

PRIVATIZING DEPOSIT INSURANCE

CHRISTINA PARAJON SKINNER*

For the past 90 years, the federal government has provided insurance to bank depositors against the risk of loss associated with a bank’s failure. In many ways, this insurance scheme—managed by the Federal Deposit Insurance Corporation (“FDIC”)—is the bedrock of banking law. FDIC insurance aims to preempt bank runs by ensuring that depositors remain confident in the security of their funds, even when turbulent times hit. In practice, however, FDIC insurance has suffered from one key design flaw—it has never managed to reconcile the trade-offs between the moral hazard it produces and the financial stability it ensures. In large part, this is due to policymakers’ inability to credibly commit to maintaining the limits on insurance payouts that Congress statutorily sets. Over the past forty years, the cap has consistently been lifted to protect uninsured depositors in each successive banking crisis.

This Article argues for a fundamental reset in deposit insurance law by privatizing insurance for deposits above the FDIC cap. Requiring banks to form private insurance schemes has been attempted in the past on the state and local levels, but lessons from those experiences appear to have been forgotten or misconstrued. Private insurance would put more skin in the game in banking supervision and reduce the taxpayer burden associated with bank resolution, while delivering the same (if not more) confidence than federal deposit insurance alone currently does.

TABLE OF CONTENTS

INTRODUCTION	455
I. FEDERAL DEPOSIT INSURANCE LAW: A PRIMER	462
A. <i>The Deposit Insurance Dilemma</i>	462
B. <i>The Origins and Evolution of Federal Deposit Insurance Law</i>	466
C. <i>The Rise and Reform of the Implicit Guarantee</i>	473
II. PRIVATELY INSURING DEPOSITS OVER THE FDIC CAP	480
A. <i>A Public-Private Insurance Model</i>	480
B. <i>Private Deposit Insurance Schemes</i>	483
1. <i>The Failures</i>	483
2. <i>The Successes</i>	488
III. REEVALUATING THE BANK SAFETY NET	493
CONCLUSION	497

INTRODUCTION

In spring 2023, the United States public witnessed three historic bank failures—Silicon Valley Bank (“SVB”), Signature Bank, and First Republic

* Associate Professor, The Wharton School of the University of Pennsylvania. With thanks to Bill Nelson and Hal Scott for helpful feedback and conversations on this draft. Keiko Wolfe provided outstanding research assistance.

Bank.¹ One of the most dramatic features of the bank failures was the remarkable interventions undertaken by the banks' regulators and the U.S. Treasury to maintain confidence in the broader banking system. Two days after SVB and Signature failed, the U.S. Treasury Secretary acted upon a recommendation from the Board of Governors of the Federal Reserve and the FDIC to promise—on the full faith and credit of the United States—to make all depositors whole, immediately.² Because a significant number of these banks' depositors held balances that far exceeded the \$250,000 cap on federal deposit insurance, this action prompted concern about a de facto expansion of the federal government's safety net, which could create the wrong incentives going forward.³

In broad strokes, deposit insurance is a policy that ensures bank depositors their money is secure in their accounts, up to a certain limit, regardless of the solvency of their bank. Without it, should a bank fail, depositors would own a claim against the bank in bankruptcy and entitled to collect whatever proceeds were available to them after the sale of the bank's good assets. In short, this means that in the event of bank failures, depositors would likely collect cents on their deposit-dollars and have to wait quite a long time to do so.⁴ Given that the business of banking is inherently unstable, without some form of deposit insurance, banks would have difficulty attracting deposits in the first place and even more difficulty preventing depositor flight at the first sign of economic disturbance. Such a tenuous state of affairs puts the stability of the nation's bank credit supply and its payments system at considerable—arguably intolerable—risk.⁵

As such, federal deposit insurance enjoys a long history in the United States. It was established at the height of the Great Depression, in the Banking Act of 1933.⁶ The passage of that legislation was significant, as it came after “a long, and often bitter, struggle to establish a nationwide deposit

¹ See *Perspectives on Deposit Insurance Reform after Recent Bank Failures: Hearing Before the S. Comm. on Banking, Hous. & Urb. Affs.*, 118th Cong. (2023).

² Press Release, Jerome H. Powell, Chair, Fed. Rsvr. Bd., Joint Statement by Treasury, Federal Reserve, and FDIC (Mar. 12, 2023), <https://www.federalreserve.gov/newsevents/pressreleases/monetary20230312b.htm>.

³ See, e.g., David Wessel, *A Debate: Should the U.S. Raise the \$250,000 Limit on Deposit Insurance?*, BROOKINGS INST. (May 2, 2023), <https://www.brookings.edu/articles/a-debate-should-u-s-raise-the-250000-ceiling-on-deposit-insurance/>.

⁴ It is important to note, in this context, “that the Omnibus Budget Reconciliation Act of 1993 included a national depositor preference provision, which provided that a failed bank's depositors (and the FDIC standing in the place of insured depositors it has already paid) have priority over nondepositors' claims.” George Hanc, *The Banking Crises of the 1980s and Early 1990s*, 11 FDIC BANKING REV., 1, 1 (1998), <https://www.fdic.gov/analysis/archived-research/banking-review/brspecial.pdf>.

⁵ See *infra* Part I.A. discussion.

⁶ Ch. 89, 48 Stat. 162 (codified as amended at 12 U.S.C. § 227).

insurance” system.⁷ Although the concept of deposit insurance was not novel at the time, legislators (and the President) disagreed about whether providing such a federal safety net for bank liabilities would do more harm than good. They were concerned that it might reduce incentives for banks to manage their risks appropriately and remove depositors’ perceived need to monitor bank managers accordingly.⁸ Ultimately, however, the public benefit to stabilizing banks and their economic function outweighed these concerns about generating “moral hazard.”⁹

Since 1933, this basic tension between financial stability and moral hazard has been challenging to avoid in the design of deposit insurance. Lawmakers have attempted to thread this needle by setting limits on how much insurance the federal government will provide. While insurance caps have increased over time,¹⁰ generally speaking, Congress has tried to maintain deposit limits that cover the vast majority of Americans’ deposits. The present FDIC insurance limit of \$250,000 covers 99 percent of accounts,¹¹ just as the

⁷ Carter H. Golembe, *The Deposit Insurance Legislation of 1933: An Examination of Its Antecedents and its Purposes*, 75 POL. SCI. Q. 181, 181 (1960). As Representative Lister Hill of Alabama put it, “The country has had nothing comparable to it since the passage of the Federal Reserve Act. It is one of the great pieces of legislation in the history of the government.” *Id.* (quoting 77 Cong. Rec. 5899 (1933)).

⁸ See *Insurance Coverage and Financial Operations of the FDIC*, in FDIC, THE FIRST FIFTY YEARS 55, 70 (1984) [hereinafter FIRST FIFTY YEARS, Ch. 4], <https://www.fdic.gov/resources/publications/first-fifty-years/book/first-fifty-chapter4.pdf> (“Dating from the early debates on deposit insurance legislation, there has been a fear that deposit guarantees would erode the discipline of depositors on the actions of banks.”); Charles W. Calomiris, *Deposit Insurance: Lessons from the Record*, 13 ECON. PERSP. 10, 10 (1989) [hereinafter Calomiris, 1989] (“Depositors, who would normally withdraw funds from high-risk banks and thus prevent such behavior, have little incentive to do so when their deposits are insured.”); Charles W. Calomiris, *Is Deposit Insurance Necessary? A Historical Perspective*, 50 J. ECON. HIST. 283, 294 (1990) [hereinafter Calomiris, 1990] (“By promoting excessive leverage and increased risk-taking, deposit insurance made a bad situation much worse.”).

⁹ The Fed’s founders were deeply skeptical of deposit insurance. See Jeffrey Lacker, *From Real Bills to Too Big to Fail: H. Parker Willis and the Fed’s First Century*, 39 CATO J. 15, 21–22 (2019), <https://www.cato.org/sites/cato.org/files/serials/files/cato-journal/2019/2/cj-v39n1-2.pdf>. As one 1950 report from the Federal Reserve explained, reflecting on this legislation, “From the individuals’ standpoint, deposit insurance provides protection, within limits, against the banking hazards of deposit ownership. But the major virtue of deposit insurance is for the Nation as a whole. By assuring the public, individuals and businesses alike, that cash in the form of bank deposits is insured up to a prescribed maximum, a major cause of instability in the Nation’s money supply is removed.” Fed. Rsrv. Staff, *Staff Study on Assessments and Coverage for Deposit Insurance*, 36 FED. RSRV. BULL. 151, 153–54 (1950), https://fraser.stlouisfed.org/files/docs/publications/FRB/1950s/frb_021950.pdf. Notably, the banks themselves also opposed deposit insurance. In 1932, the President of the American Bankers Association referred to the notion of deposit insurance as “unsound, unscientific and dangerous.” *Establishment of the FDIC*, in FDIC, THE FIRST FIFTY YEARS 33, 41 (1984) [hereinafter FIRST FIFTY YEARS, Ch. 3], <https://www.fdic.gov/resources/publications/first-fifty-years/book/first-fifty-chapter3.pdf>.

¹⁰ See *infra* Part I.B.

¹¹ See Caitlin Reilly, *Bipartisan Interest in New Deposit Insurance Cap, But for Whom*, ROLLCALL (May 10, 2023, 8:17 AM), <https://rollcall.com/2023/05/10/bipartisan-interest-in-new-deposit-insurance-cap-but-for-whom/>.

\$5,000 limit in 1935 covered 98 percent of all depositors.¹² But on their own, these insurance caps have been unable to limit moral hazard—and, in fact, that hazard has only grown.

In the heat of economic emergencies, when faced with banking meltdowns, policymakers have consistently raised or sidestepped the cap and covered the uninsured depositors and unsecured creditors. In the savings and loan (“S&L”) crisis of the 1980s and the banking crisis of the early 1990s, the FDIC used resolution tools or provided “open-bank assistance” in a way that protected the vast majority of uninsured depositors and nondeposit creditors “foster[ing] the belief that all deposits of large banks were 100 percent insured.”¹³

In 2009, during the global financial crisis, the FDIC again recommended that the Treasury Secretary create ad hoc programs to insure 100 percent of technically ‘uninsured’ deposits and likewise to protect unsecured creditors from any downside losses associated with bank failure.¹⁴ As the FDIC itself explains, “[s]ince the mid-1960s, the FDIC has handled most failed banks in a way that all depositors, and indeed all general creditors, have been afforded de facto 100 percent insurance.”¹⁵ There is, therefore, an implicit deposit insurance guarantee that differs markedly from the limits set in the law.

The presence of this implicit guarantee is problematic along a number of dimensions. For one, it undercuts the natural mechanisms of market discipline—in the absence of insurance, banks would have to compete for deposits and unsecured debt financing on prudent risk management terms.¹⁶ The knowledge of a federal safety net makes depositors complacent and bank managers relaxed.¹⁷

Relatedly, in the absence of effective market discipline by uninsured depositors, a bank’s soundness depends more heavily on effective supervision and regulation. Yet, history teaches that supervision can fall short, as

¹² FED. DEPOSIT INS. COPR., SECTION 3: HISTORY OF DEPOSIT INSURANCE IN THE U.S. 15 (2023), <https://www.fdic.gov/system/files/2024-07/options-deposit-insurance-reform-section-3.pdf>.

¹³ Hanc, *supra* note 4, at 23.

¹⁴ See *infra* Part I.B. discussion.

¹⁵ See FIRST FIFTY YEARS, Ch. 4, *supra* note 8, at 66.

¹⁶ See, e.g., Andrea M. Maechler & Kathleen M. McDill, *Dynamic Depositor Discipline in U.S. Banks 27* (Int’l Monetary Fund, Working Paper No. 03/226, 2003), <https://www.imf.org/en/Publications/WP/Issues/2016/12/30/Dynamic-Depositor-Discipline-in-U-S-16995>; see also ADAM B. ASHCRAFT, DOES THE MARKET DISCIPLINE BANKS? NEW EVIDENCE FROM THE REGULATORY CAPITAL MIX, FED. RSRV. BANK OF N.Y. STAFF REP. NO. 244 (2006) (examining how since the passage of Federal Deposit Insurance Corporation Improvement Act (FDICIA) in 1991, creditors and equity holders have played varying roles in disciplining banks); see generally Mark J. Flannery & Robert R. Bliss, *Market Discipline in Regulation: Pre- and Post-Crisis*, in OXFORD HANDBOOK OF BANKING 736 (Allen N. Berger, Philip Molyneux & John O.S. Wilson eds., 2019) (discussing the ways that the Basel framework for banking supervision incorporates principles of market discipline).

¹⁷ See *infra* Part I.A.

it is perennially beset by political motivations and constraints.¹⁸ Regulation, meanwhile, can be effective but is also imperfect; it can either overshoot and stifle too much productive bank activity or undershoot and fail to curb excessive risk.¹⁹

The implicit guarantee of uninsured deposits also creates a public image problem for banks. For most Americans, government intervention to protect businesses and wealthy households raises questions about whether taxpayer funds are being used to support entrenched and politically powerful interests. Banks depend on goodwill from the community to sustain their business model. Thus, damage to this so-called social license can hamstring their productive work.²⁰

Finally, because large banks tend to have the most uninsured deposits, the implicit guarantee can distort banking market structure.²¹ Over time, savvy depositors may leave community and regional banks and flow into systemically important ones that, as such, are likely to be rescued. While natural consolidation might not be inherently problematic, concentration that arises as a reaction to an implicit deposit guarantee could distort a more natural market structure equilibrium.²²

This all begs the question: What comes next after the Silicon Valley and First Republic failures? Recent proposals for reform fall into three main categories. The first proposal selects the standard menu choice: keep the cap on

¹⁸ See generally Christina Parajon Skinner, *The Independence of Central Bank Supervision*, (Working Paper, 2024) (on file with author) (arguing that banking supervision often tracks political priorities and thus requires greater political accountability).

¹⁹ For a literature of regulatory tailoring, see generally Tim Sablik, *Tailoring Bank Regulations*, 23 ECON. FOCUS (Fed. Rsv. Bank of Richmond), no. 3, 2018, at 26, https://www.richmondfed.org/publications/research/econ_focus/2018/q3/policy_update; Christina Parajon Skinner, *Regulating Nonbanks*, 105 GEO. L.J. 1379 (2017).

²⁰ See Christina Parajon Skinner, *Misconduct Risk*, 84 FORDHAM L. REV. 1559 (2016) (arguing that widespread misconduct in the banking sector can damage the sector's credibility with the public).

²¹ See Zoe Sagalow & David Hayes, *US Banks' Uninsured Deposits Drop Almost \$600B in Q1 2023*, S&P GLOB. (June 12, 2023), <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/us-banks-uninsured-deposits-drop-almost-600b-in-q1-2023-76097749> (stating that about 43 percent of all bank deposits were uninsured at the end of 2022); *Insured Institution Performance*, 17 FDIC Q., no 1, 2023, at 1, <https://www.fdic.gov/analysis/quarterly-banking-profile/qbp/2022dec/qbp.pdf#page=1>.

²² For literature on banking market structure, see, e.g., Carsten Krabbe Nielsen & Gerd Weinrich, *Bank Regulation and Market Structure*, 88 INT'L J. OF INDUS. ORG. 1 (2023); Kris James Mitchener & David C. Wheelock, *Does the Structure of Banking Markets Affect Economic Growth? Evidence from U.S. State Banking Markets*, 50 EXPLORATIONS IN ECON. HIST. 161 (2013). See also *Hearings on Federal Responses to Recent Bank Failures Before the Subcomm. on Fin. Insts. and Monetary Pol'y of the H. Comm. on Fin. Servs.*, 118th Cong. (2023) (written statement of Kathryn Judge, Harvey J. Goldschmidt Professor of Law and Vice Dean for Intellectual Life, Columbia Law School), <https://docs.house.gov/meetings/BA/BA20/20230510/115890/HHRG-118-BA20-Wstate-JudgeP-20230510.pdf> (discussing the implications of the bank failures on the structure of the banking system).

insurance but raise the limit.²³ The second proposal is somewhat more radical and suggests removing the cap altogether to make the explicit guarantee mirror what is now implicit.²⁴ The third proposal aims to differentiate among depositors—raising the limit for some depositors (like businesses) while keeping it the same (or lower) for all others.²⁵ Various aspects of these proposals have some merit, yet they are either difficult or impossible to operationalize or fail to address the core challenge inherent in deposit insurance design—that is, the moral hazard that accompanies a more capacious safety net.

This Article argues for a more fundamental reset in deposit insurance design. Specifically, the Article urges the privatization of the implicit guarantee by requiring banks to self-insure or obtain third-party private insurance contracts to cover 100 percent of their uninsured deposit base. Privately insuring deposits over the \$250,000 cap²⁶ has the benefit of maintaining depositor confidence during a bad economic event—just like the FDIC insurance would do—but generates a new set of incentives to monitor banks for the kind of risk-taking that can contribute to failure. A private insurance scheme establishes incentives for peer monitoring—for banks to monitor one another—or by the private insurer’s governing board. In contrast to bank supervisors, private insurers—whether they are the banks themselves in a self-insurance model or a third-party insurer—would have real ‘skin in the game’ and could be expected to monitor the insured banks more diligently and comprehensively than federal bank regulators do.²⁷

Indeed, prior to the creation of federal deposit insurance and the FDIC, states experimented with varying forms of private deposit insurance regimes. Across two different periods of U.S. history—from 1829 to 1863 and again between 1909 and 1930—fourteen different state-level private deposit insurance regimes existed. Later, between 1970 and 1985, states yet again experimented with private deposit insurance which would then exist alongside the FDIC. Some of these insurance systems were failures, but several were successful—each of them teaches something important about the optimal design of deposit insurance and how a private deposit insurance market might be structured to

²³ See FED. DEPOSIT INS. CORP., OPTIONS FOR DEPOSIT INSURANCE REFORM (2023), <https://www.fdic.gov/analysis/options-deposit-insurance-reforms/report/options-deposit-insurance-reform-full.pdf>; see also Wessel, *supra* note 3; *Perspectives on Deposit Insurance Reform after Recent Bank Failures*, *supra* note 1.

²⁴ See *id.* and accompanying text.

²⁵ Press Release, FED. DEPOSIT INS. CORP., FDIC Releases Comprehensive Overview of Deposit Insurance System, Including Options for Deposit Insurance Reform (May 1, 2023), <https://www.fdic.gov/news/press-releases/2023/pr23035.html>.

²⁶ The Article acknowledges, though does not discuss in depth, that some not significant re-set in the basic cap may be required to reflect recent inflation.

²⁷ There is, in this regard, an extensive literature on regulatory capture. For a literature review, see Ernesto Dal Bo, *Regulatory Capture: A Review*, 22 OXFORD REV. ECON. POL’Y 203 (2006).

complement federal insurance to better balance the trade-offs between financial stability and moral hazard.

In developing this argument, this Article continues a line of scholarship that was truncated after the 2008 Global Financial Crisis. Not since the 1990s have scholars examined the merits of private deposit insurance schemes; even then, that literature existed primarily in economics.²⁸ In the interim, two waves of major banking crises and failure have swept over the U.S. financial system, presenting fresh challenges and pressing legal questions about how best to reform deposit insurance in a way that accounts for the financial stability risks of a modern era while also reinstating banks' incentives to manage their business prudently.

The Article proceeds in three parts. Part I provides an overview of deposit insurance history and law. Part II develops the idea of privatizing deposit insurance above the FDIC cap. In doing so, it closely examines the private state-level insurance schemes between 1829 and 1985 and two successful models in Massachusetts and Germany, respectively, that exist in the present day. Part II also discusses the merits of private financial governance more generally, even beyond the deposit insurance context. Part III explains how a private insurance scheme might be operationalized in the United States and what its main challenges might be.

Ultimately, this Article seeks not only to develop the idea of privatization in deposit insurance law but also to situate, conceptually, the purpose of deposit insurance within the broader debate about the ideal balance between using prophylactics and safety nets to secure the stability of the national banking system.²⁹ It also intervenes in the debate about optimal banking structure—whether that is a concentrated system with few large banks or one that is more decentralized with three tiers of large, regional, and community banks.³⁰

²⁸ See, e.g., Calomiris, 1990, *supra* note 8, at 295 (arguing for “a greater role for incentive-compatible self-regulation and coinsurance among banks”).

²⁹ See, e.g., Saule T. Omarova, *License to Deal: Mandatory Approval of Complex Financial Products*, 90 WASH. U. L. REV. 63, 84 (2012) (arguing for requiring approval of complex financial products: “adopting and operationalizing the general concept of precaution in the context of post-crisis financial systemic risk regulation may be a worthwhile, and even necessary, exercise”); Saule T. Omarova, *Wall Street as Community of Fate: Toward Financial Industry Self-Regulation*, 159 U. PA. L. REV. 411 (2011).

³⁰ Cf. Michelle Bowman, *Responsive and Responsible Bank Regulation and Supervision*, Remarks at the Salzburg Global Seminar on Global Turbulence and Financial Resilience: Implications for Financial Services and Society (June 25, 2023, <https://www.federalreserve.gov/newsevents/speech/files/bowman20230625a.pdf>) (“A real concern is whether regulatory reform could have the unintended consequence of hollowing out the mid-sized tier of banks, effectively preventing the largest banks from facing new competition.”).

I. FEDERAL DEPOSIT INSURANCE LAW: A PRIMER

The design of deposit insurance presents one of the most intractable public policy dilemmas. On the one hand, the business model of banking is unavoidably fragile due to the mismatch of illiquid investment assets and highly liquid funding sources. On the other hand, this fragile business model is beneficial for society; the credit intermediation it enables has proven over time to be welfare enhancing.

As such, shoring up this business model through one or more government-provided safety nets would appear to be a good role for the State. The problem is safety nets tend to produce moral hazard, and deposit insurance is a prime example of that result. Although Congress has struggled with this dilemma for nearly 100 years, so far, its approach of raising the cap with each successive banking crisis does little more than bandage over a problem that demands a further-reaching solution.

This Part explains the basic deposit insurance dilemma that lawmakers confront. It then presents an overview of the history and evolution of deposit insurance law, illustrating the significant extent to which the dilemma persists today.

A. *The Deposit Insurance Dilemma*

Notwithstanding the fact that deposit insurance introduces moral hazard and makes uninsured depositors complacent, the economic rationale for deposit insurance is sound. The basic business model of banking is illiquid.³¹ This refers to the fact that banks primarily invest in illiquid credit assets—like commercial and consumer loans, mortgages, as well as some less-liquid securities—while principally relying on funding for those assets that is highly liquid to its holder’s ability to redeem the loan on demand. These include deposits and other forms of short-term secured and unsecured debt.³²

This liquidity mismatch (sometimes also referred to as liquidity transformation) is problematic for two interrelated reasons. It means that banks’ funding sources are relatively unstable—depositors and short-term creditors agree to ‘roll over’ their loans on a very short-term basis.³³ Depositors can

³¹ Douglas W. Diamond & Philip H. Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 J. POL. ECON. 401, 403 (1983) (“Banks are able to transform illiquid assets by offering liabilities with a different, smoother pattern of returns over time than the illiquid assets offer. . . Illiquidity of assets provides the rationale both for the existence of banks and for their vulnerability to runs”).

³² See Jennie Bai, Arvind Krishnamurthy & Charles-Henri Weymuller, *Measuring Liquidity Mismatch in the Banking Sector* (Basel Comm. on Banking Supervision Working Paper, 2014), https://www.bis.org/events/conf140909/bai_krishnamurthy_weymuller_paper.pdf.

³³ Jeanne Gobat et al., *The Net Stable Funding Ratio: Impact and Issues for Consideration* (IMF Working Paper No. 14/106, 2014) (describing implications of short-term basis funding sources on long-term financial outcomes).

withdraw their loans to banks at any time and most secured and unsecured creditors agree to renew their loans on an overnight or weekly basis. At the same time, because of fractional reserve banking, banks do not maintain cash reserves at a 1:1 ratio to their debt liabilities and therefore could not redeem (i.e., repay) 100 percent of depositors' demands should the need arise during, for example, a bank run.³⁴ This perpetual risk that more depositors will wish to withdraw their funds than the bank has liquid assets to repay them is the core source of banks' fragility.³⁵

The acute liquidity problems that a run poses to a bank can ultimately lead to that bank's failure. In other words, liquidity problems can turn into solvency problems even for an otherwise healthy bank if the bank is forced to sell off its good assets quickly, at a discounted price, to meet depositor withdrawals.³⁶ Of course, if the bank's assets are already suffering a loss in market-to-market value, a bank run can precipitate the realization of those losses and also doom the bank to fail. The costs of bank failures tend to spill over into the real economy by causing disruption to the payments system,³⁷ the "destruction of circulating medium" (i.e., deposits),³⁸ and a reduction in the availability of loans on which businesses and households depend.³⁹

At the same time, this business model—fragile as it may be—is incredibly beneficial to society overall. In the process of engaging in liquidity transformation, banks are intermediating credit.⁴⁰ This means that deposits are being used to fund loans, and these loans are critical to economic growth. As such, banks' role in intermediating credit has underpinned capitalism generally. Bank-supplied finance has enabled the very technological expansion that has exponentially improved the human condition over the past 150 years relative to the thousand years before it.⁴¹ Given the incontrovertible evidence that the banking system enables human prosperity to increase—while also serving national security in the modern

³⁴ Cf. Kathryn Judge, *Information Gaps and Shadow Banking*, 103 VA. L. REV. 101 (2017) (explaining the position of short-term creditors more generally).

³⁵ See Diamond & Dybvig, *supra* note 31, at 402 (explaining "why bank contracts are less stable than other types of financial contracts").

³⁶ Calomiris, 1989, *supra* note 8, at 11.

³⁷ *Id.*

³⁸ Golembe, *supra* note 7, at 182.

³⁹ See Christina Parajon Skinner, *Nonbank Credit*, 9 HARV. BUS. L. REV. 149, 158 (2019).

⁴⁰ *Id.*

⁴¹ See generally JOHN STEELE GORDON, AN EMPIRE OF WEALTH: THE EPIC HISTORY OF AMERICAN ECONOMIC POWER xv (2004); Christina Parajon Skinner, *Capitalism Stakeholderism*, 47 SEATTLE U. L. REV. 643 (2024); James Pethokoukis, *The Most Important Economic Chart in Western Civilization—and How It Happened*, AM. ENTER. INST. (Apr. 23, 2013), <https://www.aei.org/economics/the-most-important-economic-chart-in-western-civilization-and-how-it-happened/>; ROBERT J. GORDON, THE RISE AND FALL OF AMERICAN GROWTH 2 (2016).

economic era⁴²—policymakers of all political parties have consistently recognized the need to keep that system stable.

In a significant way, this stability depends on banks' ability to attract and retain deposits, again, a major funding source. If depositors perceive that their 'loan' to the bank is unsafe, however, and might not be repaid, they will invest in something else. Today, the financial system offers a bevy of investment products to households that mimic the bank deposit. These range from money market fund products to stablecoins to ETFs. Accordingly, banks must earn the depositor's trust and work relatively hard to keep it. As it turns out, however, human psychology makes this a difficult thing for banks to do.

Depositors have strong incentives to run on the bank. Indeed, the sources of panic that spark a run need not relate to any legitimate problem with the particular bank. As Diamond and Dybvig explain in their Nobel prize-winning work on the dynamics of bank runs, runs can be caused by almost any bad or anomalous event that is a "commonly observed random variable in the economy."⁴³

This could be a bad earnings report, a commonly observed run at some other bank, a negative government forecast, or even sunspots. It need not be anything fundamental about the bank's condition. The problem is that once they have deposited, anything that causes them to anticipate a run will lead to a run.⁴⁴

Once a few depositors think to run, they will stampede. Due to the fractional reserve banking model, there is a known advantage to being among the first to withdraw deposits—this is known as the "first mover advantage."⁴⁵ Uninsured depositors know that if they are last in line, in theory, they could get nothing.

Considerable information asymmetry between bank managers and depositors makes this inclination worse. Loans—the main investment asset of banks—are information intensive; they "are not easily valued in centrally traded markets."⁴⁶ As a result, most information about the financial health of a bank is difficult to publicly observe either because the market signals are opaque or inaccurate or because the relevant information is held privately

⁴² See Christina Parajon Skinner, *Coins, Cross-Border Payments, and Anti-Money Laundering Law*, 60 HARV. J. LEGIS. 301 (2023) (discussing how the correspondent banking system is key to enforcing sanctions and anti-money laundering laws to punish and deter illicit uses of finance).

⁴³ Diamond & Dybvig, *supra* note 31, at 410.

⁴⁴ *Id.*

⁴⁵ There is a great deal of policy literature discussing this in the context of money market funds. See, e.g., ANTOINE BOUVERET, ANTOINE MARTIN & PATRICK McCABE, FED. RESV. BANK OF N.Y., STAFF REP. NO. 1009, MONEY MARKET FUND VULNERABILITIES: A GLOBAL PERSPECTIVE (2022), https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr1009.pdf.

⁴⁶ See Calomiris, 1989, *supra* note 8.

by bank managers and their boards.⁴⁷ Knowing that bank managers have incentive to conceal bad information from the public, depositors are likely to assume that bad information is in fact being concealed—giving them more reason to run.⁴⁸

In theory, then, deposit insurance enables banks to maintain the public's confidence. For a rational actor, at least, when deposit insurance is in place “for all possible anticipated withdrawal policies of other agents, it never pays to participate in a bank run.”⁴⁹ Insurance thus buffers the fragility of the illiquid banking business model by keeping retail deposit funding stable.

There are other ways that the government can reduce banks' vulnerability to runs, most notably, by creating a central bank that acts as a lender of last resort (“LOLR”). When the central bank acts as LOLR, it lends “freely” to a bank that is experiencing acute liquidity strain from a run so that the bank can meet depositor withdrawals without implicating its basic solvency.⁵⁰ The Federal Reserve—the U.S. central bank—has indeed acted as a LOLR during past banking crises, by establishing a host of emergency liquidity facilities under Section 13(3) of the Federal Reserve Act and also by encouraging depository institutions (commercial banks, thrifts, and credit unions) to borrow from the reserve banks' discount windows (standing borrowing facilities that exist for depository institutions to use in good times or in bad), established under Section 10B of that Act.⁵¹ The central bank's LOLR facilities and discount window together with deposit insurance constitute the overarching federal bank safety net.⁵²

But in practice, the option to borrow from the central bank is often much less effective at forestalling bank runs than deposit insurance is. For one, it has always come with a stigma attached.⁵³ When a bank borrows from the Fed's discount window, bank management and bank supervisors view tapping

⁴⁷ *Id.*

⁴⁸ *Id.* (“Reasonable fears of insolvency of a subset of banks, and confusion as to which banks have suffered most from the shock, underlay most financial panics from the Roman bank run of 33 A.D. to those in the U.S. in the nineteenth and twentieth centuries.”).

⁴⁹ Diamond & Dybvig, *supra* note 31, at 415.

⁵⁰ See Olivier de Bandt, Sandrine Lecarpentier & Cyril Pouvelle, *Bank Solvency, Liquidity and Financial Crisis: What Relationship?*, BANQUE DE FRANCE: ECO NOTEPAD (July 24, 2020), <https://www.banque-france.fr/en/publications-and-statistics/publications/bank-solvency-liquidity-and-financial-crisis-what>.

⁵¹ Federal Reserve Act, Pub. L. No. 63-43, § 13(3) (1913) [hereinafter Federal Reserve Act]. For a discussion on the United States Federal Reserve as an LOLR, see generally Colleen Baker, *The Federal Reserve as Last Resort*, 46 U. MICH. J. L. REFORM 69 (2012).

⁵² Other ideas for dealing with banking system illiquidity have not been adopted in the United States, namely, Adam Smith's idea of matching maturities of assets to liabilities, see ADAM SMITH, *THE WEALTH OF NATIONS* (1789), or Milton Friedman's suggestion of narrow banking, i.e., with 100 percent reserve backing, see MILTON FRIEDMAN, *A PROGRAM FOR MONETARY STABILITY* (1960).

⁵³ See HUBERTO M. ENNIS & DAVID A. PRICE, FED. RSRV. BANK OF RICHMOND, ECON. BRIEF NO. 20-4: UNDERSTANDING DISCOUNT WINDOW STIGMA 2 (2022) (“Despite its role in stabilizing the financial system, borrowing from the discount window carries a stigma that banks may wish to avoid, as it can signal to the market that they are facing financial difficulties.”).

a contingency source of funding as an indication that something went wrong.⁵⁴ Regardless, a bank still might fail even if it has borrowed liberally from the discount window or any emergency ad hoc facilities put in place. First Republic is a good example of such an outcome. A depository institution can only borrow up to the haircut value of its collateral, and no amount of lending can make an insolvent bank solvent. In contrast, deposit insurance is a “binding commitment” directly to deposit holders themselves.⁵⁵

Overall, then, the question is not whether deposit insurance should exist but rather how extensive the federally provided safety net should be. A brief history of the evolution of deposit insurance in the United States provides insight into the original policy rationale for deposit insurance which, by the 1970s, became eclipsed by increasingly frequent commitments to guarantee 100 percent of deposits with federal—full faith and credit—insurance.

B. The Origins and Evolution of Federal Deposit Insurance Law

Congress wrestled with the idea of federal deposit insurance for some time before it landed on its final form. Between 1886 and 1933, it considered 150 separate proposals for deposit insurance.⁵⁶ The events of the Great Depression consolidated the political will to finalize the idea. Between the stock market crash in 1929 and the end of 1933, around 9,000 banks had to suspend operations which caused approximately \$1.3 billion in losses to depositors.⁵⁷ Within the first few months of 1933, 4,000 banks were closed, and President Roosevelt declared a bank holiday on March 6 of that year.⁵⁸ The holiday suspended all banking operations such that:

[N]o such banking institution or branch shall pay out, export, earmark, or permit the withdrawal or transfer in any manner or by any device whatsoever, of any gold or silver coin or bullion or currency or take any other action which might facilitate the hoarding thereof; nor shall any such banking institution or branch pay out deposits, make loans or discounts, deal in foreign exchange, transfer credits from the United States to any place abroad, or transact any other banking business whatsoever.⁵⁹

⁵⁴ See Mark Carlson & Jonathan D. Rose, *Stigma and the Discount Window*, BD. OF GOVERNORS OF THE FED. RSRV. SYS.: FEDS NOTES (Dec. 19, 2017), <https://www.federalreserve.gov/econres/notes/feds-notes/stigma-and-the-discount-window-20171219.html>.

⁵⁵ Diamond & Dybvig, *supra* note 31, at 417.

⁵⁶ Golembe, *supra* note 7, at 188.

⁵⁷ See *Introduction*, in FDIC, *THE FIRST FIFTY YEARS* 3 (1984) [hereinafter *FIRST FIFTY YEARS*, Ch. 1]

⁵⁸ *Id.*

⁵⁹ Robert Jabaily, *Bank Holiday of 1933*, FED. RSRV. HIST. (Nov. 22, 2013), <https://www.federalreservehistory.org/essays/bank-holiday-of-1933>.

Although federal deposit insurance did not yet exist, the Fed did have its discount window operating and at least some basic authority to act as LOLR.⁶⁰ But for reasons that have gone down in historical infamy, the Fed did not use its discount window policy to inject liquidity into the system and failed to act as a meaningful LOLR.⁶¹

To compensate for the lack of Fed liquidity, the Roosevelt Administration created the Reconstruction Finance Corporation (“RFC”) in 1932 to make advances to banks and other financial institutions that did not otherwise have access to the Fed’s discount window.⁶² In effect, the RFC stepped in as “the discount lending arm of the Federal Reserve.”⁶³ Although the RFC was mostly judged as a success, it might have done more to shore up the banking sector had Congress not designed it to stigmatize its users by publicly disclosing their names. By one historical account, “[a]pppearance of a bank’s name on the list was interpreted as a sign of weakness, and frequently led to runs on the bank.”⁶⁴

By the 1930s, public opinion was strongly in favor of federal deposit insurance. Senator Carter Glass, a framer of the Federal Reserve Act and erstwhile vociferous opponent of deposit insurance, eventually conceded that banking reform would only pass with the inclusion of a federal insurance program. As *Business Week* reported Glass’s sentiment in 1933,

It became perfectly apparent that the voters wanted the guarantee [of deposit insurance], and that no bill which did not contain such a provision would be satisfactory either to Congress or to the public. Washington does not remember any issue on which the sentiment of the country has been so undivided or so emphatically expressed as upon this.⁶⁵

Deposit insurance was finally included in Section 8 of the Banking Act of 1933. It had the “immediate contribution” of “restoration of public confidence in banks.”⁶⁶

⁶⁰ See Banking Act of 1933, Pub. L. No. 73–66, 48 Stat. 162 (1933) [hereinafter Banking Act of 1933] (demonstrating that the Glass-Steagall Act broadens who can borrow from Fed Reserve Bank on paper other than that ordinarily eligible for rediscount or as collateral for loans).

⁶¹ See generally DAVID C. WHEELOCK, FED. RSRV. BANK OF ST. LOUIS, MONETARY POLICY IN THE GREAT DEPRESSION: WHAT THE FED DID, AND WHY (1992), <https://fraser.stlouisfed.org/files/docs/meltzer/whemon92.pdf>.

⁶² See Michael Gou et al., *Reconstruction Finance Corporation Act*, FED. RESERVE HISTORY (Nov. 22, 2013), <https://www.federalreservehistory.org/essays/reconstruction-finance-corporation>.

⁶³ *Id.* (explaining that “[t]he governor of the Federal Reserve Board, Eugene Meyer, lobbied for the creation of the RFC, helped to recruit its initial staff, contributed to the design of its structure and policies, supervised its operation, and served as the chairman of its board. The RFC occupied office space in the same building as the Federal Reserve Board”).

⁶⁴ FIRST FIFTY YEARS, Ch. 3, *supra* note 9, at 37.

⁶⁵ *Id.* at 41 (quoting a *Business Week* Article entitled “Deposit Insurance” from April 12, 1933).

⁶⁶ FIRST FIFTY YEARS, Ch. 1, *supra* note 57, at 3.

Like the Federal Reserve, Congress gave the FDIC a public-private ownership structure. The capital stock of the FDIC was divided into Class A and Class B shares.⁶⁷ The Class A stock would be held by “member” and nonmember banks (this referred to membership in the Federal Reserve System).⁶⁸ The Act required banks to subscribe a portion of their capital stock to the FDIC,⁶⁹ and in exchange they would be entitled to receive a six percent dividend on those shares.⁷⁰ Every bank that joined the Federal Reserve System would be required to become a Class A stockholder, and no state bank could join the System without first doing so (as such, state banks could join the FDIC by applying directly to the Corporation without necessarily joining the Federal Reserve System as well, but membership in the System required membership in the FDIC). Notably, this same ownership structure was adopted in the Federal Reserve System whereby member banks were required to subscribe to the capital stock of their regional Reserve Bank and receive a six percent dividend in return.⁷¹

The Class B stock would be held by the Federal Reserve Banks and would not earn a dividend.⁷² The federal government also made an initial contribution. In the Act, Congress appropriated \$150,000,000 in capital stock “subscribed for by [the Treasury Secretary] on behalf of the United States.”⁷³

Importantly, although the FDIC would be in part owned by its private beneficiaries—the banks—management and control of the FDIC would remain in public hands. The 1933 Act established that the FDIC would be governed by a three-member board of directors, one of whom would be the Comptroller of the Currency (the chief regulator of national banks) while the remaining two board members would be appointed by the President with the advice and consent of the Senate.⁷⁴ Congress also structured the Board to be bipartisan and independent by requiring that “not more than two of the members of such board of directors shall be members of the same political

⁶⁷ Banking Act of 1933.

⁶⁸ *Id.* § 2(a) (explaining that the terms “banks,” “national bank,” “national banking association,” “member bank,” “board,” “district,” and “reserve bank” as having the “meanings assigned to them in section 1 of the Federal Reserve Act, as amended”).

⁶⁹ *Id.* § 8(e). (providing that “[e]very member bank shall apply to the Corporation for class A stock of the Corporation in an amount equal to one half of 1 per centum of its total deposit liabilities as computed in accordance with regulations prescribed by the Federal Reserve Board.”).

⁷⁰ *Id.* § 8(d).

⁷¹ Pam Martens & Russ Martens, *These Are the Banks that Own the New York Fed and Its Money Button*, WALL ST. ON PARADE (Nov. 12, 2019), <https://wallstreetonparade.com/2019/11/these-are-the-banks-that-own-the-new-york-fed-and-its-money-button/>; *De Novo Bank Application Process*, FED. RSRV. SYS.: FED. PARTNERSHIP, <https://www.fedpartnership.gov/bank-life-cycle/start-a-bank/de-novo-bank-application-process> (last visited Aug. 7, 2024).

⁷² See Dividends and Surplus Funds of Reserve Banks, 12 U.S.C. § 289; Section 7. Division of Earnings, BD. OF GOVERNORS OF THE FED. RSRV. SYS., <https://www.federalreserve.gov/about-thefed/section7.htm> (last visited Aug. 7, 2024).

⁷³ Banking Act of 1933 § 8(c).

⁷⁴ Banking Act of 1933 § 8(b).

party” and setting terms that would last six years.⁷⁵ In case of any remaining doubt, the text of the Act specified that Class A stockholders shall have no vote at meetings of stockholders.⁷⁶

In terms of the insurance itself, the Act provided for a temporary plan that was meant to operate for six months to be then replaced by a permanent plan. The temporary plan provided \$2,500 of insurance for each depositor.⁷⁷ While capital subscriptions would provide the initial seed money for the FDIC, the deposit insurance fund would be maintained on an ongoing basis through assessments on the banks, the Class A stockholders.⁷⁸ The assessment would be calculated on the basis of a bank’s total deposits, and no bank would be permitted to pay dividends to shareholders until paying its assessment to the FDIC.⁷⁹

The plan that was meant to take effect six months later, on June 30, 1934, would have insured deposits on a sliding scale. Pursuant to it, deposit insurance would cover 100 percent of deposits up to \$10,000. From there, a co-insurance model would kick in: The FDIC would cover 75 percent of the next \$40,000 and 50 percent of deposits exceeding \$50,000.⁸⁰ All banks participating in the FDIC insurance scheme would be required to become members of the Federal Reserve System within two years.⁸¹

This plan never came into effect. It was superseded by the more sweeping changes instated by the Banking Act of 1935.⁸² In that piece of legislation, the insurance limit was set at a fixed cap of \$5,000 per depositor; by that point, Congress had realized that \$5,000 covered 98 percent of depositors, and so it made sense as a landing point for maximum coverage. The co-insurance model was abandoned. The 1933 Act had been silent as to criteria for admission to

⁷⁵ *Id.*

⁷⁶ Banking Act of 1933 § 12B(d).

⁷⁷ *Id.* § 8(y) (“If any member of the Fund shall be closed on or before June 30, 1934, on account of inability to meet its deposit liabilities, the Corporation shall proceed in accordance with the provisions of subsection (l) of this section to pay the insured deposit liabilities of such member; except that the Corporation shall pay not more than \$2,500 . . .”). See also *The 1930s*, FED. DEPOSIT INS. CORP., <https://www.fdic.gov/about/history/1930-1939.html> (last visited Aug. 7, 2024) (In 1934, at this level, “about 47 per cent of circulating medium was protected by insurance or government guaranty.”)

⁷⁸ Banking Act of 1933 § 8(l).

⁷⁹ *Id.*

⁸⁰ FED. DEPOSIT INS. CORP., *OPTIONS FOR REFORMING DEPOSIT INSURANCE* (2023), <https://www.fdic.gov/analysis/options-deposit-insurance-reforms/report/options-deposit-insurance-reform-full.pdf>.

⁸¹ See Federal Deposit Insurance Act, 12 U.S.C. § 1818(a) (addressing the requirement for state-chartered banks to join the Federal Reserve System as part of FDIC insurance criteria), <https://www.fdic.gov/regulations/laws/rules/1000-600.html#1000sec.1818>; *Federal Reserve Membership*, FED. RES. BANK OF RICHMOND, https://www.richmondfed.org/banking/oversight_and_regulation/federal_reserve_membership (last visited Aug. 7, 2024).

⁸² *FIRST FIFTY YEARS*, Ch. 3, *supra* note 9, at 55, 57. (noting that, “[d]uring 1934, FDIC staff began drafting what would become Title I of the Banking Act 1935.”). Then-FDIC Chairman Leo Crowley had a vision that “consisted of attempting to strengthen the banking system, while using every legal means available to conserve FDIC financial resources. This philosophy dominated FDIC behavior until the mid-1960s.” *Id.*

the FDIC; the 1935 Act established some guidelines. Before admitting a new bank member, the FDIC was required to consider a bank's capital adequacy, its future earnings prospects, its management, and how the "convenience and needs of the community [were] to be served by the bank."⁸³ The fee structure was also changed—required capital subscriptions were eliminated, and the assessments were lowered to one-twelfth of a percentage of total deposits.⁸⁴

Otherwise, the Banking Act of 1935 empowered the FDIC in two important respects.⁸⁵ First, it gave the FDIC rudimentary powers to determine and enforce a bank's safety and soundness. For example, should the FDIC board of directors find "that an insured bank or its directors or trustees have continued unsafe or unsound practices in conducting the business of such bank, or have knowingly or negligently permitted any of its officers or agents to violate any provision of any law or regulation to which the insured bank is subject," the board would be required to notify the bank's primary regulator—the Comptroller for national banks, the state bank supervisor for state nonmember banks, or the Federal Reserve Board for state member banks—with "a statement with respect to such practices or violations for the purpose of securing the correction thereof."⁸⁶ If the bank did not make the requested corrections within 120 days, the FDIC could terminate its insurance.⁸⁷ Second, the FDIC received authority to require any insured bank to obtain other kinds of insurance to protect against "burglary, defalcation, and other similar insurable losses."⁸⁸ Today, we might call that operational risk.

The Banking Act of 1935 also increased the FDIC's power by authorizing it to extend assistance to banks in ways other than through deposit insurance. With the so-called purchase and assumption ("P&A") power, the FDIC obtained the authority to make a loan to, or buy assets from, an insured bank if it would facilitate a merger with another bank in order to avoid losses to the FDIC insurance fund.⁸⁹ In 1950, the FDIC's authority to assist an ailing

⁸³ Banking Act of 1935, Pub. L. No. 305-74, § 101(g), 49 Stat. 684, 684 (1935) [hereinafter Banking Act of 1935] (amending Section 12B of the Federal Reserve Act); see FIRST FIFTY YEARS, Ch. 3, *supra* note 9, at 52.

⁸⁴ Banking Act of 1935 § 101(h)(1).

⁸⁵ In addition, the Banking Act of 1935 gave the FDIC power to determine whether certain mergers between insured and uninsured banks could proceed and whether nonmember banks could open new branches. FIRST FIFTY YEARS, Ch. 3, *supra* note 9, at 52. It also required the FDIC to prohibit nonmember insured banks from paying interest on demand deposits, to match the requirement in the Banking Act of 1933 that prohibited banks from paying interest on deposits. *Id.*

⁸⁶ Banking Act of 1935 § 101(i).

⁸⁷ *Id.*

⁸⁸ *Id.* § 101(6).

⁸⁹ *Id.* § 101(4) ("[T]he Corporation may, upon such terms and conditions as it may determine, make loans secured in whole or in part by assets of an open or closed insured bank, which loans may be in subordination to the rights of depositors and other creditors, or the Corporation may purchase any such assets or may guarantee any other insured bank against loss by reason of its assuming the liabilities and purchasing the assets of an open or closed insured bank.").

bank was increased such that it could provide what is known as open bank assistance (“OBA”), whereby, “[t]o prevent an insured depository institution from closing, the FDIC provide[s] . . . loans, contributions, deposits, asset purchases, or the assumption of liabilities.”⁹⁰ In some sense, as will be later discussed, the P&A and OBA authorities position the FDIC quite closely to a central bank’s lender of last resort.⁹¹

Indeed, at its inception, federal deposit insurance was in many ways seen as a quasi-central banking function. The benefits of deposit insurance for financial stability were viewed in terms of the money supply. In other words, insuring deposits meant that a bank’s failure would not disrupt a bank’s, or other banks’, payments activities.⁹² Further, to the extent insurance prevented runs on other banks, it would also prevent the disruption of credit intermediation more broadly across the banking system.⁹³ Precisely as then-former Senator Robert Owen testified at House Hearings on deposit legislation in 1932:

The first observation I wish to make is that to provide the people of the United States with an absolutely safe and a convenient place to put their savings and their deposits is essential to the stability of banking, bank deposits and loans, the checks which function as money, and business conditions in every line It is a far greater matter than the very important end of protecting the individual depositor or the bank from loss.⁹⁴

So understood, deposit insurance was aimed at restoring “to the community, as quickly as possible, circulating medium destroyed or made unavailable as a consequence of bank failures.”⁹⁵ Although “protecting the individual depositor or the bank from loss” were also seen as “very important,” protecting

⁹⁰ FED. DEPOSIT INS. CORP., *MANAGING THE CRISIS: THE FDIC AND RTC EXPERIENCE* 152 (1998).

⁹¹ Golembe, *supra* note 7, at 193–94.

⁹² See CLARK WARBURTON, *FDIC, DEPOSIT GUARANTY IN EIGHT STATES DURING THE PERIOD 1908-1930* (1959) (former FDIC chairman Clark Warburton) (“Failure of a bank has results of far-reaching significance. The amount of the means of payment, or circulating medium of the community, is suddenly and sharply curtailed. Such curtailment creates immediate confusion throughout the community: general inability to meet the terms of contracts, paralysis of commerce, interruptions in the flow of goods and services, and consequent disturbances to the lives of large numbers of people. The reserves of purchasing power of many people not associated with business and unprepared to take the risks of investors become unusable and subject to serious loss.”).

⁹³ See Michael McLeay, Amar Radia & Ryland Thomas, *Money Creation in the Modern Economy*, BANK OF ENG. Q. BULL. (2014), <https://www.bankofengland.co.uk/-/media/boe/files/quarterly-bulletin/2014/money-creation-in-the-modern-economy.pdf> (last visited Aug. 7, 2024) (When a bank makes a loan, i.e., intermediates credit, it credits the borrowers account with new deposits. Thus, the act of intermediating credit is also the act of creating new money.).

⁹⁴ Golembe, *supra* note 7, at 192 (quoting Hearings Before the Subcommittee of the Committee on Banking and Currency on H. R. 11362, 72d Cong., 117 (1932) (statement of Robert Owen)).

⁹⁵ *Id.* at 189.

creditors and banks from all losses was “incidental to the achievement of the primary [monetary] objective.”⁹⁶ As such, Section 8 of the Banking Act of 1933 amended Section 12B of the Federal Reserve Act to create the FDIC and empower it “to insure . . . the deposits of all banks which are entitled to the benefits of insurance under this section.”⁹⁷

Congress took a two-pronged approach to stitching together a new safety net. Whereas 12B created deposit insurance, 12A empowered the Fed. Although the Fed had always, since its creation in 1913, possessed the power to buy assets (primarily Treasuries) in the open market under Section 14 of the Federal Reserve Act, it failed to use that authority in the Great Depression to ease credit and monetary conditions (just like it failed to lend liberally through its discount window).⁹⁸ Reflecting on that experience, Section 12A of the Banking Act created the Federal Reserve’s Open Market Committee, the “FOMC” and gave it a clear direction.⁹⁹ The FOMC would be responsible for open-market operation policy, “with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country.”¹⁰⁰

Taking both provisions together, the new Sections 12A and 12B of the Federal Reserve Act meant that monetary stability would be better buffered against disturbance by making the Fed responsible for fluid credit conditions, while the FDIC would use deposit insurance to safeguard against the destruction of the existing supply of bank credit, and the payments system, caused by bank runs.¹⁰¹ The 1950 Deposit Insurance Act removed Section 12B from the Federal Reserve Act and created a separate body of law in the Federal Deposit Insurance (“FDI”) Act.¹⁰² Yet even though the FDI Act “reinforced the FDIC’s separate identity” from the Fed, the fact that deposit insurance was envisioned to work in tandem with Fed liquidity would continue to inform its overarching design.

Today, much of the basic governance and ownership structure, and legal authority of the FDIC remains substantially the same. The board of directors was expanded to include the director of the CFPB, the Comptroller of the

⁹⁶ *Id.* at 192 (quoting Hearings, *supra* note 92).

⁹⁷ Banking Act of 1933 § 8.

⁹⁸ See A HISTORY OF THE FEDERAL RESERVE, VOLUME 1: 1913-1951, FED. RSRV. BANK OF MINNEAPOLIS (discussing the Fed’s limited use of open market operations and discount window lending during the Great Depression), <https://www.minneapolisfed.org/article/2023/a-history-of-the-federal-reserve>.

⁹⁹ Banking Act of 1933 § 12A.

¹⁰⁰ *Id.*

¹⁰¹ Golembe, *supra* note 7, at 194–95 (noting, on this view, that “[i]t is no coincidence that a serious attempt was made to establish both a central bank and a deposit insurance system in the same Act in 1913”).

¹⁰² See Federal Deposit Insurance Act, Pub. L. No. 81-797, 64 Stat. 873 (1950) (codified as amended in scattered sections of 12 U.S.C.).

Currency, and another nonagency head director.¹⁰³ Banks are still assessed based on their total liabilities, though the rate of that assessment varies depending on a risk-based determination that turns on a bank's examination results and its rating under the so-called CAMELS system.¹⁰⁴

Over time, the insurance limits have also been increased, usually, though not always, to keep pace with inflation. In 1950, the cap was raised to \$10,000; in 1966 to \$15,000; in 1969 to \$20,000; in 1974 to \$40,000, and in 1980 to \$100,000.¹⁰⁵ The 1980 legislation was not meant to reflect inflation but rather to address the reality that banks and savings and loan associations had accumulated large amounts of certificates of deposits outstanding, and so a more sizable increase would be needed to maintain around the historic coverage rate.¹⁰⁶ After the 2008 global financial crisis, the 2010 Dodd-Frank Act raised the cap to \$250,000 where it remains in law today.¹⁰⁷

The most significant shift in deposit insurance law was not made through legislation, but rather through the development of an implicit guarantee that far exceeds the cap.

C. *The Rise and Reform of the Implicit Guarantee*

The source of the implicit guarantee is uninsured depositors. The Diamond and Dybvig model, which theorizes that deposit insurance will eliminate incentives for depositors to run, ¹⁰⁸ depends implicitly on the premise that those same incentives extend with equal force to those depositors not covered within the FDIC cap. In reality, however, uninsured depositors are very much incentivized to run by their knowledge of the first-mover advantage,¹⁰⁹ and do in fact run without some form of guarantee. They are an influential group. Since 1995, the amount of uninsured deposits at banks has risen considerably,

¹⁰³ See 12 U.S.C. § 1812(a).

¹⁰⁴ 12 U.S.C. § 1817(1)(A). 12 U.S.C. § 1817(3)(B) requires the FDIC to maintain a ratio of the deposit insurance fund balance to estimated insured deposits of 1.35% or more. The CAMELS system (Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk) is used to assess the soundness of banks and other financial institutions.

¹⁰⁵ See *History of Banking and Deposit Insurance: 1950-1959*, FED. DEPOSIT INS. CORP., <https://www.fdic.gov/about/history/timeline/1950-1959.html> (discussing the increase to \$10,000 in 1950); *History of Banking and Deposit Insurance: 1960-1969*, FED. DEPOSIT INS. CORP., <https://www.fdic.gov/about/history/timeline/1960-1969.html> (noting the increases to \$15,000 in 1966 and \$20,000 in 1969); Brian Martucci, *FDIC Deposit Insurance Limits Per Bank Account*, MONEYCRASHERS (Feb. 24, 2023) <https://www.moneycrashers.com/fdic-deposit-insurance-limits/> (detailing the increases to \$40,000 in 1974 and \$100,000 in 1980).

¹⁰⁶ FIRST FIFTY YEARS, Ch. 4, *supra* note 8, at 69–70.

¹⁰⁷ 12 U.S.C. § 1821(a). Notably, since the beginning, individuals can legally increase their effective coverage rates by spreading deposits across multiple separately insured accounts.

¹⁰⁸ See Diamond & Dybvig, *supra* note 31, at 416.

¹⁰⁹ See *supra* note 45 and accompanying text.

thus increasing the proportion of account holders apt to run.¹¹⁰ In some sense, then, the flight risk presented by a now-large uninsured depositor base has forced policymakers' hand.

Since the 1980s, the FDIC has used its powers to effectively guarantee 100 percent of deposits, extending the coverage to account owners that hold more than the insured limit in an individual account. Government action to lift the deposit cap has now fossilized into a new de facto guarantee after repeating this intervention in the banking and S&L crises of the 1980s, the 2008 global financial crisis, and recently with Signature Bank and SVB.

S&L Crisis—Bank failures were relatively infrequent in the decades after the establishment of the FDIC.¹¹¹ But in 1981, the number of failures rose dramatically, peaking at about 200 bank failures per year by the late 1980s.¹¹² Between 1980 and 1995, over 2,900 banks and thrifts (i.e., savings and loan associations) failed.¹¹³

S&L institutions or “thrifts” had become popular in the United States in the 1950s and 1960s, as society pursued its goal of widespread homeownership.¹¹⁴ By 1980, there were nearly 4,000 thrifts with total assets of about \$600 billion—with about two-thirds of that sum in mortgage loans.¹¹⁵ But as inflation rose in the mid-1980s, the thrifts had difficulty sustaining their mandated business model.¹¹⁶ Although new legislation removed the cap that had previously limited the returns thrifts could provide on deposits, the thrifts were still saddled with long-term fixed rate mortgages at much lower than market rate.¹¹⁷ Restrictions against branching inhibited their ability to diversify credit risk.¹¹⁸ In these market and regulatory conditions, many thrifts became insolvent.¹¹⁹

¹¹⁰ Ron J. Feldman & Jason Schmidt, *Increased Use of Insurance Deposits*, FED. RSRV. BANK OF MINNEAPOLIS (Mar. 1, 2001), <https://www.minneapolisfed.org/article/2001/increased-use-of-uninsured-deposits>; FED. DEPOSIT INS. CORP., *supra* note 23.

¹¹¹ There were about fifteen bank failures per year. Noelle Richards, *Federal Deposit Insurance Corporation Improvement Act of 1991*, FED. RSRV. HIST. (Dec. 19, 1991), <https://www.federalreservehistory.org/essays/fdicia#:~:text=The%20FDIC%20took%20action%20to,to%20the%20passing%20of%20FDICIA>.

¹¹² *Id.*

¹¹³ Drew DeSilver, *Most U.S. Bank Failures Have Come in a Few Big Waves*, PEW RSCH. CTR. (Apr. 11, 2013), <https://www.pewresearch.org/short-reads/2023/04/11/most-u-s-bank-failures-have-come-in-a-few-big-waves/>. Over 1,000 thrifts failed, and about 1,600 banks failed. Hanc, *supra* note 4, at 1.

¹¹⁴ Kenneth J. Robinson, *Savings and Loan Crisis*, FED. RSRV. HIST. (Nov. 22, 2013), <https://www.federalreservehistory.org/essays/savings-and-loan-crisis>.

¹¹⁵ *Id.*

¹¹⁶ See FED. DEPOSIT INS. CORP., *HISTORY OF THE EIGHTIES – LESSONS FOR THE FUTURE* 168 (1997), https://www.fdic.gov/bank/historical/history/167_188.pdf.

¹¹⁷ Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (codified as amended in scattered sections of 12 U.S.C.) (allowing thrifts to pay interest on deposit accounts).

¹¹⁸ Bert Ely, *Savings and Loan Crisis*, ECONLIB (Aug. 8, 1990), <https://www.econlib.org/library/Enc/SavingsandLoanCrisis.html>.

¹¹⁹ Estimates of the bailout range from \$150 billion to \$500 billion. Kitty Calavita et al., *The Savings and Loan Debacle, Financial Crime, and the State*, ANN. REV. SOCIO. 19 (1997);

Thrift institutions at that time were insured by the Federal Savings and Loan Insurance Corporation (“FSLIC”).¹²⁰ The cost of resolving the failed thrifts was so great that the FSLIC had to be recapitalized by taxpayers and was ultimately abolished in 1989, and its responsibilities were transferred to the FDIC.¹²¹ The U.S. General Accounting Office (“GAO”) estimated the total cost of resolving the S&L crisis to be \$160.1 billion;¹²² \$132 billion came from federal taxpayers.

Banks, meanwhile, experienced their own challenges in a much-changed competitive and regulatory environment. The 1970s were hallmarked by the advent of considerable market risk, resulting from exchange rate volatility caused by the unraveling of the fixed-exchange rate regime that prevailed under Bretton Woods,¹²³ as well as the interest rate risk that arose from the Fed’s efforts to curb inflation.¹²⁴ By the 1980s, banks were also forced to compete with thrifts—which were now permitted to offer interest on their deposits¹²⁵—and with newly innovated financial products like money market funds and commercial paper.¹²⁶ Between 1980 and 1991, between 1,300 and 1,600 banks failed or required assistance from the FDIC;¹²⁷ by 1991, the FDIC had become severely undercapitalized and at risk of insolvency itself. In 1990, the FDIC’s then-Chairman, L. William Seidman, wrote in the Corporation’s Annual Report that the year had “presented difficulties and challenges beyond anyone’s expectations.”¹²⁸

Given the magnitude of these interventions, it is not surprising that Congress addressed the structure of deposit insurance in 1991.¹²⁹ It passed new

Timothy Curry & Lynn Shibut, *The Cost of the Savings and Loan Crisis: Truth and Consequences*, FDIC BANKING REV. 26, 30 (1986).

¹²⁰ See Hanc, *supra* note 4.

¹²¹ Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, 101 Stat. 552 (1987) (providing for the recapitalization of the FSLIC and extending the full-faith-and-credit protection of the U.S. government to federally insured deposits); Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 (1989) (authorizing use of taxpayer funds to resolve failed thrifts and moving thrift deposit insurance to the FDIC).

¹²² U.S. GOV’T ACCOUNTABILITY OFF., FINANCIAL AUDIT: RESOLUTION TRUST CORPORATIONS 1995 AND 1994 FINANCIAL STATEMENTS 13, 26 (1996 <https://www.gao.gov/products/aimd-96-123> [hereinafter GAO REPORT]).

¹²³ See, e.g., Christoffer J. P. Zoeller, *Closing the Gold Window: The End of Bretton Woods as a Contingency Plan*, 47 POL. & SOC’Y 1, 4–6 (2019).

¹²⁴ See Jeff Sommer, Lessons From the ‘80s, *When Volcker Reigned and Rates Were High*, N.Y. TIMES (Aug. 5, 2022), <https://www.nytimes.com/2022/08/05/business/inflation-investing-paul-volcker.html>.

¹²⁵ See Richards, *supra* note 111.

¹²⁶ Hanc, *supra* note 4, at 2.

¹²⁷ See, e.g., JOHN O’KEEFE, FDIC DIVISION OF RESEARCH AND STATISTICS, THE TEXAS BANKING CRISIS: CAUSES AND CONSEQUENCES (1980–1989) (providing an example of one state that had many bank failures), https://fraser.stlouisfed.org/files/docs/publications/texasbankcrisis_1980_1989.pdf; Richards, *supra* note 111.

¹²⁸ FED. DEPOSIT INS. CORP., MANAGING THE CRISIS: THE FDIC AND THE RTC EXPERIENCE (1998).

¹²⁹ *Hearing on Perspectives on Deposit Insurance Reform After Recent Bank Failures Before the S. Comm. on Banking, Hous., and Urb. Affs.*, 118th Cong. (2023) (statement of Andrew

legislation to try to reconcile the realities of a changed and changing banking structure and its apprehension about growing moral hazard.

One clear goal of this legislation, the Federal Deposit Insurance Corporation Improvement Act of 1991 (“FDICIA”), was to force uninsured depositors to bear losses from a bank’s failure.¹³⁰ To that end, it imposed a ‘least cost resolution requirement’ on the FDIC, which prohibits the agency from providing assistance to any bank unless it is both necessary to provide insurance coverage for the insured deposits and the assistance is the “least costly to the Deposit Insurance Fund of all possible methods for meeting the Corporation’s obligation under this section.”¹³¹ This means that providing open bank assistance or engaging in a P&A would have to be less costly than closing the bank and paying off the insured deposits with the proceeds from liquidating its assets. Further, FDICIA specifically prohibited the FDIC from taking “any action, directly or indirectly” that would increase losses to the insurance fund by protecting uninsured depositors or creditors other than depositors.¹³²

While this statutory prohibition may seem unequivocal, Congress added an escape hatch. In Section 1823(c)(4)(G) it made an exception to these rules for cases that presented “systemic risk.”¹³³ Pursuant to this exception, the government (acting through the Secretary of the Treasury) can lift the cap if two thirds of both the FDIC board and the Federal Reserve Board of Governors recommend that complying with the restrictions would “have serious adverse effects on economic conditions or financial stability” and that FDIC assistance would “avoid or mitigate such adverse effects.”¹³⁴ The FDIC was given authority to recover losses to the insurance fund by imposing a special assessment on banks.¹³⁵ The systemic risk exception was not used until 2008.¹³⁶

Olmem, Partner, Mayer Brown LLP) (referring to THE U.S. S. COMM. ON BANKING, HOUS. AND URB. AFFS., REPORT OF THE SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS TO ACCOMPANY S. 543 TOGETHER WITH ADDITIONAL VIEWS 44–45 (1991)), <https://www.banking.senate.gov/imo/media/doc/Olmem%20Testimony%207-20-23.pdf>.

¹³⁰ See FREDERIC S. MISHKIN, *EVALUATING FDICIA* (1996) (providing a scholarly review of this piece of legislation).

¹³¹ 12 U.S.C. § 1823(c)(4)(A)(ii).

¹³² 12 U.S.C. § 1823(c)(4)(E)(i); see also GAO REPORT, *supra* note 122 at 5 (“[u]nder the least-cost requirements, FDIC generally has resolved failed or failing banks using three basic methods, which do not constitute open bank assistance. These are: (1) directly paying depositors the insured amount of their deposits and disposing of the failed bank’s assets (deposit payoff and asset liquidation); (2) selling only the bank’s insured deposits and certain other liabilities, and some of its assets, to an acquirer (insured deposit transfer); and (3) selling some or all of the failed bank’s deposits, certain other liabilities, and some or all of its assets to an acquirer (purchase and assumption). According to FDIC officials, they have most commonly used purchase and assumption, as it is often the least costly and disruptive alternative.”).

¹³³ 12 U.S.C. § 1823(c)(4)(G).

¹³⁴ *Id.*

¹³⁵ 12 U.S.C. § 1823(c)(4)(G)(ii).

¹³⁶ CONG. RESEARCH SERV., IF12378, THE CAMELS RATING SYSTEM (2023), <https://crsreports.congress.gov/product/pdf/IF/IF12378>.

Global Financial Crisis—Beginning in 2006, the U.S. housing market declined dramatically, prompting a decline in the price of mortgage-related assets, especially those consisting of subprime mortgage loans.¹³⁷ As the value of these loan portfolios declined, financial institutions had difficulty renewing their short-term funding and experienced a liquidity squeeze. Amid massive uncertainty about the value of these assets, institutions withdrew from lending to one another—unsure how creditworthy their counterparty might be—and the interbank credit market effectively froze.¹³⁸ As the GAO would later describe it, “[b]y late summer of 2008, the ramifications of the financial crisis ranged from the continued failure of financial institutions to increased losses of individual savings and corporate investments and further tightening of credit that would exacerbate the emerging global economic slowdown.”¹³⁹

In 2008 and 2009, the Treasury invoked the systemic risk exception three times. First, on October 14, 2008, the Treasury invoked the exception to create two broad-based facilities that would protect uninsured deposits and creditors. The Temporary Liquidity Guarantee Program (“TLGP”) guaranteed newly issued senior unsecured debt (to help banks with funding), and the Transaction Account Guarantee Program (“TAGP”) provided temporary unlimited coverage for non-interest-bearing transaction accounts, i.e., checking accounts.¹⁴⁰ On January 15, 2009, the Treasury invoked the systemic risk exception again to provide assistance to Citigroup. The agencies urged Treasury that the failure of such a large and interconnected institution would destabilize financial markets and spook foreign investors.¹⁴¹ In September 2008, Treasury invoked the exception for a third time to allow the FDIC to assist Wachovia to facilitate its sale to Citigroup.¹⁴² Wachovia ultimately decided to merge with Wells Fargo, and assistance from the FDIC was not needed.¹⁴³

¹³⁷ GAO REPORT, *supra* note 122, at 1–2.

¹³⁸ *See id.*

¹³⁹ *Id.*

¹⁴⁰ For an overview, see *id.* at 19–23.

¹⁴¹ *Id.* at 26–27. See Press Release, Bd. of Governors of the Fed. Rsrv. Sys., Joint Statement by Treasury, Federal Reserve, and the FDIC on Citigroup (Nov. 23, 2008), <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20081123a.htm> (Specifically, the assistance came in the form of a loss-sharing agreement, which “the limited the potential losses Citigroup might suffer on a fixed pool of approximately \$300 billion of loans and securities backed by residential and commercial real estate and other such assets.” The idea was that the package of assistance provided by regulators may have helped to allow Citigroup to continue operating by encouraging private sector sources to continue to provide liquidity to Citigroup during the crisis.”).

¹⁴² *Id.* (“The FDIC announced that it had agreed to provide protection against large losses on a fixed pool of Wachovia assets to facilitate the orderly sale of Wachovia’s banking operations to Citigroup and avert an imminent failure that might exacerbate the serious strains then affecting the financial markets, financial institutions, and the economy.”).

¹⁴³ See Scott G. Alvarez, The Acquisition of Wachovia Corporation by Wells Fargo & Company, Testimony Before the Financial Crisis Inquiry Commission (Sept. 1, 2010), <https://www.federalreserve.gov>; see also *Wells Fargo to Buy Wachovia for \$15.1 Billion*, BANKS DAILY (Oct. 5, 2008), <https://banksdaily.com/news/banks/Wells-Fargo-buy-Wachovia-15-billion>.

Alongside the systemic risk related assistance, Congress also agreed to temporarily raise the insurance cap to \$250,000. During this time, the Fed was also operating several different emergency liquidity programs to assist nonbanks and markets, including those that would support the money market fund sector, the commercial paper sector, investment banks, and insurance companies.¹⁴⁴

Just as it had in 1991, Congress became concerned that these interventions would increase moral hazard and decided to address deposit insurance in post-crisis legislation. In the 2010 Dodd-Frank Act, Congress thus revised the systemic risk exception in several key respects.¹⁴⁵ For one, it limited assistance under the systemic risk exception to situations where the financial institution is already in FDIC receivership.¹⁴⁶ Second, it established that the FDIC could only make the exception “widely available”—as it did with the TLGP and TAGP—with congressional approval.¹⁴⁷ The Dodd-Frank Act also permanently raised the insurance cap to \$250,000.¹⁴⁸

Signature, SVB, First Republic—Signature, SVB, and First Republic foundered for reasons similar to those seen in the 1980s. When interest rates increased, the value of these banks’ fixed-income assets declined, as bond prices and yields are inversely related. When the interest earned on those assets (mostly government securities) dropped below the rate the banks were paying on their deposits, to asset-liability mismatch, which can cause bank insolvency. SVB also had a liquidity problem. Its deposit base had been declining for the past few years. The majority of their depositors were VC-backed firms that experienced a retreat in VC funding starting in 2021 and, in reaction, these firms began to draw down on their deposits to finance their operations, thereby straining SVB’s liquidity.

On Wednesday, March 8, SVB tried to confront its unrealized losses by raising more capital in the market. That capital-raising effort tipped off the public that the bank had a potential solvency problem given the size of its mark-to-market losses. Around 97 percent of their depositors were uninsured and began to run. This sequence of events ultimately led to the bank’s failure by Friday morning.¹⁴⁹ First Republic Bank suffered guilt by association. It was

¹⁴⁴ See, e.g., Tobias Adrian & Ernst Schaumburg, *The Fed’s Emergency Liquidity Facilities During the Financial Crisis: The CPFF*, FED. RSRV. BANK OF NEW YORK, LIBERTY ST. ECON. (Aug. 20, 2012), <https://libertystreeteconomics.newyorkfed.org/2012/08/the-feds-emergency-liquidity-facilities-during-the-financial-crisis-the-cpff/>.

¹⁴⁵ See Dodd-Frank Wall Street Reform and Consumer Protection (Dodd-Frank) Act, Pub. L. No. 111-203, § 1104, 124 Stat.1376, 2120 (2010).

¹⁴⁶ *Id.* § 1105.

¹⁴⁷ *Id.* § 1106.

¹⁴⁸ *Id.* § 335(a).

¹⁴⁹ See BD. OF GOVERNORS OF THE FED. RSRV., REVIEW OF THE FEDERAL RESERVE’S SUPERVISION AND REGULATION OF SILICON VALLEY BANK (2023), <https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf>.

another large regional bank with a large uninsured depositor base and an asset-liability mismatch. Fearing the worst, its depositors, witnessing SVB, also began to run in mid-March 2023.

The government used three safety net tools to deal with this banking crisis. One was the systemic risk exception which the Treasury invoked to guarantee all deposits at Signature and SVB.¹⁵⁰ The second was an emergency liquidity facility designed by the Fed under Section 13(3) of the Federal Reserve Act, dubbed the Bank Term Funding Program (“BTFP”).¹⁵¹ Although the banks could have borrowed (and did) through the 10B discount window, the BTFP offered slightly more favorable terms, allowing loans for up to one year (rather than 90 days) and allowing banks to pledge their assets at par, rather than with the typical ‘haircut’ that is taken at the discount window.¹⁵² However, only Treasury debt, agency debt, or agency MBS was accepted as collateral at the BTFP; essentially all banks’ assets are accepted as collateral at the regular discount window. Third, the FDIC used its P&A authority to ease the acquisition of First Republic Bank by JPMorgan Chase, a transaction that ensured all of First Republic Bank’s uninsured depositors would be protected too.

Just like the S&L crisis and the Global Financial Crisis, the failures of SVB, Signature, and First Republic have drawn attention to deposit insurance reform. These reform ideas have fallen into three main buckets. First, there is the proposal to raise the cap (again). This suggestion is rather uninspiring given that the \$250,000 limit already covers the vast majority of depositors (upwards of 97 percent),¹⁵³ and so modest increases would be meaningless vis-à-vis the uninsured depositors that tend to hold millions if not billions in transaction accounts. On that understanding, a second suggestion is to remove the cap entirely.¹⁵⁴ That seems rather unappealing too, as it eliminates even the prospect of market discipline and invites a much larger role for the state in banking system regulation and supervision. Finally, some propose increasing the cap for business accounts, which maintain large balances out of necessity,

¹⁵⁰ Powell, *supra* note 2.

¹⁵¹ Press Release, Bd. of Governors of the Fed. Rsrv. Sys., Federal Reserve Board Announces It Will Make Available Additional Funding to Eligible Depository Institutions to Help Assure Banks Have the Ability to Meet the Needs of All Their Depositors (Mar. 12, 2023), <https://www.federalreserve.gov/newsevents/pressreleases/monetary20230312a.htm>; Bd. OF GOVERNORS OF THE FED. RSRV. SYS., REPORT TO CONGRESS PURSUANT TO SECTION 13(3) OF THE FEDERAL RESERVE ACT: BANK TERM FUNDING PROGRAM (2023), <https://www.federalreserve.gov/publications/files/13-3-report-btftp-20230316.pdf> (detailing the establishment of BTFP under Section 13(3) of the Federal Reserve Act).

¹⁵² *Id.*

¹⁵³ See FED. DEPOSIT INS. CORP., OPTIONS FOR DEPOSIT INSURANCE REFORM 4 (2023), <https://www.fdic.gov/analysis/options-deposit-insurance-reforms/report/options-deposit-insurance-reform-full.pdf> (noting that the \$250,000 limit already covers the vast majority of depositors).

¹⁵⁴ See, e.g., Wessel, *supra* note 3 (argument of Professor Pat McCoy) (“So instead of lifting the cap, we should limit the ratio of uninsured deposits to assets and increase regulation of banks similar in size to those two banks.”).

while keeping it the same for households (or making it even lower).¹⁵⁵ This idea has some merit but would pose challenges, and considerable expense, for banks to implement in practice.

None of these ideas successfully deals with the moral hazard that comes with increasing insurance coverage, in one way or another. Nor do they address the political economy of policymakers' inability to credibly commit to limited insurance, even in the absence of an explicit statutory guarantee. The next Part argues for a fundamental reset in deposit insurance law: privatizing deposit insurance above the FDIC cap.

II. PRIVATELY INSURING DEPOSITS OVER THE FDIC CAP

Until this point, the Article has explained the purpose and rationale, and evolution of, federal deposit insurance law. It also discussed the development of an implicit guarantee that departs from statutory law through the successive ad hoc interventions of the past four decades. This policy seems socially sub-optimal insofar as it results in the worst of both worlds—it weakens market discipline while increasing moral hazard. Uninsured depositors do not monitor or charge banks for risk premia at the levels that they should; they also run. Meanwhile, banks take less than the optimal level of care, betting that their depositors will always get rescued.

To address these poor incentives, this Part makes the case for private deposit insurance. It urges Congress to adopt a new legal requirement within the FDI Act that banks self-insure all deposits in accounts that exceed the FDIC cap. This requirement would, this Part argues, encourage more robust peer monitoring among banks, generate mechanisms for external but private supervisory review, and reduce the taxpayer burden and pressure on the federal deposit insurance fund. This Part is chiefly dedicated to building support for such idea by discussing past experiments with private deposit insurance and the merits of private financial governance more broadly. It starts by briefly sketching the outline of a model of privatization reform but leaves Part III to operationalize it and discuss broader implications.

A. A Public-Private Insurance Model

Arguably, deposit insurance can instill an adequate level of public confidence in banking only if 100 percent of banks' deposits are insured. If even a small portion of deposits are left uninsured, some depositors will have an

¹⁵⁵ See FED. DEPOSIT INS. CORP., *OPTIONS FOR INSURANCE REFORM 9–12* (2023), <https://www.fdic.gov/analysis/options-deposit-insurance-reforms/report/options-deposit-insurance-reform-full.pdf> (discussing targeted coverage and the implications of different insurance caps for business and individual accounts).

incentive to run; when they do, their actions are likely to spark panic among other depositors even if those other depositors are insured. Incomplete knowledge about how deposit insurance works, high levels of risk aversion, and low levels of trust in government institutions incentivize these rational actors to behave ‘irrationally.’¹⁵⁶

But there is no inherent reason why the federal government should provide all the insurance necessary to reduce the social costs that arise from the manifestation of these individual incentives. Federal deposit insurance is in some ways anachronistic. In the nineteenth century, the law prohibited banks from branching across state lines and thus inhibited their ability to diversify their lending by geography and sector. This contributed to banks’ vulnerability to runs. The so-called unit bankers—those that opposed branches as against their own self-interest—fought in favor of an alternative source of bank stability, namely, federal deposit insurance. They reasoned that if the public knew there was deposit insurance, this would counteract the tendency toward branching as a mechanism for stability.¹⁵⁷ Since 1997, banks have been permitted to branch and thus invest in credit assets pursuant to their parameters for prudent risk management.¹⁵⁸ Nevertheless, public expectations have settled around—and have provided legitimacy for—a significant government safety net, and the FDIC system has, overall, performed quite well. The core problem that still requires fixing is the incentives generated from the implicit guarantee of the uninsured depositor base.

In principle, public policy could take the opposite approach. Uninsured depositors could be forced to suffer losses and thus be incentivized to be better bank monitors. Consider, for example, the case of the Penn Square Bank failure and resolution in 1982.¹⁵⁹ That bank, once described as a “bank with a freewheeling culture in which the chief executive enjoyed ‘quaffing beer from his cowboy boot while entertaining out of town customers,’”¹⁶⁰ failed after years of “reckless underwriting.”¹⁶¹ Rather than handle the failure through the then-typical P&A, the FDIC opted to close the bank and pay off depositors.

¹⁵⁶ The question of whether the rational model prevails in macroeconomic theory is a well-debated one. For a brief discussion on how macroeconomics has incorporated behavioral economics, see generally John C. Driscoll & Steinar Holden, *Behavioral Economics and Macroeconomic Models* (Fed. Rsv. Bd., Working Paper No. 2014-43, 2014), <https://www.federalreserve.gov/pubs/feds/2014/201443/201443pap.pdf>.

¹⁵⁷ Calomiris, 1990, *supra* note 8, at 286; see generally Golembe, *supra* note 7.

¹⁵⁸ Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (“Riegle-Neal Act”), Pub. L. No. 103-328, 108 Stat. 2338 (1994).

¹⁵⁹ For a history of this bank failure, see generally PHILLIP L. ZWEIG, *BELLY UP: THE COLLAPSE OF THE PENN SQUARE BANK* (1986).

¹⁶⁰ *Continental Illinois: A Bank That Was Too Big to Fail*, FED. RSRV. HIST. (May 15, 2023), <https://www.federalreservehistory.org/essays/continental-illinois> [hereinafter Federal Reserve History].

¹⁶¹ Robert Bennett, *Penn Square’s Failed Concept*, N.Y. TIMES, Aug. 16, 1982, at D1 (noting that one Penn square client, Mr. Simpson, said, “I could hardly believe it – they loaned me \$2.5 million hardly asking any questions and then sold the loan to Continental.”)

However, more than “half of the bank’s \$470.4 million in deposits exceeded the \$100,000 insurance limit.”¹⁶² Given the egregious nature of the bank’s conduct, the FDIC feared “it would lose all credibility if it effected a P&A in the Penn Square case.”¹⁶³ In particular, a P&A “would have given financial markets a signal that all deposits, at least in banks above a certain size, were, for all practical purposes, fully insured. Discipline in the markets would have been seriously eroded, with deleterious long-term ramifications.”¹⁶⁴

In fact, the payoff strategy in Penn Square did change depositor behavior.

Uninsured depositors became more sensitive to the possibility of loss and could not assume that all but the smallest bank failures would be handled through purchase and assumption transactions. . . . [They] generally became more selective in their choice of banks, and the public’s concern about the condition of banks was increased.¹⁶⁵

But this strategy was the exception; it did not become the rule. In particular, when Continental Illinois failed just two years later, in large measure due to its exposure to Penn Square’s loans, the FDIC provided it with a range of public assistance.¹⁶⁶

Again, uninsured depositors featured centrally in the failure story of Continental Illinois. In May 1984, the bank experienced a large-scale run by depositors in reaction to rumors that it might become insolvent.¹⁶⁷ This run was “spearheaded by depositors with large uninsured deposits and other bank creditors.”¹⁶⁸ The run only stopped when, on May 17, the FDIC, Fed, and OCC announced a public assistance package that included a guarantee of all of the bank’s creditors, a direct \$2 billion loan, and an open-ended commitment to accessing Fed liquidity.¹⁶⁹ While the Continental Illinois package was, at its

¹⁶² FED. DEPOSIT INS. CORP., *supra* note 90 at 233–34.

¹⁶³ HANDLING BANK FAILURES, *in* FDIC, THE FIRST FIFTY YEARS 81, 98 (1984). [hereinafter FIRST FIFTY YEARS, Ch. 5].

¹⁶⁴ *Id.*

¹⁶⁵ *Id.*

¹⁶⁶ FED. DEPOSIT INS. CORP., *supra* note 90, at 32 (“As part of the Continental OBA transaction, the FDIC acquired problem assets with an adjusted book value of \$3.5 billion. Continental established a special 250-employee unit, known as the FDIC Asset Administration (FAA) unit, within the bank to service those assets. Except for having indemnification authority, the FAA had full delegated authority to manage and dispose of problem assets. The FDIC reimbursed the FAA on a “cost-plus” basis, which meant that the FAA received the cost of its expenses plus incentive compensation based on a tiered scale of net collections.”); Federal Reserve History, *supra* note 160, at 1 (“Federal regulators sought to avoid the bank’s failure, which they determined would have resulted in widespread economic harm, by providing the bank with substantial public financial support. The episode ignited a national debate that continues to this day over whether large financial institutions enjoy undue privileges because regulators consider them too big to fail.”).

¹⁶⁷ Federal Reserve History, *supra* note 160, at 2.

¹⁶⁸ *Id.*

¹⁶⁹ *Id.* at 3.

time, ad hoc, this kind of swift and sweeping assistance has, as just discussed, become an implicit guarantee. It seems unlikely at this juncture in our economic history, and given the magnitude of the U.S. banking sector today, that politicians will have the stomach to consistently enforce Penn Square-type punishment on uninsured depositors going forward.

Together, the premise that federal deposit insurance at some level is socially and economically worthwhile—but not necessarily justifiable when comprehensive—points to the merits of a public-private model. That is, while the FDIC may insure 95–98 percent of all deposits, banks should be required to establish and maintain their own private insurance scheme to cover the rest.

A public-private coinsurance model could take one of two different forms. In a cooperative model, banks would collectively establish, run, and fund the insurance scheme. The banks would pay premia into their industry-organized insurance scheme, which would pay out depositors not covered by the FDIC limit and other creditors in the event of one bank's failure. A second model would allow third-party insurers to create and sell to the banks a new insurance product that would cover uninsured deposits. A third-party insurance scheme would not meaningfully hinge on cooperation among banks but would rather underwrite and issue individual policies and payouts on a bank-by-bank basis. Both models would work as co-insurance schemes because the banks would be responsible for insuring their deposit-funding above the FDIC cap; the government would cover the rest.

The institutional details of each model are considered in further depth below, upon analyzing historical and comparative examples of private deposit insurance schemes for insights and lessons learned—as well as the theory of why similar private financial 'clubs' have been successful in other settings.

B. Private Deposit Insurance Schemes

This section does the descriptive work of supporting this Article's proposal for private deposit insurance by discussing private deposit insurance schemes throughout the United States' economic history. It also considers the experience with private deposit insurance in Germany. In view of both failed and successful schemes, this Part argues that private insurance models can be highly effective at improving stability and reducing moral hazard, relative to the status quo, but that this outcome depends on the appropriate institutional design.

1. The Failures

On the local level, state-based private deposit insurance schemes operated widely during three separate periods of U.S. history. Despite operating on the state level, they had no public financial support. Most of them are

remembered as failures. However, a careful analysis of their experience reveals that their lack of success largely resulted from design flaws within the insurance systems or uncorrected yet widespread misconduct in the management of the insured banks.¹⁷⁰

1829–1863—The first state-level insurance scheme was established in New York in 1829. The origins of the scheme were the “public dissatisfaction with the existing banking structure.”¹⁷¹ In response to this public sentiment, then-Governor, Martin Van Buren was presented with a plan to “make all the banks responsible for any loss the public may sustain.”¹⁷²

There was no American precedent for deposit insurance at the time. Apparently, the idea for the proposal was inspired by “regulations of the Hong merchants in Canton, where a number of men, each acting separately, have, by the grant of the government, the exclusive right of trading with foreigners, and are all made liable for the debts of each in case of failure.”¹⁷³ Because banks similarly had “the exclusive right of making a paper currency for the people of the state,” it was thought that “by the same rule [they] should in common be answerable for that paper.”¹⁷⁴ In other words, the very concept of deposit insurance was based on the rationale that the privilege of issuing notes should come with the responsibility of ensuring the soundness of those notes. Accordingly, the scheme that developed in New York, named the New York Safety Fund, followed a mutual liability model, and it was copied in five other states—Vermont (in 1831), Michigan (in 1836), Indiana (in 1834), Ohio (in 1845), and Iowa (in 1858). All but three were failures.¹⁷⁵

The New York scheme failed in 1842 for several reasons. First, the Safety Fund limited the required contributions of its members to an annual assessment of 1/2 percent of total capital.¹⁷⁶ As a result, the losses that the Fund suffered from 1837 to 1842 depleted it with no mechanism for replenishment.¹⁷⁷ By 1842, the Safety Fund could no longer “credibly guarantee the value of member banks’ notes and deposits and, therefore, could not adequately ensure liquidity of member bank’s obligations.”¹⁷⁸ Second, the Safety Fund suffered “unusually large losses” due to “fraud or unsound banking practices” at the insured institutions.¹⁷⁹ Problematically, the Safety Fund’s Commissioners were

¹⁷⁰ See William B. English, *The Decline of Private Deposit Insurance in the United States*, 38 CARNEGIE-ROCHESTER CONF. SERIES ON PUBLIC POL’Y 57, 61, 103 (1993) (providing a detailed history of design and management flaws with a focus on the experience of the 1980s).

¹⁷¹ Golembe, *supra* note 7, at 182.

¹⁷² *Id.*

¹⁷³ *Id.* at 183.

¹⁷⁴ *Id.*

¹⁷⁵ See English, *supra* note 170, at 61, 100.

¹⁷⁶ Calomiris, 1989, *supra* note 8, at 12.

¹⁷⁷ Calomiris, 1990, *supra* note 8, at 286.

¹⁷⁸ Calomiris, 1989, *supra* note 8, at 12.

¹⁷⁹ Calomiris, 1990, *supra* note 8, at 286.

at the mercy of this sort of misconduct. As economist and historian Howard Bodenhorn has written,

One of the many shortcomings of the Safety Fund Act was the limited powers granted to the bank commissioners. While they could seek injunctions against fraudulent or insolvent banks, they had no real authority over banks pursuing excessively risky strategies or even those that may have been insolvent had their portfolios been accurately marked to market. Other than moral suasion, the commissioners had no effective, controlling legal authority.¹⁸⁰

Third, the Safety Fund suffered from adverse selection. Members were permitted to leave the system at will, and so healthy banks retreated once they suspected other banks might soon suffer losses. With each successive failure, more healthy banks opted out, until only the riskiest banks participated.¹⁸¹ A similar adverse selection problem doomed the schemes in Vermont and Michigan as well.

During the same period, all of these private insurance schemes faced pressure from the growth of alternatives to the banking charters. The free banking movement, which began in the 1830s, produced legislation that allowed banks to issue their own private notes provided they were collateralized by state bonds or mortgages in an amount equal to the outstanding notes that had been issued.¹⁸² This system worked as a direct alternative to private insurance, and many banks began to leave the state-chartered system—and the relevant insurance scheme—and opt into the free banking system.¹⁸³ Later, in 1863, Congress established a national banking system and placed a prohibitive tax on state bank notes.¹⁸⁴ As a result, only national banks could issue national bank notes (collateralized by U.S. debt), and so many banks likewise converted their state to a national charter. Because these national bank notes were

¹⁸⁰ HOWARD BODENHORN, *STATE BANKING IN EARLY AMERICA: A NEW ECONOMIC HISTORY* 155, 161 (2002).

¹⁸¹ Calomiris, 1989, *supra* note 8, at 13.

¹⁸² Golembe, *supra* note 7, at 186.

¹⁸³ See Richard Sylla, *U.S. Securities Markets and the Banking System, 1790-1840*, REV. FED. RSRV. BANK ST. LOUIS, May/June 1998, at 96–97, <https://files.stlouisfed.org/files/htdocs/publications/review/98/05/9805rs.pdf>; see also Daniel Sanches, *The Free-Banking Era: A Lesson for Today?*, FED. RSRV. BANK PHILA. RSCH. DEP'T: ECON. INSIGHTS, Q3 2016, at 9, https://www.philadelphiafed.org/-/media/frbp/assets/economy/articles/economic-insights/2016/q3/eiq316_free_banking_era.pdf; Kerri Allen & Jeff Legette, *Understanding Federal Reserve Supervision and Becoming a State Member Bank*, FED. RSRV. SYS. CMTY. BANKING CONNECTIONS <https://www.cbefrs.org> (last visited Aug. 23, 2024) (explaining the role of state and national charters and the historical context of banks' movement between different banking systems).

¹⁸⁴ See *National Banking Acts of 1863 and 1864*, FED. RSRV. HIST. (July 31, 2022), <https://www.federalreservehistory.org/essays/national-banking-acts-of-1863-and-1864>; *The Civil War: The Senate's Story*, U.S. SENATE, <https://www.senate.gov/artandhistory/history/common/civil-war/NationalBankActs.htm> (last visited Aug. 7, 2024).

backed by the full faith and credit of the United States, much less deposit insurance was required.¹⁸⁵

1909–1933—During this period, mutual deposit insurance schemes were yet again established in eight separate states—Oklahoma, Kansas, Texas, Nebraska, Mississippi, South Dakota, Washington, and North Dakota.¹⁸⁶ At this time, newly enacted state deposit guaranty laws made it compulsory for banks operating with a State charter to participate in a deposit guaranty plan.¹⁸⁷ Usually, these schemes were privately run but incorporated bank supervision from the state.

The first problem with these schemes was that they suffered from the same design flaws as the prior period of private insurance.¹⁸⁸ Several of these schemes placed upward limits on assessments. In particular, although none limited the size of the accounts that depositors could hold, several limited the amount or frequency of assessments that could be charged to banks.¹⁸⁹ Adverse selection was also a problem for those schemes that allowed banks to voluntarily exit.¹⁹⁰

This period of private insurance law also featured supervisory failure quite prominently. As before, there was rampant mismanagement in banks, and the state supervisory authorities were inadequate to address it. The examinations were routinely “perfunctory” even when required for initial admission to the

¹⁸⁵ *Antecedents of the FDIC*, in FED. DEPOSIT INS. CORP., THE FIRST FIFTY YEARS 13, 24 (1984). [hereinafter FIRST FIFTY YEARS, Ch. 2]. This state of play remained only for a little while. By 1870, deposits were twice the size of national bank notes and by 1900 deposits made up seven times the volume of circulating national bank notes. *Id.*

¹⁸⁶ See WARBURTON, *supra* note 92, at 3.

¹⁸⁷ *Id.* at 5–7. For a sampling of these laws or sources discussing them, see 1909 Wash. Sess. Laws 65–66, <https://leg.wa.gov/codereviser/documents/sessionlaw/1909pam1.pdf> (discussing Washington deposit insurance law); Thornton Cook, *Deposit Guaranty in Mississippi*, 29 Q. J. OF ECON. 419 (1915) (discussing the Mississippi law); *State v. Smith*, 234 N.W. 764 (S.D. 1931) (reviewing a constitutional and South Dakota law challenge to the bank assessments); J.N. Dolley, *The New Kansas Banking Laws*, Address to the Twenty-Second Annual Convention of the Kansas Bankers' Association, 5 (May 26, 1909) (“Speaking through their Legislature they have said that they would do all possible to make those credits safe and the true representation of their accumulated savings—something that could not be swept away by a tremulous breath from the stock exchange of New York City, or the explosion of a badly constructed bomb in a mismanaged foreign trust company”) (explaining the merits of deposit insurance law for Kansas banks).

¹⁸⁸ WARBURTON, *supra* note 92, at 37 (“When the Oklahoma law was enacted, forty years had elapsed since the State bank-obligation insurance systems of the nineteenth century had been in operation, and very little was known about their character or the success of their operations.”).

¹⁸⁹ *Id.* at 38–40. Though some, like Texas, did limit insurance to certain kinds of deposits. Texas also managed its fund more successfully than other states by accumulating a “sizable permanent fund used as a revolving fund to provide for immediate payment of depositors” and orchestrating the “levy of special assessments after each failure to recoup the permanent fund.” *Id.* at 256.

¹⁹⁰ WARBURTON, *supra* note 92, at 112. In Kansas, entry (i.e., participation) was also voluntary. Banks could withdraw provided they gave six months’ notice to the Bank Commissioner. WARBURTON, *supra* note 92, at 113.

scheme.¹⁹¹ Supervision was generally lax.¹⁹² Often, bank examiners lacked competence or adequate resources to rigorously evaluate the banks within their jurisdiction. In Kansas, for example, although the Commissioner who presided during the first few years of the scheme, J.N. Dolley, tried to maintain a high-quality supervisory team, “bank supervision was handicapped, as in other States, by frequent changes in the Commissionership and by a salary scale for examiners insufficient to retain the most competent men.”¹⁹³ This was a common theme across all eight of the state supervisory regimes.

Litigants were often successful at undercutting conduct rules. In one Kansas case, for example, the Bank Commission had written to a bank informing it that their insurance had been terminated for prolonged violation of the law. It asked the bank in question to “Kindly remove the guaranty sign and erase any reference to guaranteed deposits from your windows, stationery or other places.”¹⁹⁴ The bank ignored the notice and six weeks later was closed for failure. The Commissioner did not issue guaranty fund certificates and depositors filed suit. Apparently,

[t]he bank had complied with all provisions of the deposit guaranty law, though violating other laws, and the Commissioner’s power to terminate participation was limited to cases of violation of the deposit guaranty law. In addition, the depositors had not been notified, and their right to protection was not cut off by the Commissioner’s letter to the bank.¹⁹⁵

And market discipline was weak. In Texas, “under the guaranty fund plan, no depositors lost any money, they were not very mad at bankers even when the bank failure came about as a result of simple fraud.”¹⁹⁶

For one or more of these reasons, each of these schemes failed by 1933.

1970–1985—During this period, thirty private deposit insurers operated in the United States.¹⁹⁷ These insurance schemes all followed the mutual liability model. State governments established these funds to provide insurance for banks and thrifts within the state, but none operated with financial backing from the state.¹⁹⁸ As the thrifts and banks began to fail in the late

¹⁹¹ WARBURTON, *supra* note 92, at 10 (“Except in Mississippi, inadequate time was allowed for making examinations; and supervisory officials doubtless were reluctant to close banks which they had previously permitted to remain in operation.”).

¹⁹² *Id.* at 202. As one president of a Texas bank reflected on the scheme in 1934, “The danger to the Guaranty Fund was caused very largely by our loose method of supervision at that time.” *Id.*

¹⁹³ *Id.* at 127. Similarly, in Nebraska, examiners were stretched thin for resources and salary was not competitive and the quality of supervision declined over the lifetime of the guaranty fund. WARBURTON, *supra* note 92, at 287.

¹⁹⁴ *Id.* at 126.

¹⁹⁵ *Id.*

¹⁹⁶ *Id.* at 203.

¹⁹⁷ See English, *supra* note 170, at 57.

¹⁹⁸ See *id.* at 58.

1970s and early 1980s, losses severely strained the schemes and many of them failed. Notable insurance scheme failures included the American Savings Insurance Corporation in Mississippi in 1976, the Nebraska Depository Institution Guaranty Corporation in 1983, the Ohio Deposit Guaranty Fund in 1985, the Maryland Savings Share Insurance Corporation in 1985, and the Rhode Island Share and Deposit Indemnity Corporation in 1991.¹⁹⁹

In most cases, the failure of one or two of the largest banks within the scheme was enough to render it insolvent.²⁰⁰ In studying this period, Bill English summarized the problem well: “The failure of the large member was sufficient to wipe out the reserves of the deposit insurer. This loss, coupled with the loss of confidence in the regulatory authorities, touched off runs at other insured institutions.”²⁰¹ As discussed earlier, banks’ excessive risk-taking to compete in a more challenging market and competitive environment was largely the reason for the wave of thrift and bank failures. Thus, that dynamic can be seen as the root of these insurance schemes’ struggles as well. However, the schemes presumably could have survived if they had had the authority to replenish their funds with assessments on the remaining banks unless the remaining banks were themselves insufficiently capitalized to have adequately buoyed the scheme.

2. The Successes

Arguably, however, these examples should not be taken as dispositive of the question whether private insurance could work for its intended aim—i.e., protection of the monetary base and the accompanying payment system. Other examples illustrate that private, local-level deposit insurance can be successful. Thus, while the above examples provide helpful lessons in how not to design and operate a private deposit insurance scheme, they need not foreclose such experimentation going forward.²⁰²

19th century Indiana, Ohio, Iowa—Three of the state insurance schemes that were established in the first wave of private deposit insurance were successful. Each of them also pursued a mutual liability program, indicating that the model itself was not inherently the problem. In Indiana, all branches within the state were required to be mutually liable for each other’s deposits.²⁰³ But the Indiana system was distinctive insofar as it “relied on bankers themselves to make

¹⁹⁹ See *id.* at 64.

²⁰⁰ See *Failing Bank Resolutions*, FED. DEPOSIT INS. CORP., <https://www.fdic.gov/resources/resolutions/failing-bank-resolutions/> (last visited Aug. 7, 2024); *Bank Failures in Brief*, FED. DEPOSIT INS. CORP., <https://www.fdic.gov/bank/historical/bank/> (last visited Aug. 7, 2024).

²⁰¹ English, *supra* note 170, at 75.

²⁰² Calomiris, 1989, *supra* note 8, at 28 (“A successful self-regulating system of bank liability insurance is much more than a pipedream; it is the mechanism that characterizes the only successful liability insurance systems in the historical record”).

²⁰³ See IND. CONST. art. XI, § 5.

and enforce laws and regulations through a Board of Directors.”²⁰⁴ Importantly, the Board also had the power to decide when to close a bank upon two-thirds a vote—and “without recourse to courts.”²⁰⁵ This is significant because many of the insurance schemes failed around the same time, or would fail in future periods, either due to the ineptitude of state regulators or interference by the courts. This scheme also allowed its Board to set limits on banks’ assets relative to their capital and thus acted as a quasi-bank regulator too.²⁰⁶

The Ohio scheme was managed by a similar Board of Control with even greater power and authority. It had “virtually unlimited discretionary powers during a banking crisis, including the right to force banks to make loans to one another.”²⁰⁷ During the 1857 banking crisis, the Board of Control managed and directed interbank lending in a way that protected the Ohio banking sector from the broader national financial crisis.²⁰⁸ In Iowa, the private supervisory arm of the private insurance scheme also had sweeping powers—it could close banks, limit dividend payments, and regularly examine banks.²⁰⁹ Overall, as Professor Calomiris underscores, “An especially important feature of the three successful insurance schemes and clearing houses was the alignment of the incentive to regulate and the authority to regulate.”²¹⁰

These schemes never failed. Rather, they were eventually rendered moot with the creation of the national banking system in 1863, which prompted state-chartered banks to convert to national charters, thereby withering membership in the funds.²¹¹

19th century clearing houses—Beginning in the 1850s, banks began to band together to provide interbank financial services but also to manage the economic disruptions caused by crises. In the absence of a central bank, private Clearinghouse banks formed across America and performed some of the most important functions of a central bank. Their function during the frequent banking crises of this time was to operate formal coinsurance arrangements.²¹² In particular, when banks faced tremendous outflows of deposits, the Clearinghouses devised a system to enable banks to meet redemptions without

²⁰⁴ Calomiris, 1990, *supra* note 8, at 288.

²⁰⁵ Calomiris, 1989, *supra* note 8, at 15.

²⁰⁶ *Id.*

²⁰⁷ Calomiris, 1990, *supra* note 8, at 288.

²⁰⁸ Calomiris, 1989, *supra* note 8, at 16.

²⁰⁹ *Id.* at 17.

²¹⁰ *Id.* at 19.

²¹¹ See *National Banking Acts of 1863 and 1864*, FED. RESV. HIST., <https://www.federal-reservehistory.org/essays/national-banking-acts-of-1863-and-1864> (last visited Aug. 7, 2024) (discussing how the National Banking Act led to the decline of state-chartered banks by imposing a high tax on state bank notes, effectively forcing many to convert to national charters).

²¹² See Gary Gorton, *Clearinghouses and the Origins of Central Banking in the United States*, 45 J. ECON. HIST. 277, 277 (1985) (“During banking panics the clearinghouse united banks into an organization resembling a single firm which produced deposit insurance.”); *id.* at 279 (“The U.S. clearinghouse system experienced eight banking panics prior to the creation of the Federal Reserve System.”).

facing fatal strains on their liquidity. During the panics of 1857, 1893 and 1907, the Clearinghouses transformed into a “single, firm-like organization uniting the member banks in a hierarchical structure topped by the Clearinghouse Committee”—which effectively performed as deposit insurer.²¹³

In particular, the Clearinghouses developed a system of so-called clearinghouse certificates.²¹⁴ Members that needed currency would apply to the Clearinghouse’s Loan Committee, submit collateral, and receive the certificates as a percentage of the collateral in return. During the panic of 1857, these certificates were then used in lieu of currency for the satisfaction of interbank obligations, which freed up currency to meet depositors’ redemption claims.²¹⁵ Clearinghouse members agreed to accept the certificates from one another, and the system thus worked until stability was restored. During the panics of 1893 and 1907, the Clearinghouses issued these certificates directly to the public.²¹⁶ Although certificates were not insurance against any one bank’s failures, because the public knew that they were claims against the entire consortium of banks that were members of the Clearinghouse, “bank-specific risk [became] irrelevant to depositors, [and] a secondary market in these claims could and did quickly develop.”²¹⁷

Importantly, members’ willingness to accept the certificates of others in the satisfaction of obligations depended on their ability to trust in the overall soundness of each other. Like the successful insurance boards in Indiana, Ohio, and Iowa, the Loan Committee had a great deal of power. It could decide whether to accept collateral or demand more collateral, and it could allocate funds from healthy banks to troubled banks.²¹⁸ Accordingly, the Clearinghouses—owned and operated by their members—would impose capital and reserve requirements as well as reserve ratios and restrictions on portfolio holdings attendant to membership; they would also routinely refuse membership to institutions that could not meet these standards.²¹⁹ To be sure, this was a coinsurance model in all but formal name. If a member bank failed and its posted collateral did not cover the outstanding certificates, those losses

²¹³ *Id.* at 280.

²¹⁴ See, e.g., Charles W. Calomiris & Larry Schweikart, *The Panic of 1857: Origins, Transmission, and Containment*, 51 J. ECON. HIST. 807 (1991) (studying the panic of 1857 to illustrate how state banks’ ability to cooperate largely determined the panic’s outcome).

²¹⁵ Gorton, *supra* note 212, at 280–81.

²¹⁶ See Jon Moen & Ellis W. Tallman, *Clearinghouse Loan Certificates as Interbank Loans in the United States, 1860–1913*, 11 FIN. HIST. REV. 23, 34 (2004) (noting that during the Panics of 1893 and 1907, clearinghouses issued loan certificates directly to the public in denominations suitable for general circulation, effectively serving as a substitute currency to maintain liquidity during banking crises); see also Gorton, *supra* note 212 at 285 (explaining how the issuance of clearinghouse loan certificates to the public during financial panics helped stabilize the banking system by providing an alternative to cash withdrawals).

²¹⁷ Gorton, *supra* note 212 at 282.

²¹⁸ Gorton, *supra* note 212 at 281.

²¹⁹ English, *supra* note 170, at 107; Calomiris, 1989, *supra* note 8, at 11.

would be shared by the other members on a pro rata basis.²²⁰ Notably, the Clearinghouses all operated on a local and regional level given the necessity for close and constant peer monitoring.

To be clear, this mechanism provided liquidity—like an LOLR function—not deposit insurance. But its success in stabilizing the banking system during panics, without generating moral hazard, is worth highlighting in this discussion about the potential for private sector led alternatives that reinvigorate market discipline.

Present-day Massachusetts—Not all examples of successful private deposit insurance were in the nineteenth century. In the state of Massachusetts, the Massachusetts Depositors Insurance Fund [“DIF”] was established in 1934 and continues to operate well today. It insures all deposits above the FDIC cap.²²¹ According to their website, “[n]o depositor has ever lost a penny [in a Massachusetts state-chartered bank] insured by both the FDIC and the DIF.”²²² The DIF is privately managed and funded by member assessments and interest income from its investments.²²³ It supervises members by reviewing quarterly financial reports, and by meeting regularly with the FDIC and the Massachusetts Division of Banks following those agencies’ exams, from which it gleans information to risk-adjust the assessments of its member banks.²²⁴

Of key interest, the Massachusetts DIF was successful in shoring up state banks throughout the Global Financial Crisis. In their study of the DIF, Danisewicz, Lee, and Schaeck compared deposit flows and lending between 2004 and 2015 in banks that are members of the Massachusetts DIF with groups of banks that only had access to FDIC insurance.²²⁵ They found that during the crisis, deposits of Massachusetts DIF member banks increased relative to these other non- Massachusetts-DIF banks. In turn, the Massachusetts DIF banks, who had better access to deposit financing reduce their lending less during the financial crisis.²²⁶ The stabilizing effect of the Massachusetts DIF was reinforcing—depositors began to reallocate their funds to banks that offered additional protection via their membership in the DIF during the crisis.²²⁷ Their findings thus show that the private deposit insurance fund provided additional protection for some depositors’ wealth during the 2008 crisis.²²⁸

²²⁰ Gorton, *supra* note 212, at 281.

²²¹ *FAQs, DEPOSITORS INS. FUND*, <https://www.difxs.com/DIF/DIFFFAQs.aspx> (last visited Aug. 7, 2023). Initially, membership in the DIF was mutually exclusive with membership in the FDIC, but that rule was changed in 1956. Piotr Danisewicz et al., *Private Deposit Insurance, Deposit Flows, Bank Lending, and Moral Hazard*, 52 J. FIN. INTERMEDIATION 1, 3 (2022).

²²² *DEPOSITORS INS. FUND*, *supra* note 221.

²²³ Danisewicz et al., *supra* note 221, at 4.

²²⁴ *Id.*

²²⁵ *Id.* at 2–3.

²²⁶ *Id.* at 2–3, 15.

²²⁷ *Id.* at 3.

²²⁸ *Id.* at 15.

Germany—So far, all of the success stories of private deposit insurance have been about schemes operated on the local level. In 1975, the German Bank Association (today known as the Federal Association of German Banks), established an insurance scheme for private banks in Germany well before one was required in law.²²⁹ That scheme—the Einlagensicherungsfonds des Bundesverbandes deutscher Banken e.V., or “ESF”—illustrates that private deposit insurance can work well on a national level as well, and with the membership of large, internationally active banks.²³⁰

Before the EU-level deposit directive required each member state to establish a public deposit guarantee scheme (“DGS”) to cover up to €1,000 in deposits, the ESF was essentially unlimited, and universal.²³¹ Today, this scheme operates to provide insurance coverage for deposits not covered by the German DGS, up to 15 percent of a member bank’s own funds, similar to the Massachusetts DIF.²³² It protects private individuals up to a maximum of €5 million and companies up to €50 million.²³³ Technically, the scheme is voluntary but, because the Bank Association can recommend to the State that a bank license be withheld, in practice, most banks participate.²³⁴ Members pay set premiums and, as required, ‘extraordinary premiums’ if the fund runs low.²³⁵ There is no public funding at all.

Because the DGS together with the ESF provide a very high degree of, if not unlimited, deposit insurance coverage, depositors themselves have little incentive to monitor the banks and exercise market discipline.²³⁶ To compensate for the inadequate incentives imposed on depositors, the scheme is designed to foster robust peer monitoring among the private banks. The ESF, like other successful private deposit insurance schemes, has supervisory and regulatory power over members. Members are required to comply with the

²²⁹ Thorsten Beck, *Deposit Insurance as Private Club: Is Germany a Model*, 42 Q. REV. ECON. & FIN 701, 702 (2002); see generally FIN. STABILITY BD., THEMATIC REVIEW ON DEPOSIT INSURANCE SYSTEMS (2012), https://www.fsb.org/wp-content/uploads/r_120208.pdf.

²³⁰ See Beck, *supra* note 229, at 714; see also DEUTSCHE BANK, U.S. RESOLUTION PLAN: JULY 2018 SUBMISSION PUBLIC SECTION 36 (2018) (discussing its access to the Germany private deposit insurance scheme), <https://www.federalreserve.gov/supervisionreg/resolution-plans/deutsche-bank-1g-20180701.pdf>.

²³¹ See Council Directive 14/49, 2014 O.J. (L 173) 149 (EU).

²³² *Deposit Protection*, DEUTSCHE BUNDESBANK EUROSISTEM, <https://www.bundesbank.de/en/tasks/banking-supervision/individual-aspects/deposit-protection/deposit-protection-622748> (last visited Aug. 8, 2023).

²³³ Alexander Glos & Jan Struckmann, *Reforms of the German Voluntary Deposit Protection Scheme on the Horizon*, FRESHFIELDS (Dec. 20, 2021), <https://riskandcompliance.freshfields.com/post/102hes1/reforms-of-the-german-voluntary-deposit-protection-scheme-on-the-horizon>. *But see id.* (discussing a possible decrease in the maximum depositor protection in January 2030, though coverage would still remain at €1million for persons and €10 million for companies).

²³⁴ See Beck, *supra* note 229.

²³⁵ See *id.*

²³⁶ See *id.*

by-laws of the scheme. In the case of violations, the scheme can impose corrective actions or expel a member altogether.²³⁷

The ESF scheme has proven its mettle in several different crises. In November 1983, the mega-bank Schroder, Munchmeyer, Hengst & Co. failed. Notably, the problems at the bank were discovered by the ESF's supervisory board—not by the German Federal Supervisory Office.²³⁸ Upon its failure, “the ‘club’ of private German banks work[ed] in quick cooperation with public officials to minimize the impact on the banking system.”²³⁹ After that incident, the German banking environment was “almost boring” until the 2008 financial crisis.²⁴⁰ During the crisis, the ESF scheme operated as intended. Further, the Bank Association provided guarantees to eight major banks in lieu of government assistance; no private German banks failed from 2008 to 2010.²⁴¹

* * *

This detailed study of prior and current experiments in private deposit insurance schemes has provided valuable insight into the optimal design of a U.S. private deposit insurance scheme that could complement and cooperate with the FDIC. Remarkably, across time and geography, the success of private deposit insurance schemes has turned on a few common design elements, just as their failures have resulted from similar design flaws.

III. REEVALUATING THE BANK SAFETY NET

This Part turns to the question of how the United States Congress might operationalize a private deposit insurance scheme. It does so with a view to the entire safety net—which includes, most importantly, the central bank acting as lender-of-last resort. It also acknowledges the implications for banking market structure and suggests some adjustments in competition law to accommodate the formation of a private insurance scheme.

For ease of reference, the Article will refer to the insurance scheme proposed herein as the American Banking Safety Scheme (“ABSS”). Before delving into the institutional design of the ABSS, some discussion of the model choice is important. As the examples in Part II highlighted, private deposit insurance schemes can be managed and operated in one of two ways.

²³⁷ *See id.*

²³⁸ *Id.* at 710.

²³⁹ *Id.*

²⁴⁰ Michael Goedde-Menke, Thomas Langer & Andreas Pflingsten, *Impact on the Financial Crisis on Bank Run Risk—Danger of the Days After*, 40 J. BANKING & FIN. 552, 524 (2014).

²⁴¹ Martin Hellwig, *Germany and the Financial Crises 2007–2017* (June 2018) (drft. manuscript), <https://www.riksbank.se/globalassets/media/konferenser/2018/germany-and-financial-crisis-2007-2017.pdf>.

One model can be characterized as a third-party insurance model. In those schemes, an insurer operates external to the banking system itself and also outside the state. The insurance scheme issues policies to banks that qualify and usually has some significant supervisory and monitoring power, or it may piggyback on those powers of the state. With the exception of the Ohio and Iowa systems of the nineteenth century, and the Massachusetts DIF, these models have not been successful because they ultimately could not control fraud or excessive risk-taking in banks or had to limit their ability to replenish after losses in order to maintain membership.

The second model arguably holds more promise for the U.S. banking system. The experience of the clearinghouses and German ESF suggest that private deposit insurance likely works best when offered to bank-members as a “club good.”²⁴² Clubs are usually very adept at developing and enforcing “rules of entry and conduct”²⁴³ thanks to the reputational benefits that members enjoy from gaining acceptance to the club and remaining members in good standing. Aside from these reputational dynamics, clubs usually have members that are tight-knit, reducing the cost of peer monitoring for infractions. Further, and related, club members usually share interests in the benefits offered by the club and so are able to reach consensus on mutually agreeable rules of the road. Given these features and incentives within the club, economists have long recognized that private governance is an important kind of club good that tends to produce effective self-governance.²⁴⁴

Beyond the theory of club goods, and the successes detailed above, financial market actors have, over centuries, demonstrated a propensity to devise and maintain market solutions to market problems. The development of stock exchanges is often considered a prime and early example of industry innovation of market structures aimed at enhancing the efficiency of their operations. The London Stock Exchange developed from groups of banks and traders meeting in coffeehouses and agreeing upon rules and conventions of trade. Their interest in the success of the Exchange, together with strong reputational implications of undercutting the alliance, evolved into the ‘my word is my bond’ mentality—which worked.²⁴⁵

²⁴² See Beck, *supra* note 229 (noting this in respect of the German ESF); see generally James M. Buchanan, *An Economic Theory of Clubs*, 32 *ECONOMICA* 1 (1965) (departing from classic public versus private goods model to theorize club goods).

²⁴³ Edward Peter Stringham, *How Private Governance Made the Modern World Possible*, *CATO UNBOUND* (Oct. 5, 2015), <https://www.cato-unbound.org/2015/10/05/edward-peter-stringham/how-private-governance-made-modern-world-possible>.

²⁴⁴ *Id.*

²⁴⁵ See, e.g., *id.*; Paul G. Mahoney, *The Exchange as Regulator*, 83 *VA. L. REV.* 1453 (1997); Francis E. Merrill, *The Stock Exchange and Social Control*, 43 *AM. J. SOCIO.* 560 (1938) (discussing how stock exchanges regulate and control their members). See also Catherine E. Rudder, *Private Governance as Public Policy: A Paradigmatic Shift*, 70 *J. POL.* 899 (2008) (arguing that private governance and a variant, public-private governance, produce a significant portion of the rules that govern citizens’ lives day-to-day).

The same basic evolution transpired in New York. Early stockbrokers met in 1797 taverns and coffeehouses and adopted, among themselves, a “Constitution and Nominations of the Subscribers” to govern their trading practices and decorum.²⁴⁶ Later, this would become the New York Stock Exchange, which continues to this day to be a successful self-regulatory organization.²⁴⁷ All exchanges today establish their own rules for listing and monitor listed companies for compliance; de-listing—cutting off access to the exchange’s valuable public market access—is the consequence for noncompliance.²⁴⁸

As a club good, private deposit insurance has the potential to be stabilizing during a crisis while curbing the propensity toward moral hazard in normal times. Of course, this success is entirely contingent on the right institutional design.

Supervision with ‘Skin in the Game’—Perhaps the most important design element in such a scheme is affording a Governing Board with relatively strong statutory rights to supervise the member banks. At a minimum, the Governing Board would need access to information about banks’ risk-management practices, their capitalization and liquidity, and their capital funding structure. Ideally, it would be aware of each bank’s supervisory rating, whether that is a rating given under the CAMELS system or the LFI rating for the largest banks.²⁴⁹

Of course, access to this information would require the federal and state level bank supervisors to be willing and legally able to share such supervisory information. Importantly, however, the Governing Board should not, pursuant to its internal rules, be permitted to rely exclusively on the safety and soundness determinations of state or national bank supervisors.

After all, the history of bank supervision has been riddled with errors of oversight and inaction, due to political capture, agency costs, lack of expertise, or insufficient resource. While a full analysis of the shortcomings of bank supervision is well beyond the scope of this paper, one need only reflect on their appearance in the brief histories of private insurance discussed above to appreciate that government-led bank supervision is apt to allow too much risk-taking, fraud, or otherwise bad behavior fall through the cracks.

²⁴⁶ Stringham, *supra* note 243.

²⁴⁷ See Self-Regulatory Organizations, 88 Fed. Reg. 46820 (July 14, 2023) (providing an example of how the NYSE operates under the supervision of the SEC as a self-regulatory organization).

²⁴⁸ See Jonathan Macey, Maureen O’Hara & David Pompilio, *Down and Out in the Stock Market: The Law and Economics of the Delisting Process* (Feb. 2005) (unpublished manuscript) (available at https://ccl.yale.edu/sites/default/files/files/Jon_Macey.pdf).

²⁴⁹ For detail on these rating systems, see *Large Institution Supervision Coordinating Comm.*, BD. OF GOVERNORS OF THE FED. RSRV. SYS. (Jan. 17, 2024), <https://www.federalreserve.gov/supervisionreg/large-institution-supervision.htm>; Lewis Gaul & Jonathan Jones, *CAMELS Ratings and Their Information Content*, (Off. Comptroller Currency Working Paper, 2021), <https://www.occ.treas.gov/publications-and-resources/publications/economics/working-papers-banking-perf-reg/pub-econ-working-paper-camels-ratings.pdf>.

Inevitably, when these risks manifest, they put pressure—sometimes fatally—on the deposit insurance fund. Accordingly, the ABSS should have the ability to cooperate with federal and state bank supervisors, to be sure, but it should also have the authority to conduct its own peer monitoring and review. Given that banks would be self-funding this scheme, and become mutually liable upon a bank's failure and resolution, one could be confident that this level of 'skin in the game' would incentivize diligent monitoring.²⁵⁰

At first blush, the ability of the Governing Board to scrutinize banks' balance sheets seems overly intrusive and possibly a violation of antitrust law. Normally, this sort of information is kept highly confidential.²⁵¹ But the aversion to information-sharing is only a recent norm; clearly, banks shared information routinely to facilitate their clearinghouse cooperation.²⁵² As for the law's presumption that such information sharing could lead to anti-competitive price-fixing, that presumption may need some updating and adjusting.²⁵³

Restoring Market Discipline—Of course, supervisory peer monitoring is only effective to the extent that there is an enforcement mechanism to back it up. The typical consequence of taking on too much risk or failing to address misconduct would be to expel the bank from the scheme. That, however, would work at cross-purposes to the confidence-building goals of universal participation. In theory, the prospect of expulsion would incentivize monitoring by depositors, but in reality, we know that depositors almost never punish their banks by moving their deposits to another institution no matter how poorly bank management behaves.²⁵⁴

Instead, banks should discipline one another through the inter-bank lending channel.²⁵⁵ Riskier banks should get higher overnight rates or perhaps no overnight loans at all. The problem with this approach is that since 2012, the Federal Reserve has operated what is known as an "ample-reserves" regime.²⁵⁶

²⁵⁰ With that being said, each bank would only be responsible for a small fraction of losses. This would be especially true when considering the incentive to control the risk of a community bank.

²⁵¹ See, e.g., Peter Conti-Brown, *The Curse of Confidential Supervisory Information*, BROOKINGS INST. (Dec. 20, 2019), <https://www.brookings.edu/articles/the-curse-of-confidential-supervisory-information/>.

²⁵² See *supra* notes 212–220 and accompanying text.

²⁵³ See, e.g., Michael K. Vaska, *Conscious Parallelism and Price Fixing*, 52 U. CHI. L. REV. 508 (1985); Edward J. Schneiderman, *The Creation of a Separate Rule of Reason: Antitrust Liability for The Exchange of Price Information Among Competitors*, 1979 DUKE L.J. 1004; Lawrence J. White, *Antitrust and the Financial Sector*, MONEY & BANKING (Jan. 21, 2019), <https://www.moneyandbanking.com/commentary/2019/1/18/antitrust-and-the-financial-sector>.

²⁵⁴ See, e.g., Rajkamal Iyer, Manju Puri & Nicholas Ryan, *Do Depositors Monitor Banks?* (Fed. Rsr. Bank of N.Y. Working Paper, 2013), https://www.newyorkfed.org/medialibrary/media/research/conference/2013/stable_funding/depositors_Iyer_et_al.pdf.

²⁵⁵ Admittedly, this is more relevant for the largest banks; the challenge would be in stimulating such market-discipline for the thousands of smaller banks.

²⁵⁶ See Jane Ihrig, Zeynep Senyuz & Gretchen C. Weinbach, *Implementing Monetary Policy in an "Ample-Reserves" Regime: The Basics*, BD. OF GOVERNORS OF THE FED. RSRV. SYS. (July 1, 2020), <https://www.federalreserve.gov/econres/notes/>

In this operating framework, the Fed supplies the banking system with such a large volume of reserves that banks no longer have much need to borrow from one another in the interbank market at prevailing market rates; instead, they borrow directly from the Fed at a separate rate that the Fed administers known as the “interest on reserves” or IOR rate.²⁵⁷ The principal purpose of the IOR rate is to control the money supply; it is not designed to discipline banks for their risk-taking or reward them for their prudence. Again, the unintended consequences of the ample-reserves framework are beyond this Article’s scope, but it suffices for now to say that this framework too would need to be adjusted by a return to reserve scarcity.²⁵⁸

The private insurance contract—To give full effect to the benefits of this design, the terms of the deposit contract should be relatively stark and easy to understand. This could be accomplished in two main ways. First, participation should be compulsory for all FDIC-member banks. A universal participation requirement has the benefit of eliminating any possibility of adverse selection that could eventually deplete the fund. It would also ensure that the public has maximum confidence in the banking sector overall. Any amount of uncertainty about the scope of coverage is generally enough to spark a run.²⁵⁹ If participation were universal, banks and policymakers could confidently assure the public that the implicit guarantee has been made explicit—thus reducing all uncertainty—but via a cost-sharing model with banks.

The second most important contract term would allow the Governing Board an unlimited ability to assess banks. An annual assessment could be set as a percentage of liabilities, adjusted a risk-sensitive basis, but the scheme must be able to levy special assessments after one or more bank failures in order to maintain incentives for robust monitoring and the exercise of market discipline.

CONCLUSION

In the wake of three major bank failures in the spring of 2023, lawmakers and academics have debated deposit insurance reform. On the one hand, limiting deposit insurance with a cap has led to runs by uninsured depositors, prompting policymakers to step in with ad hoc rescues of this group and thus

feds-notes/implementing-monetary-policy-in-an-ample-reserves-regime-the-basics-note-1-of-3-20200701.html.

²⁵⁷ See JOHN R. WALTER & RENEE HALTOM, FED. RSRV., BANK OF RICHMOND, ECON. BRIEF NO. 09-12: THE EFFECT OF INTEREST ON RESERVES ON MONETARY POLICY (2009), https://www.richmondfed.org/publications/research/economic_brief/2009/eb_09-12.

²⁵⁸ See, e.g., Claudio Borio, Getting Up from the Floor (Bank of Int’l Settlements, Working Paper No. 1100, 2023), <https://www.bis.org/publ/work1100.pdf> (explaining these policy tradeoffs).

²⁵⁹ See Goedde-Menke, Langer & Pfingsten, *supra* note 240 (theorizing that what people know, understand, or believe about deposit insurance shapes their incentives to run).

extend the federal safety net beneath them. On the other hand, removing the cap altogether seems to create perverse incentives for lackadaisical behavior by large account-holding depositors and bank managers alike—both of whom should be monitoring banks—all while potentially burdening the average taxpayer.

Overlooked in this debate, however, is the potential for privatized deposit insurance over the prevailing FDIC cap. A close examination of this proposal reveals that when private insurance schemes are designed correctly, they can increase overall financial stability while decreasing moral hazard in a way that FDIC-provided insurance alone cannot do. Accordingly, this Article has argued for a new American Bankers Safety Scheme that would associate banks together to self-insure their deposits above the FDIC cap. It has provided historic and economic evidence to support such proposal and sketched out the basics of its design.