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RETHINKING WHICH ACCOUNTS QUALIFY FOR DEPOSIT INSURANCE

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ABSTRACT

In a bid to understand how the Federal Deposit Insurance Corporation (FDIC) can aid in promoting financial stability, economists have recently called the definition of core deposits into question. Deposit insurance is extended to core deposits because they represent the stable funding base that the banking system relies on for liquidity. But the criteria used by the FDIC to determine whether a funding source is insurable are not consistent with any objective criteria available to define core deposits. Herein I assess current FDIC criteria and whether the kinds of deposits currently insured are good candidates for coverage. I find brokered deposits to be particularly ill-suited to insurance. The FDIC could further promote banking-system stability while simultaneously reducing potential costs by ending its extension of insurance to brokered deposits.

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The dollars in our wallets are maintained by the Federal Reserve, and, as the sign on the door to every institution insured by the Federal Deposit Insurance Corporation (FDIC) reminds us, our "deposits are backed by the full faith and credit of the United States government." For most purposes, currency in circulation is a direct substitute for funds deposited in a bank account. A deposit is only good if it can be redeemed into currency, which depends on the solvency of the depository. The FDIC safeguards the nation's depositors by pledging to pay out all insured deposits in the event that the private depository is met with illiquidity or insolvency.

The FDIC does not receive direct congressional funding. Depository institutions pay premiums into a deposit-insurance fund, which is used to pay for any losses caused by an insolvent bank. Most of these losses are the insured deposits held by a failed bank, as well as any administrative costs of managing a failed bank held in receivership. As a result, defining which deposits qualify for insurance is of prime importance for the FDIC's operations.

Section 1506 of the Dodd-Frank Act of 2010 required that a study be commissioned on core deposits and brokered accounts. The goals of this study were twofold.[1] First, Congress wanted to reassess the definition of a "core deposit" used for the purpose of calculating the insurance premium assigned by the FDIC. Second, a closer look at the relationship between core deposits and the larger US economy was warranted, particularly concerning any stabilizing effects that could accrue to the banking sector by redefining core deposits.

In this paper I look at why deposit insurance exists, and to what extent different financial accounts should be insured. I construct alternative criteria to gauge the appropriateness of a funding source's coverage by the FDIC and conclude with some further policy changes that would reduce the costs of insurance and promote the stability of the banking sector, as well as the broader financial arena.

1. Federal Deposit Insurance Corporation, *Study on Core Deposits and Brokered Deposits* (FDIC, 2011), http://www.fdic.gov/regulations/reform/coredeposit-study.pdf.

I. WHY DEPOSIT INSURANCE?

Congress established the FDIC in 1933 as a response to widespread bank failures during the Great Depression. In a bid to restore confidence in the financial system, the federal government pledged to safeguard deposits through deposit insurance. The Federal Deposit Insurance Act of 1933 obliges the payment of deposit insurance "as soon as possible" to mitigate any disruption caused by a bank failure.[2] These payments are enabled through the deposit-insurance fund, as well as through an emergency line of credit from the US Treasury if necessary. To its credit, no depositor has ever lost a penny of insured deposits in the FDIC's history, and payouts to insured depositors generally happen within one business day.[3]

One unfortunate side effect of a fractional-reserve banking system is the omnipresent possibility of bank illiquidity. A bank takes on deposits that are payable on demand while financing the asset side of its balance sheet with securities (typically loans) of longer maturity. Using short-term deposits to fund longer-term investment projects leaves banks open to the risk that new funding will not be renewed (or rolled over), thus rendering the bank illiquid. A bank will not generally be exposed to the illiquidity of the maturity mismatch it generates so long as withdrawals are largely uncorrelated with one another. Given the law of large numbers, on any given day only a small percentage of total depositors demand their funds. There remains a possibility, however, that a sufficient number of depositors will claim their funds simultaneously and the bank will become illiquid. The mix of illiquid assets with liquid liabilities can give rise to panics among depositors fearful of suffering a loss on their deposited funds. This incentive holds regardless of the actual financial position of the bank, as any fractional-reserve bank will be exposed to illiquidity and cannot perfectly predict when and to what extent depositors will make withdrawals.[4]

The FDIC provides insurance to remove the possibility of a bank run. By guaranteeing a deposit to a sufficient amount, the FDIC has effectively eliminated the possibility of a bank run, because no depositor need worry that his funds will not be paid back on demand and at par value.[5]

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2. See FDI Act, 12 U.S.C. 5 1821(f).

3. Federal Register, "Deposit Insurance Regulations; Definition of Insured Deposit," proposed rule, 78 Fed. Reg. (2013): 11604–9, http://www.federalregister.gov/articles/2013/02/19/2013-03578/deposit-insurance-regulations-definition-of-insured-deposit.

4. Douglas W. Diamond and Philip H. Dybvig, "Bank Runs, Deposit Insurance, and Liquidity," *Journal of Political Economy* 91, no. 3 (1983): 401–19.

5. Historical alternatives to dealing with the common bank run exist—including the suspension of convertibility of deposited funds, clearinghouse loans to finance short-term illiquidity and banks cross-guaranteeing each others' deposit bases. See George Selgin and Lawrence H. White, "The Option Clause in Scottish Banking," *Journal of Money, Banking and Credit* 29, no. 2 (1997): 270–73; Richard H. Timberlake Jr., "The Central Banking Role of Clearinghouse Associations," *Journal of Money, Credit and Banking* 16, no. 1 (1984): 1–15; Charles W. Calomiris, "Deposit Insurance: Lessons from the Record," *Economic Perspectives*, Federal Reserve Bank of Chicago, 13 (May–June 1989): 10–30; James E. Hartley, "Mutual Deposit Insurance: Other Lessons from the Record." *Independent Review* 6, no. 2 (2001): 235–52.

While deposit insurance solves the apparent problem of depositors withdrawing their funds en masse, it creates the secondary problem of moral hazard.[6] Removing the threat of losses diminishes the incentive for a depositor to monitor the financial position of his bank. (Perhaps unsurprisingly, the first states in the United States to experiment with mandated deposit-insurance plans were also those with poorly capitalized, state-chartered banks.)[7] In response, the FDIC also undertakes a monitoring and regulating role of the financial system to ensure that its potential payouts are minimized. It does so through two avenues, one active and the other passive.[8]

The FDIC actively monitors the risk-based capital ratios of insured banks. When a bank's capital ratio falls below 8 percent, it is given a warning. A drop below 6 percent can result in a mandated change of management or a forced corrective action. Finally, when the bank's capital ratio falls below 2 percent, it is termed "critically undercapitalized," the institution is closed, and the FDIC is appointed as the receiver of the bank. In this role the FDIC must resolve the failed institution and pay out the guaranteed amount to insured depositors.

The FDIC also passively monitors banks by limiting the types and amounts of liabilities it will guarantee. By limiting insurance to "core deposits," it leaves large depositors and holders of noncore deposits exposed to potential losses. This exposure creates an incentive for these depositors (and lenders) to monitor a bank's investment portfolio, and to allocate capital to only those banks deemed sufficiently strong to make good on their liabilities. Therefore, it is critically important that the FDIC accurately define which bank liabilities constitute core deposits. A sufficient amount must be included to remove the incentive for a bank run, but guaranteeing too many noncore deposits will reduce the incentive for depositors to aid in the monitoring of depository institutions and lead to an unnecessary increase in moral hazard.

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6. Sudipto Bhattacharya, Arnoud W. A. Boot, and Anjan V. Thakor, "The Economics of Bank Regulation," *Journal of Money, Credit and Banking* 30, no. 4 (1998): 745–70; Clifford F. Thies and Daniel A. Gerlowski, "Deposit Insurance: A History of Failure," *Cato Journal* 8, no. 3 (1989): 677–93. While the literature more commonly focuses on increased risk taking by bankers as the consequence of the moral hazard of deposit insurance, Bert Ely looks at "regulatory moral hazard." Any deposit-insurance fee will be paid by solvent banks, which are also not able to easily avoid paying such fees. As a consequence, regulatory diligence will have a tendency to decrease, because it will always be paid by surviving banks, which effectively cover losses from bank insolvencies caused by lax regulatory policies. Bert Ely, "Regulatory Moral Hazard: The Real Moral Hazard in Federal Deposit Insurance," *Independent Review* 4, no. 2 (1999): 241–54.

7. Nicholas Economides, R. Glenn Hubbard, and Darius Palia, "Federal Deposit Insurance: Economic Efficiency or Politics?," *Regulation* 22, no. 3 (1999): 15–17.

8. It is questionable how effective the FDIC is in distinguishing between bank illiquidity and insolvency. George G. Kaufman finds that over 90 percent of emergency lending during the US S&L crisis in the 1980s went to institutions that subsequently failed. George G. Kaufman, "Do Lender of Last Resort Operations Require Bank Regulation?" (paper presented at the American Enterprise Institute conference, Is Banking Regulation Necessary?, in Washington, DC, October 27, 1999).

II. WHAT ARE CORE DEPOSITS?

In the normal course of business, even as some bank customers add to or withdraw from their accounts, a significant part of the money on deposit at banks remains untouched. These stable deposits represent "core deposits," which banks use to fund their lending operations. Core deposits are not defined by statute but rather through convention. They represent the stable funding base utilized by a bank. As such, core deposits typically include demand deposits, negotiable orders of withdrawal (NOW), automatic transfer service (ATS) accounts, money-market demand accounts (MMDAs), and most savings and time deposits under $250,000.[9]

From the fractional-reserve bank's perspective, core deposits represent a mostly stable funding base due to the fact that they are less interest-rate sensitive than other assets. The key problem facing such a bank is balancing the maturity mismatch between its on-demand liabilities and its long-term assets. Since core deposits show little fluctuation in their redemption demands, they provide the bank with predictable "costs," as well as a measure of customer loyalty. Core deposits, thus, provide an element of stability to the otherwise potentially destabilizing activity of maturity transformation.

Because of the importance of the deposits for both depositors and banks, the FDIC insures all accounts that are categorized as core deposits. Doing so removes the incentives for depositors to monitor the financial positions of their banks, however, and can potentially breed destabilizing forces. To mitigate these destabilizing forces, as well as to limit the amount of potential payouts it is obliged to make, the FDIC guarantees deposits only up to a finite amount, as shown in table 1.

The onset of the crisis in 2008 ended the longest continuous period that deposit insurance had undergone in the United States without an increase in the insurable limit. The 150 percent increase in the limit to $250,000 was a large increase in nominal terms, though the resulting maximum insurance limit was still less, in inflation-adjusted terms, than in 1980. In both real and nominal terms, the FDIC today provides deposit coverage far in excess of its original level of coverage. Since the FDIC's inception in 1934, the nominal insurable limit has increased a hundredfold, which represents a 600 percent increase when adjusted for inflation.

9. While essentially identical to the common demand deposit, the NOW account is a remnant of Regulation Q. Active until July 2011, Regulation Q mandated that interest could not be paid on demand deposits. NOW accounts were structured to comply with Regulation Q while still providing an interest-bearing deposit account. Regulation Q once allowed for an "artificially sharp distinction between no-yield money and no-check savings," which in turn allowed the Federal Reserve more defined control over the money supply. Roger W. Garrison, "Interest-Rate Targeting During the Great Moderation: A Reappraisal," *Cato Journal* 29, no. 1 (2009): 190. This sharp distinction was no longer necessary as monetary policy moved from money-supply targeting to interest-rate targeting under the Volcker Fed.

TABLE 1. FDIC INSURABLE LIMIT PER BANK

	Insurable limit ($)	Insurable limit ($2008)
1934	2,500	40,168
1935	5,000	78,578
1950	10,000	89,337
1966	15,000	99,677
1969	20,000	117,331
1974	40,000	174,688
1980	100,000	261,290
2008–present	250,000	250,000

Source: FDIC, "A Brief History of Deposit Insurance in the United States" (paper prepared for the International Conference on Deposit Insurance, Washington, DC, September 1998), http://www.fdic.gov/bank/historical/brief/brhist.pdf.

III. WHAT QUALIFIES A DEPOSIT FOR INSURANCE?

The FDIC establishes five criteria for evaluating whether a source of bank funding is a core deposit and consequently whether it qualifies for insurance.[10] These criteria are important, as they determine the relevant trade-off between the amount of deposits insured by the FDIC and the degree of residual monitoring activity by uninsured depositors.

1. *Interest rates*. Deposits that offer higher interest rates are generally riskier. If interest rates are high relative to the industry, a bank may be taking on undue risks and require sanctions or withholding of deposit insurance from its products. The FDIC discourages extending insurance to high-interest-rate products.
2. *Whether the deposits can be gathered quickly in large amounts*. Deposits that can be gathered quickly, as is the case with Internet-based and high-interest-rate products, are unstable in the sense that they can also leave the bank quickly. The FDIC discourages insuring financial products that are easily gathered (and easily shed).
3. *Customer relationship*. Deposits received based on a customer relationship are more stable than those that do not go through the time-consuming exercise of building a relationship. The FDIC will generally assign a greater desirability for insurance to financial products that have resulted from a customer-banker relationship.
4. *Liquidity*. Uninsured deposits have the ability to exacerbate liquidity problems in a weak bank because frightened depositors may shift their uninsured

10. FDIC, *Study on Core Deposits*, 49–52.

deposits to more stable accounts. The corollary holds true as well. Highly liquid assets that can be easily drained from a bank are good candidates for insurance to remove the incentives that could lead to en masse redemptions.

5. *Time to maturity*. If a deposit has a low time to maturity (or few restrictions on early withdrawal for a time deposit), that increases the probability that depositors will withdraw it from a weak institution. Financial products with shorter maturities (or those closer to maturity) are more easily redeemed, and as such they can benefit from insurance to remove the incentive individuals have to withdraw them too quickly from their bank.

Setting criteria for deposit insurance coverage is crucial to safeguarding systemically important assets while not fomenting a sense of complacency. Since the defining characteristics of a currency substitute are that it is redeemable on demand and at par value, any criterion addressing these issues would shed light on the demand by depositors for insurance. (This includes criteria 4 and 5, as well as criterion 1 to the extent that deposits do not necessarily represent an interest-bearing transaction.)[11]

In a similar vein, one could look to criteria that assess a depositor's awareness of the risks involved in a fractionally reserved deposit when deciding whether to provide insurance to a funding source.

The FDIC must consider the trade-off between the amount of deposits to insure and the increased monitoring activities it will need to undertake to replace those depositors unconcerned with their bank's liquidity. The FDIC chooses the insurable limit in making this decision (while implicitly assuming that larger deposit holders are more financially literate and understand the risks involved), but an alternative metric would be a direct assessment of the depositor's knowledge of the undertaking. While no easy measure exists to gauge depositors on their knowledge directly, certain accounts that are channeled through a financial intermediary (such as an investment advisor) imply greater knowledge of the risks involved. As such, a deposit made in such circumstances would not require insurance, or at least would not necessarily fall prey to the self-fulfilling panic described by Diamond and Dybvig.[12] None of the FDIC's current criteria measure for depositor financial literacy, though criterion 3 on customer relations comes close.

To set criteria from the opposite side of the transaction, one would need to look to the determinants of how stable and important the deposit is to the financial stability of the bank. Criteria 1, 2, 4, and 5 all measure how stable the deposit is within the corpus of the bank's assets, and as such help to determine how important it is that they be insured.

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11. Jesús Huerta de Soto, *Money, Bank Credit and Economic Cycles*, trans. Melinda A. Stroup (Auburn, AL: Ludwig von Mises Institute, 2006), ch. 1; Philipp Bagus and David Howden, "The Legitimacy of Loan Maturity Mismatching: A Risky, But Not Fraudulent, Undertaking," *Journal of Business Ethics* 90, no. 3 (2009): 399–406.
12. Diamond and Dybvig, "Bank Runs."

However, some of the criteria to assess whether a source of funding qualifies for deposit insurance are questionable. Relying on the method that procures funding, as in criterion 2, obfuscates the issue of whether the funding is stable by instead focusing on how quickly it can be gathered. Criterion 3 begs the question by claiming, paradoxically, that insured deposits are stable, but also that they consequently require insurance to maintain their stability. Whether a funding source is a candidate for insurance should depend on its stability as a stand-alone uninsured deposit, not whether it would be more stable if insured (as it almost assuredly will).

While determining what deposits should be insured poses no significant theoretical problem, practical issues plague the actual decision. If deposit insurance did not result in moral hazard, for example, there would be no significant cost to insuring a deposit, save for administering the insurance fund. Since moral hazard does exist, and can only be imperfectly tempered through regulatory solutions, the FDIC must rely on depositor monitoring to operate effectively.[13] Whether this monitoring comes directly, e.g., from depositors selecting better-capitalized banks, or indirectly, e.g., from banks maintaining well-capitalized positions based on reputational concerns, is of little import. What is a relevant concern for any deposit-insurance plan is identifying those depositors most at risk and those deposits most systematically important to a well-functioning financial system.

IV. BROKERED DEPOSITS

Those funds the FDIC labels as core deposits *generally* coincide with the scope of insured accounts. In one significant exception, the FDIC has traditionally extended insurance to a deposit base that does not meet its own definition of core deposits: brokered deposits.

Brokered deposits arise when a third party places a client's money on demand or in short-term loans. A common example of such a deposit would be where several individuals deposit a small sum of money with their broker. The broker in turn compiles these small deposits into one large-denomination deposit, which is then invested or deposited into an investment vehicle. The economies of scale available through this practice enable brokers to garner higher interest rates on their deposits than would otherwise be feasible, and as a consequence the practice also opens a new funding source, because depositors are attracted to these higher returns. Under current FDIC rules, only well-capitalized banks (i.e., those with a capital ratio above 10 percent) are allowed to solicit or accept brokered deposits. Banks that do accept these funds have access to an alternative pool of funding, as well as a reduction in handling costs by reducing the number of depositors for a given amount of deposits. Together with core deposits, brokered deposits comprise a bank's deposit base.

13. Many financial products now offered by banks are direct responses to bypassing remnant legislations, e.g., sweep accounts to avoid reserve requirements or NOW and ATS accounts to avoid Regulation Q.

While brokered deposits may augment a bank's liquidity position, they represent a tenuous funding source. As these deposits are generally more interest-rate sensitive than generic deposits, their stability (in terms of both turnover and likelihood of remaining deposited with a bank) can be unstable. The FDIC for its part has acknowledged these problematic aspects of brokered deposits, but it has created only a partial solution. Since the FDIC views a blanket prohibition on the use of brokered deposits as unduly restrictive, it has reached a compromise by insuring brokered deposits up to a limit of $250,000 per *broker* per bank. One effect of this limit is to temper the amount of deposit brokering any one broker can intermediate. As a result of this, a bank accepting a brokered loan is not overly exposed by sudden withdrawals instigated by the broker (either directly through the broker moving his depositors' funds to a different bank or indirectly through depositors withdrawing their money due to a loss of trust in their broker). By the end of Q1 2011, $562.3 billion of brokered deposits provided funding to the banking system (table 2). Of these, almost 85 percent ($477 billion) are insured by the FDIC.

TABLE 2. BROKERED DEPOSITS HELD BY INSURED DEPOSITORIES (MARCH 31, 2011)

SIZE OF BANK	NUMBER OF BANKS	TOTAL BROKERED DEPOSITS ($ BN.)	SHARE OF DOMESTIC DEPOSITS (%)
Under $1bn.	6,904	47.1	14.9
$1–$10 bn.	563	104.7	13.7
$10–$50 bn.	71	122.7	12.0
Over $50 bn.	36	287.8	59.4

Source: FDIC, "Study on Core Deposits and Brokered Deposits," July 8, 2011, http://www.fdic.gov/regulations/reform/coredeposit-study.pdf.

Note that fewer than half of all FDIC-insured banks report holding brokered deposits, and that these brokered accounts are concentrated in the largest banks in the country—those with assets greater than $50 billion. Thus, the main beneficiaries of federally insured broker accounts are the largest banks in the country. These banks have the most diversified deposit base and are thus the least in need of deposit insurance.

Because the beneficiary banks of these brokered deposits are also the country's largest banks, there is the ever-present danger that the "too big to fail" issue will lead to less-prudent asset management than would otherwise be the case. Brokered deposits are an attractive but also tenuous and potentially unstable funding source. While insurance grants benefits to banks when deposits are concentrated and susceptible to correlated withdrawals, brokered deposits can span geographic, industry, and demographic divides. This can result in significantly less correlation between the redemption demands of their deposited components. As a result, banks

taking brokered deposits are less in need of insurance to remove the incentives for depositors to withdraw funding in light of the expectation that other depositors will also do so.

At the same time, the typical depositor in a brokered fund is wealthier than the standard holder of a core deposit. Due to their status as a form of investment, brokered deposits are usually funded by individuals already meeting their base currency need through a core deposit. In this way, insurance on brokered deposits is regressive, because the benefits accrue primarily to wealthier investors at the expense of more common core-deposit holders.[14] This benefit is a subset of the larger wealth transfers inherent in deposit insurance. With any one-size-fits-all policy, well-run banks will be overcharged for their deposit insurance while poorly run banks will be undercharged.[15]

Insuring brokered deposits gives a benefit to the bank holding them because the insurance provides an extra guarantee to depositors that is not necessary. On the one hand, these deposits are not primarily undertaken as an uncertainty hedge, as is the case with other deposits. Brokered deposits instead represent a demand to remain liquid while still participating in a potentially lucrative investment. In distinction, core deposits are not undertaken with the primary goal of earning the depositor a profit but instead with the goal of providing a safety blanket should an unforeseen event arise. On the other hand, there is no significant naïveté on the side of depositors in a brokered fund. While they may not personally understand the risks involved in a fractional-reserve deposit account, their brokerage surely does. Since all brokered funds go through, by definition, a financial intermediary (i.e., the broker), depositors are in effect outsourcing the understanding of how the deposit-taking side of the financial system functions. Therefore, there is no significant knowledge gap that must be protected via deposit insurance.

Because the FDIC subsidizes both brokerages and banks accepting brokered deposits through its insurance, we may expect them to be used in excess of what is prudent. The risks of banking instability are increased as a consequence, as brokerages entice their clients to partake in this guaranteed "investment," while banks shift to this relatively lower-cost (though less-stable) funding source. Indeed, failed banks over the past four years have relied more heavily on brokered deposits than on their conventional core-deposit base. The rationale is simple—large quantities of brokered deposits can be collected, in part due to the increased interest banks

14. The author would like to thank an anonymous reviewer for pointing this out.

15. Bert Ely, "Regulatory Moral Hazard." This two-tiered pricing system (for well- and poorly run banks) is similar to the two-tiered deposit-insurance system in place from 1989 to 2006, where the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) could both be utilized by deposit-taking institutions. Depending on the benefits sought, banks could shift funds from being covered under one system to being covered under the other. At one point, SAIF premiums were five times higher than BIF premiums, leading Alan Greenspan to lament that the government was enforcing "two different prices for the same item—namely, government-mandated deposit insurance." David B. Sicilia and Jeffrey L. Cruikshank, *The Greenspan Effect* (New York: McGraw-Hill, 2000), 97–98.

can offer depositors (through investing the proceeds in riskier assets and decreased management costs), and depositors have little incentive to assess the broker or the bank's stability because the funds are FDIC insured. While these problems also exist in various degrees with core deposits, the economies of scale offered by brokered deposits and their tenuousness as a funding source breed instabilities. Brokered deposits are relied on for quick liquidity, but they can also reverse quickly, leading to an illiquidity crisis that drains deposit-insurance reserves.

V. CORE DEPOSITS AND BANKING STABILITY

The amount of core deposits held in a bank is closely related to its probability of default. Banking failures are associated with higher levels of brokered deposits, and firms more dependent on them have lower post-insolvency resolution values.[16] Two points bear mentioning in this regard: (1) when brokered deposits are substituted for core deposits, banks face an elevated default probability,[17] and (2) when uninsured brokered deposits are substituted for other noncore deposits, banks do not see an effect on the probability of bank failure.[18] A shift in funding from core to brokered deposits increases bank instability and, with it, raises FDIC costs for resolving these failed institutions.

Indeed, the FDIC has recognized the instability that insured brokered deposits produce.[19] In particular, it notes four aspects of the problem: (1) brokered deposits allow banks to attract large volumes of funds from outside their natural market area, irrespective of their knowledge of these new markets; (2) insurance provided to brokered funds eliminates the need for depositors to analyze the viability and sustainability of the underlying financial institution; (3) reduced market discipline results, because a link is severed between the providers of funds and their end users; (4) insured funds allow for poorly managed and illiquid institutions to function longer than market forces would generally dictate, thus increasing FDIC resolution costs.

Insuring deposits allows for greater ease of substitution between currency and deposit accounts. Because insurance stabilizes the demand for deposits, banks benefit through greater ease in planning their lending operations.[20] The cost of providing the benefit of security to depositors and simplified planning to depositories is a reduction in private-sector monitoring of liquidity and solvency, as well as the

16. Rosalind L. Bennett and Haluk Unal, "The Cost Effectiveness of the Private Sector Organization of Failed Banks" (FDIC Center for Financial Research Working Paper No. 2009-11, FDIC Center for Financial Research, Arlington, VA, 2011), http://www.fdic.gov/bank/analytical/cfr/2009/wp2009/CFR_WP_2009_11.pdf; William P. Osterberg and James B. Thomson, "Underlying Determinants of Closed-Bank Resolution Costs," in *The Causes and Costs of Depository Institution Failures*, ed. Allin F. Cottrel, Michael S. Lawlor, and John H. Wood (Amsterdam: Kluwer Academic Press, 1995).
17. FDIC, *Study on Core Deposits*, 36.
18. Ibid., 37.
19. Ibid., appendix 8.
20. Ibid., 36–37.

potential costs of resolving failed institutions. In continuing to insure brokered deposits, the FDIC not only opens itself up to larger potential losses through insurance claims, but it also promotes banking-sector instability through decreased depositor discipline.

The Independent Community Bankers of America notes that due to the broad definition assigned to brokered deposits, depositors utilize local, community banking services less as brokers shift their funds to larger markets.[21] Clients can deposit their money at arm's length through brokered accounts, while lacking knowledge of how their deposits will be spent. This severs the depositor-banker relationship, which the FDIC recognizes is important in building a stable funding base.[22] While attractive to depositors, this places potential losses on the FDIC through insurance claims, and it also increases the pressure on local banks to find a deposit base to service the needs of their communities. The standard deposit base that local depositors would have provided is instead brokered into what is more akin to an investment than a standard deposit. Insurance extended to brokered loans gives these depositors undue risk-adjusted returns, while simultaneously placing increased pressures on local banks to secure funding.

The American Bankers Association holds that the FDIC should avoid classifying deposits based on the channel through which they are obtained and should instead focus on the specific characteristics of the deposit.[23] This would require a rewriting of the criteria the FDIC uses to assign insurance to a financial product. It would have the benefit of focusing attention on the question of *why* certain financial products should be insured instead of on the proximal results of such insurance.

In looking for new classification criteria to use in determining which deposits should be insured, the FDIC should take a closer look at some of its own conclusions from its recent assessment of core and brokered-deposit funding (FDIC 2011). While most of the FDIC's response to section 1506 of the Dodd-Frank Act has been to more effectively monitor the core deposits of the banking sector, an alternative exists. By limiting its deposit coverage of some financial products, the FDIC can garner the aid of private investors in monitoring bank stability. Such private-sector monitoring is notably absent in today's environment, where high coverage limits on a wide range of financial products remove the incentive for private agents to take an interest in their bank's stability. In particular, removing FDIC insurance coverage from brokered accounts would solve five problems:

21. Letter from Independent Community Bankers of America to Sheila Bair, April 29, 2011, http://www.icba.org/files/ICBASites/PDFs/cl042911.pdf.

22. See Mitchell Berlin and Loretta J. Mester, "Deposits and Relationship Lending," *Review of Financial Studies* 12, no. 3 (1999): 579–607.

23. American Bankers Association, "Change Rules Governing Core, Brokered Deposits" (American Bankers Association, 2011), http://regreformtracker.aba.com/2011/05/aba-change-rules-governing-core.html.

1. Brokered deposits are riskier investments than other insured accounts. They are not concerned primarily with the safe return of their funds (as is the case with demand deposits) but rather with seeking a suitable risk-return trade-off. To the extent that the FDIC removes the risk of the deposit, the depositors will seek simply the highest returns possible. For the bank accepting brokered deposits, this implies a search for the highest-yielding investments, which typically are associated with elevated risk levels.

2. Because depositors in brokered accounts seek greater returns, holding them accountable for losses would avoid promoting risky investment activity. Spreading the costs of FDIC insurance among all depositors (and potentially taxpayers) reduces the accountability of these original depositors to their losses. It also skews the risk-return trade-off by reducing (or eliminating) risk while not compromising the expected return.

3. Removing insurance from brokered accounts would hold brokers accountable to their clients in reporting the real risk of investing in riskier activities. Deposit insurance guarantees that the original deposit will be repaid, so at present there is no threat of the loss of principle to the depositor. As a result, the depositor's emphasis may be placed solely on maximizing gains instead of on balancing that goal with minimizing losses.

4. Removing insurance from brokered deposits will still allow banks to utilize them as a funding source. The only difference will be that to obtain funding through this channel, banks, brokers, and depositors will have to be accountable for potential losses. Thus, no funding options are removed from the banks' existing scopes of operations, as long as the risk profiles can be justified relative to other investments.

5. The FDIC already recognizes that brokered deposits are not stable enough to be included in the calculation of core deposits. By continuing to insure these funds, the FDIC promotes their use and the belief among depositors that brokered deposits offer superior risk-return profiles compared with more conventional investment funds. The role of the FDIC is to secure core deposits that provide a substitute for holding currency, not to mitigate investment risk. Eliminating insurance on brokered deposits would entice investors to hold their cash requirements in core deposits, thus strengthening banks' balance sheets. Alternatively, removing insurance may encourage individuals to move their deposits into more conventional investments, thus removing the illusion of stable funding from the banking system. Instead of investing directly in equity or debt markets, brokered depositors currently turn to the banking sector to make their investment decisions. One unfortunate result is an unwarranted emphasis on debt financing as banks loan out these deposits in their intermediary role. Without the advantageous risk-adjusted returns of brokered accounts, equity investments would be stimulated at the expense of debt finance.

VI. CONCLUSIONS

An adequate core-deposit base is necessary to promote bank stability. It is unclear that including brokered deposits to boost this number increases the deposit base, and to the extent that it provides an illusion of stable funding it is actually destabilizing. The continued role of the FDIC in insuring brokered deposits removes market discipline and increases instability at the taxpayers' expense. Insuring these deposits may also harm the competitiveness of the banking industry. If the FDIC were to cease insuring brokered deposits, banks would have to rely on a stable deposit base to finance their lending activities.

The banking crisis of 2008 demonstrated that monitoring the quality of the banking sector's assets is very difficult, because asset quality is subject to sudden reversals. One alternative is to focus on banking-sector liabilities. From the banking sector's standpoint, these liabilities—whether deposits on demand or short-term loans—are problematic because if many depositors redeem them simultaneously, banks face illiquidity and eventually insolvency. Brokered deposits in particular represent a troublesome area because they fulfill none of the criteria that the FDIC has established as necessary for a funding source to qualify for insurance.

The FDIC can streamline its operations and promote a more stable financial sector by correctly identifying which funds should qualify for insurance. Insuring only those deposits identified as being both germane to a bank's maturity mismatch *and* deposited by an individual with the motive of having on-demand availability would hold banks accountable for the full costs of offering risky "deposit-like" products, while simultaneously removing the subsidized gains to depositors holding these "deposit-like" accounts. To the extent that brokered deposits appear similar to core deposits, yet lack the same uncertainty-hedging motive, removing them from the list of insurable funds would promote banking-sector stability by strengthening bank balance sheets.