of deposits and the potential speed of bank runs. Based on those findings, additional changes may be needed in the operation of the deposit insurance program.

#### b. Effectiveness of the Resolution Process.

The easiest way to address a failing bank is for the FDIC to promptly orchestrate a purchase and assumption transaction, where another bank purchases the failing bank in its entirety and assumes all of its assets and liabilities. However, in the case of SVB and Signature, it took the FDIC more than two weeks to sell the assets of SVB and more than one week to sell the assets of

[27] California Department of Financial Protection and Innovation, *Review of DFPI's Oversight and Regulation of Silicon Valley Bank* (2023), p. 45-46.

Signature. And in each case, the FDIC was left with residual assets. It is still unclear why the FDIC was not able to promptly orchestrate a purchase and assumption transaction for SVB or Signature in their entireties. Accordingly, the Committee should examine the FDIC's resolution process and determine if further reforms are needed. Similarly, the prompt corrective action mandates established by FDICIA have not worked as anticipated to reduce losses to the deposit insurance fund by closing failing banks while they still have positive equity. The Committee should re-examine how prompt corrective action operates in practice to determine if any reforms can be made to improve the speed and effectiveness of bank resolutions.

**c. Treatment of Uninsured Depositors.**

As discussed above, the policy against protecting uninsured depositors set by FDICIA has been significantly eroded since the 2008 financial crisis. Indeed, federal banking regulators are taking significant regulatory actions for financial stability purposes to protect uninsured depositors – contrary to the policy set by FDICIA. For example, banking regulators recently issued an advanced notice of proposed rulemaking on imposing a long-term debt (LTD) requirement on regional banks.[28] Because most of these institutions have the vast majority of their assets in their depository, the LTD requirement would merely shift losses incurred in an institution's resolution from uninsured depositors to the LTD holders, which, again, is an outcome directly at odds with FDICIA. In some cases, there are sensible policy reasons for adopting a TLD requirement, but advancing that policy should first involve Congress amending FDICIA and setting clearer parameters around the protection of uninsured depositors.

[28] *The Resolution-Related Resource Requirements for Large Banking Organizations*, Advanced Notice of Proposed Rulemaking, Fed. Reg. Vol. 87, No. 204 (October 24, 2022).

### d. Ad Hoc SRE Assessments.

One problem with the SRE is that the determination of how assessments should be levied to cover losses incurred from SRE's use has been left to the discretion of the FDIC. This has made the assessment process less predictable, less fair, and less effective at reducing risks. Because assessments are now determined *ex post*, banks cannot proactively adjust their risk profiles to minimize their exposure to such assessments. A better approach would be for the FDIC to establish an assessment schedule prior to the use of the SRE and make the assessment calculations more risk-based.

### e. Discount Window Reform.

The Federal Reserve's discount window has never played the role Congress intended when it established the Federal Reserve System over a century ago, but it should be a key policy tool to prevent economic shocks from spreading throughout the banking system.[29] Unfortunately, discount window borrowing has acquired a stigma among banks, making even healthy banks reluctant to borrow from the window even when it could help mitigate emerging bank runs. The Committee should examine if legislative changes could help improve the reliability and operation of the discount window as such changes could strengthen the deposit insurance program.

### f. Recognize the Limitations of Deposit Insurance.

Finally, it is important to remember the limits of what can be achieved with federal deposit insurance. Although deposit insurance can greatly enhance the resilience of the banking system by reducing the risk of runs and mitigating the costs and spillover effects of bank failures, it cannot address all financial risks nor forestall on its own all financial crises. It works best when it focuses on its core purpose: protecting the deposits of everyday Americans and resolving failed banks.

[29] *See Meltzer*, p. 433., p. 433.

Leveraging the deposit insurance fund for other purposes would divert the FDIC's attention from its already demanding tasks and risks undermining the administration of the federal deposit insurance program.

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