COMPETITIVE ENTERPRISE INSTITUTE

WEBmemo

August 16, 2017 **No. 43**

Shrinking Government Bureaucracy

Rethinking the Federal Deposit Insurance Corporation

Free Market Reforms to Improve Financial Safeguards and Reduce Taxpayer Risk

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The Franklin D. Roosevelt administration and Congress created the Federal Deposit Insurance Corporation (FDIC) during the Great Depression as a response to runs on banks that left many depositors without access to their money (as part of the 1933 Banking Act, better known as Glass-Steagall). However, in return for confidence in the banking system, federal deposit insurance introduced a systemic problem of moral hazard—the incentive to engage in more risky behavior that results when adverse consequences are lessened by a third-party guarantee.

Banks are more likely to make risky investments knowing their customers' deposits are guaranteed. Customers, meanwhile, are less likely to pay attention to banks' business practices. If all banks are perceived as being equally safe, customers will choose based on other considerations beside sound investment practice, resulting in a loss of competitive market discipline in the banking system.

Ideally, the moral hazard of deposit insurance should be eliminated from the banking system by abolishing the FDIC, which would require legislation by Congress. If that were to prove not politically possible, the impact of moral hazard could be significantly lessened by reducing the FDIC's coverage limit. The coverage limit was raised to its current level of $250,000 from the pre-financial crisis level of $100,000, first as an emergency measure during the crisis,[1] then made permanent in the Dodd-Frank Act.[2] Congress should reduce the level back to $100,000 and enable the administration to then reduce it gradually to $50,000.

The median savings balance for an American household is $5,200, and the average is $33,766 (a number skewed upwards by a small number of very high account balances).[3] Therefore, reducing the coverage level to $100,000 and then $50,000 would still guarantee savings for most Americans, and would end an implicit subsidy or bailout for richer Americans, who have other options for storing their wealth.

Lowering coverage levels would also reduce the FDIC's incentive to over-supervise banks. With fewer public funds at risk, the FDIC's need for prudential supervision would be lessened. It also would lessen the incentive to engage in abusive practices like Operation Choke Point, an FDIC-led campaign to deny access to the financial system to legal but controversial businesses, like firearms dealers.[4]

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The FDIC's role in bank resolution should also be reduced, at least to the levels present before the financial crisis.

Finally, the Consumer Financial Protection Bureau (CFPB) should no longer have a seat on the FDIC's board or any role in bank supervision.

Notes

[1] Federal Deposit Insurance Corporation, "Emergency Economic Stabilization Act of 2008 Temporarily Increases Basic FDIC Insurance Coverage from $100,000 to $250,000 Per Depositor," news release, October 7 2008, https://www.fdic.gov/news/news/press/2008/pr08093.html.
[2] Federal Deposit Insurance Corporation, "Basic FDIC Insurance Coverage Permanently Increased to $250,000 Per Depositor," news release, July 21 2010, https://www.fdic.gov/news/news/press/2010/pr10161.html.
[3] ValuePenguin, "Average Savings Account Balance in the U.S.: A Statistical Breakdown," using data from the Federal Reserve's 2013 Survey of Consumer Finances, accessed July 17 2017, https://www.valuepenguin.com/banking/average-savings-account-balance.
[4] Iain Murray, "Operation Choke Point: What It Is and Why It Matters," *Issue Analysis* 2014 No. 1, Competitive Enterprise Institute, July 2014, https://cei.org/content/operation-choke-point.