POLICY SPOTLIGHT

More Bank Equity Means Less Reliance on Deposit Insurance

STEPHEN MILLER | MAY 2023

In a recent report, the Federal Deposit Insurance Corporation (FDIC) has explored reform options after extending unlimited deposit insurance in the aftermath of Silicon Valley Bank's (SVB's) and Signature Bank's failures. The report even lists private deposit insurance, which has worked well in other countries, as an option before perhaps prematurely dismissing it. However, the recent bank failures of SVB, Signature, and First Republic speak more to the dangers of making extensive use of run-prone funding, especially deposits with balances above $250,000, for which the FDIC provides no insurance. If banks instead funded with more equity, that would reduce the use of run-prone funding and the burden on the deposit insurance fund.

ON DEPOSIT INSURANCE AND BANK CAPITAL

Deposit insurance aims to reduce, if not eliminate, incentives for "first-come, first-served" runs by depositors; in principle, insured depositors won't run. However, US banks can fund with uninsured deposits (and other similar short-term, run-prone debt). In the last call reports filed in Q2 2022, Q2 2022, and Q1 2023, respectively, before SVB, Signature, and First Republic Bank failed, uninsured deposits equaled $151.6 billion, $79.5 billion, and $50.8 billion, respectively. That amounted to 86.4 percent, 89.3 percent, and 48.2 percent of their total deposit liabilities and 71 percent, 69 percent, and 23 percent of each bank's total asset funding, respectively. Tangible equity funded only about 8 percent of assets held by each bank.

If instead each bank funded asset holdings with only 8 percent uninsured deposits and 71 percent, 69 percent, or even 23 percent tangible equity, we would not have seen a run. Banks that fund with more equity capital tend to be more resilient when facing unexpected shocks because equity investors know they could lose their investment, and more equity funding relative to debt, including deposits, keeps a bank further away from insolvency.

CURRENT BANK CAPITAL COMPLEXITY

Since the late 1980s, bank capital requirements have increased moderately from historically low values but in the process became much more complex. Banks can now choose whether to hold assets that require more capital funding (such as commercial loans) or low or no capital (such as mortgage-backed securities or Treasuries and reserves). Under this approach, SVB, Signature, and First Republic each satisfied these complex capital requirements, but as during the previous crisis, this demonstrates that banks can comply with complex capital requirements even while in distress.

BENEFITS OF A SIMPLER, HIGHER APPROACH

Policymakers could eliminate these complex approaches to reporting capital and simply increase equity capital requirements, perhaps making room for simpler comparisons between accounting measures of capital, such as book or tangible equity, and the market value measures of equity, which equity investors already do. When the market measure lies above the accounting value, that could be a good sign but it may also mean that the bank is growing fast or taking more risk than is paying off for now. But when the market value falls below the accounting measure, that suggests the bank is performing poorly.

Lobbyists argue that equity is an expensive funding source and that further increases would reduce lending. Yet research shows that increasing equity capital requirements to 15 percent of total assets passes reasonable cost-benefit analysis. While higher equity requirements may raise the cost of borrowing, banks with higher levels of tangible equity are more likely to lend through economic cycles, including downturns, which helps sustain economic growth over the long run.

KEY TAKEAWAY

The FDIC has put forth proposals to reform deposit insurance following recent bank failures. The common denominator in these failures was the heavy reliance of each bank that failed on uninsured deposits, a form of short-term, run-prone funding. If banks instead funded with considerably more equity, reliance on deposit insurance would diminish.

FURTHER READING

Federal Deposit Insurance Corporation, *Options for Deposit Insurance Reform*, May 1, 2023.

James R. Barth and Stephen Matteo Miller, “Benefits and Costs of a Higher Bank Leverage Ratio” (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, November 28, 2017).

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John Cochrane, “Toward a Run-free Financial System,” Chapter 10 in *Across the Great Divide: New Perspectives on the Financial Crisis*, ed. Martin Neil Baily and John B. Taylor (Stanford: Hoover Institution Press, 2014).

Thomas L. Hogan and Kristine Johnson, “Alternatives to the Federal Deposit Insurance Corporation,” *Independent Review* 20, no. 3 (2016): 433–54.

Stephen Matteo Miller, “Why Certain Corporations Get Bailed Out & What You Might Do About it” *FinRegRag*, October 16, 2020.

Stephen Matteo Miller, “On SVB’s Failure and Other Bank Distress: What’s Going On?” *FinRegRag*, March 14, 2023.

Stephen Matteo Miller, “Basel III and Excess Reserves: Another Case Study of the Unintended Consequences of Risk-Based Capital Requirements” (Mercatus Policy Brief, Mercatus Center at George Mason University, Arlington, VA, June 29, 2021).

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