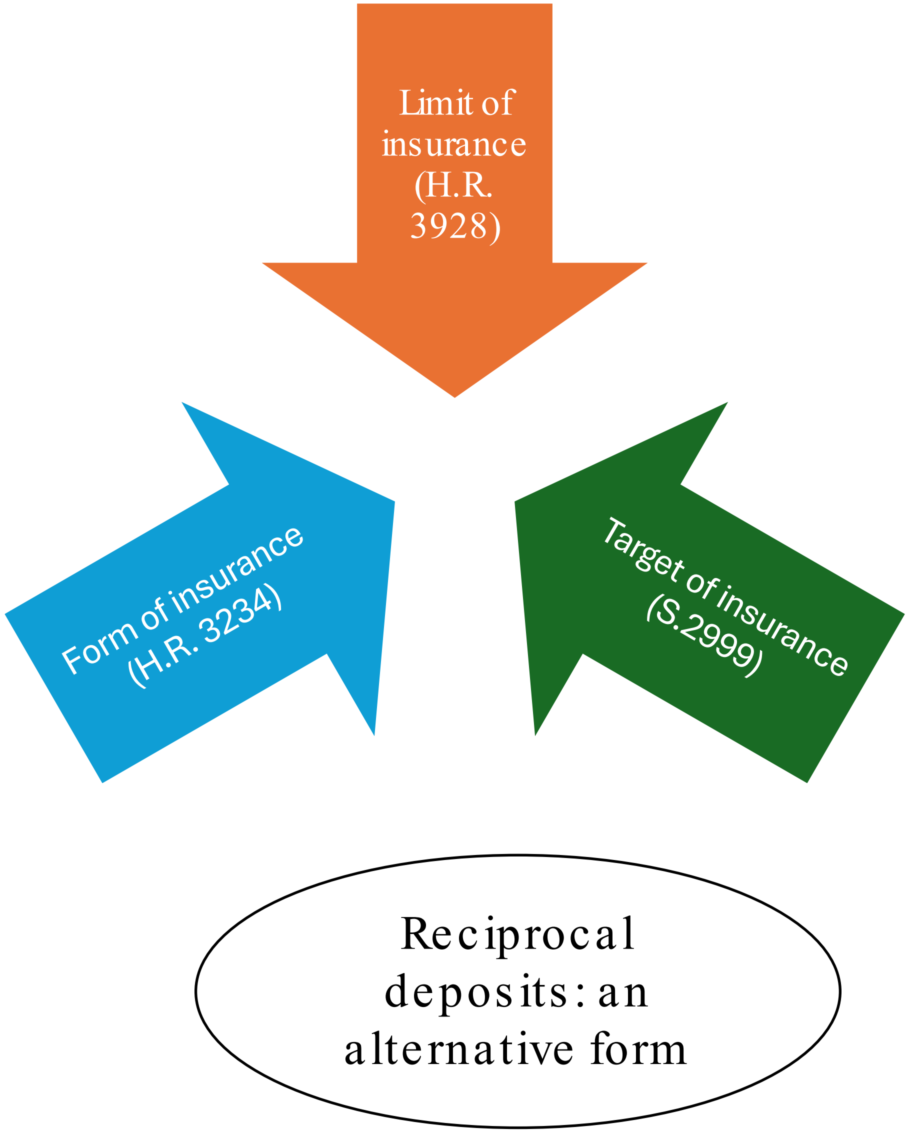
Deposit Insurance: How Much, What, and How?

Amiyatosh Purnanandam*
McCombs School of Business
University of Texas, Austin

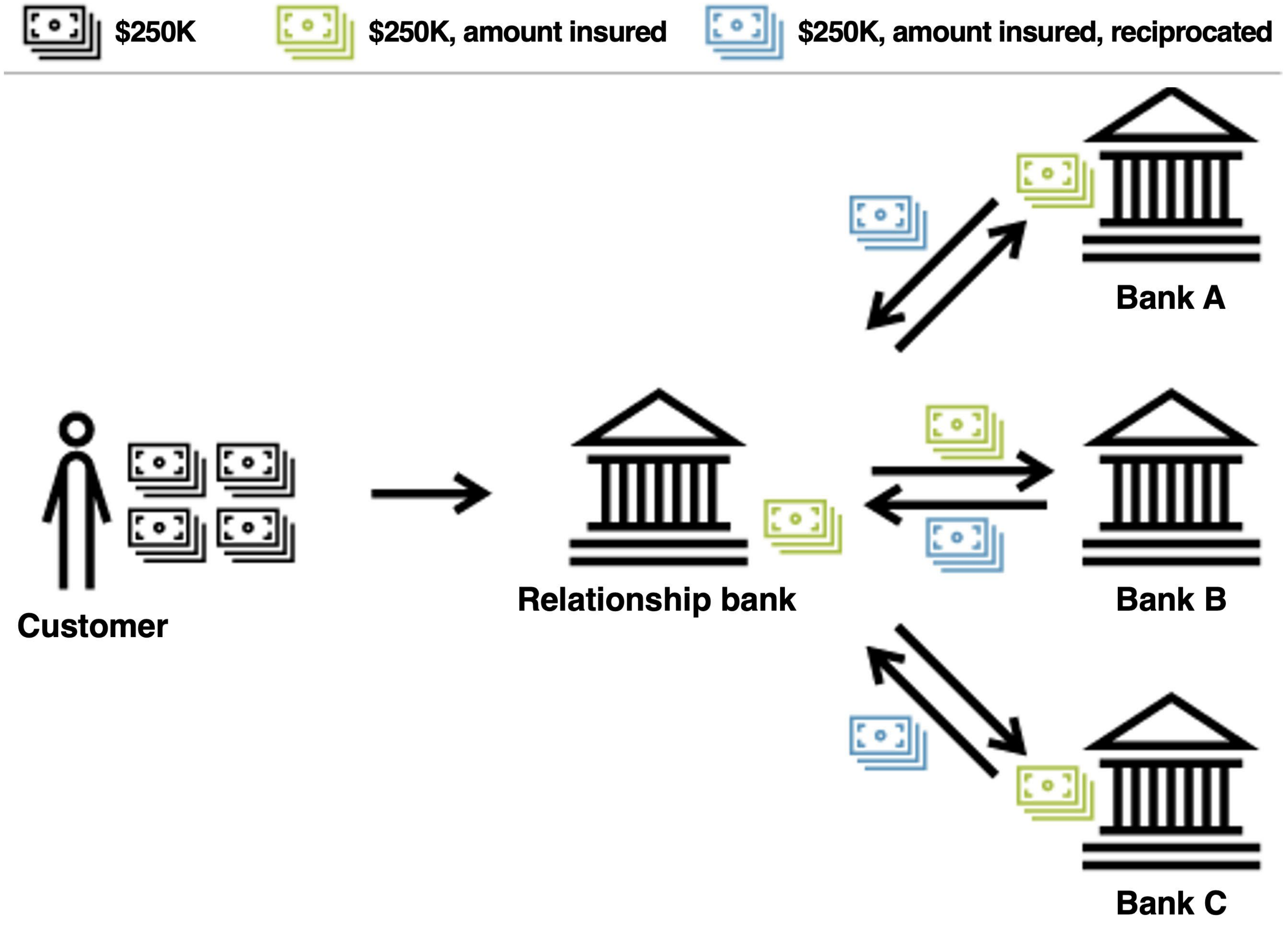
*Based on joint work with Shohini Kundu (UCLA) and Edward Kim (University of Michigan)

TEXAS McCombs

Recent Policy Discussions



Reciprocal Deposits as a *Market-Based* Solution for Deposit Insurance



Search and Match Frictions: IntraFi Network

A centralized match maker: IntraFi

Network onboarding requires time and incurs set-up costs: **3-6 months** to join the network

1. Integrate systems with provider – investments in technology, cybersecurity, compliance, and marketing
2. Obtain KYC verification and custodian approval
3. Prepare deposit placement agreements, rate-bridge agreements and client disclosures
   - Depositors can exclude banks (an element of market discipline)

Our Setting: 2023 Banking Turmoil Triggered by Runs

FT FINANCIAL TIMES

US regional banks swap $220bn in deposits to soothe insurance nerves

NEW YORK, May 24, 2023 – US regional banks are rushing to exploit rules that allow depositors to hold tens of millions of dollars in insured accounts, offering security far exceeding government-backed insurance to soothe clients unnerved by the recent banking turmoil.

Among regional banks advertising high-balance insured accounts is PacWest Bancorp, which like the former SVB often lends to start-ups and their investors. Beverly Hills, California-based PacWest's website says clients can "rest assured" because the bank can offer up to $175mn in insurance coverage per depositor, or 700 times the FDIC cap.

Shares of PacWest have plunged more than a third since mid-March. The bank said in its most recent financial filing that it was enrolling more of its customers in "reciprocal deposit networks", over which hundreds, or in some cases thousands, of banks spread customers' funds in order to stretch insurance limits.

Utilization of Reciprocal Deposit Networks Post-SVB

FT FINANCIAL TIMES

US regional banks sw
soothe insurance ner

NEW YORK, May 24, 2023 – US reg
allow depositors to hold tens of mill
security far exceeding government-b
the recent banking turmoil.

Among regional banks advertising h
Bancorp, which like the former SVB
Beverly Hills, California-based PacW
because the bank can offer up to $17
700 times the FDIC cap.

Shares of PacWest have plunged mo
in its most recent financial filing tha
"reciprocal deposit networks", over
banks spread customers' funds in or

REUTERS®

NYCB discloses over $18.7 bln in reciprocal deposit capacity, shares rise

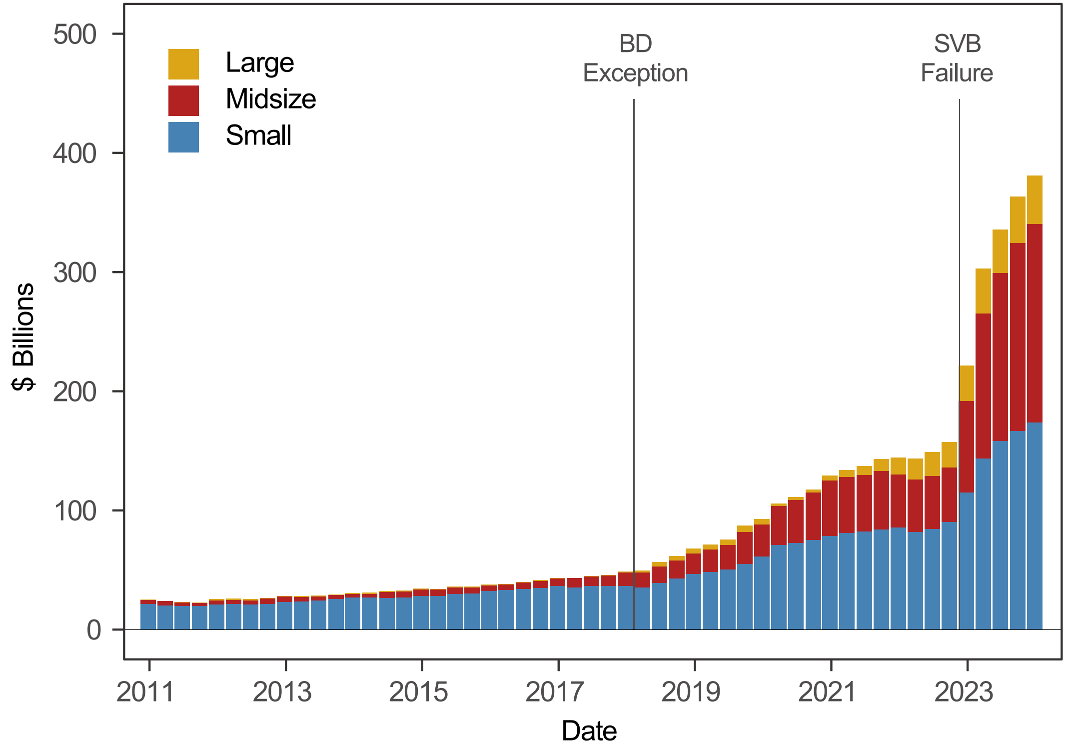
February 15, 2024 – New York Community Bancorp (NYCB.N) **shares rose 5%** on Thursday after it disclosed it has more than **$18.7 billion in reciprocal deposit capacity** to offer its customers expanded deposit insurance, **calming investor worries around its stability**.

NYCB said if it utilizes the reciprocal deposit capacity, its **share of fully insured deposits to total deposits would be 95%**.

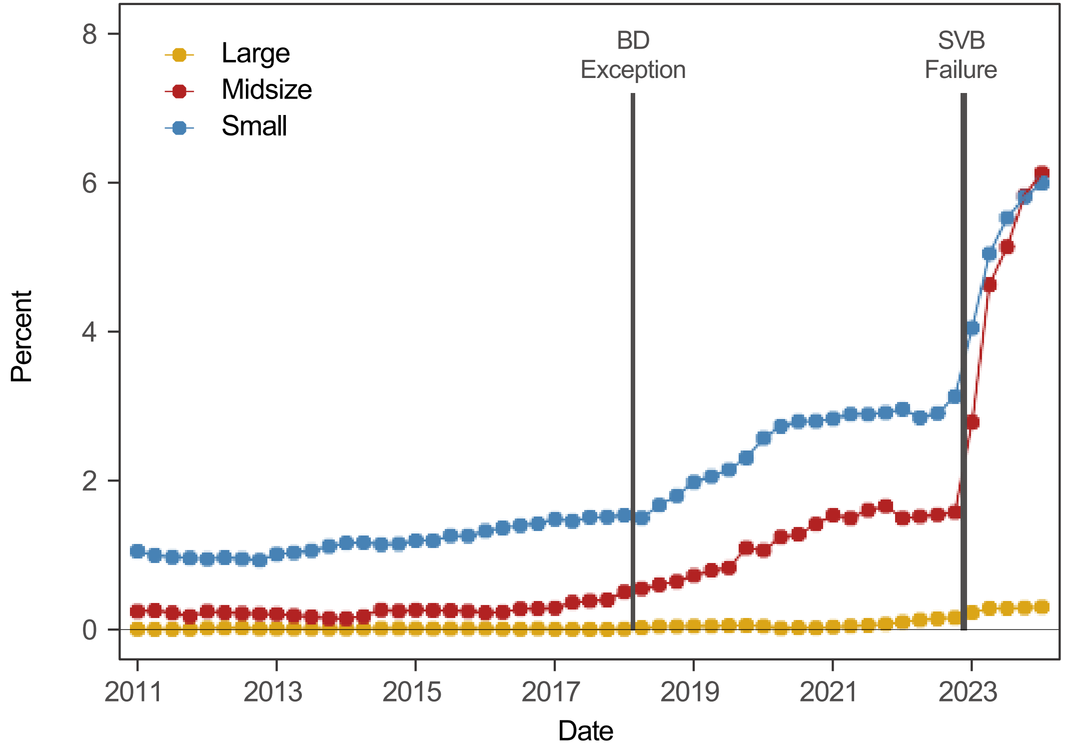
"It's important that such a high level of deposits are insured and I think the outright risk of a run on the bank on deposits is somewhat muted," D. A. Davidson analyst Peter Winter told Reuters..

TEXAS McCombs

Reciprocal Deposits Becoming a Major Source of Deposit Funding



(a) Reciprocal Deposits ($ bns)



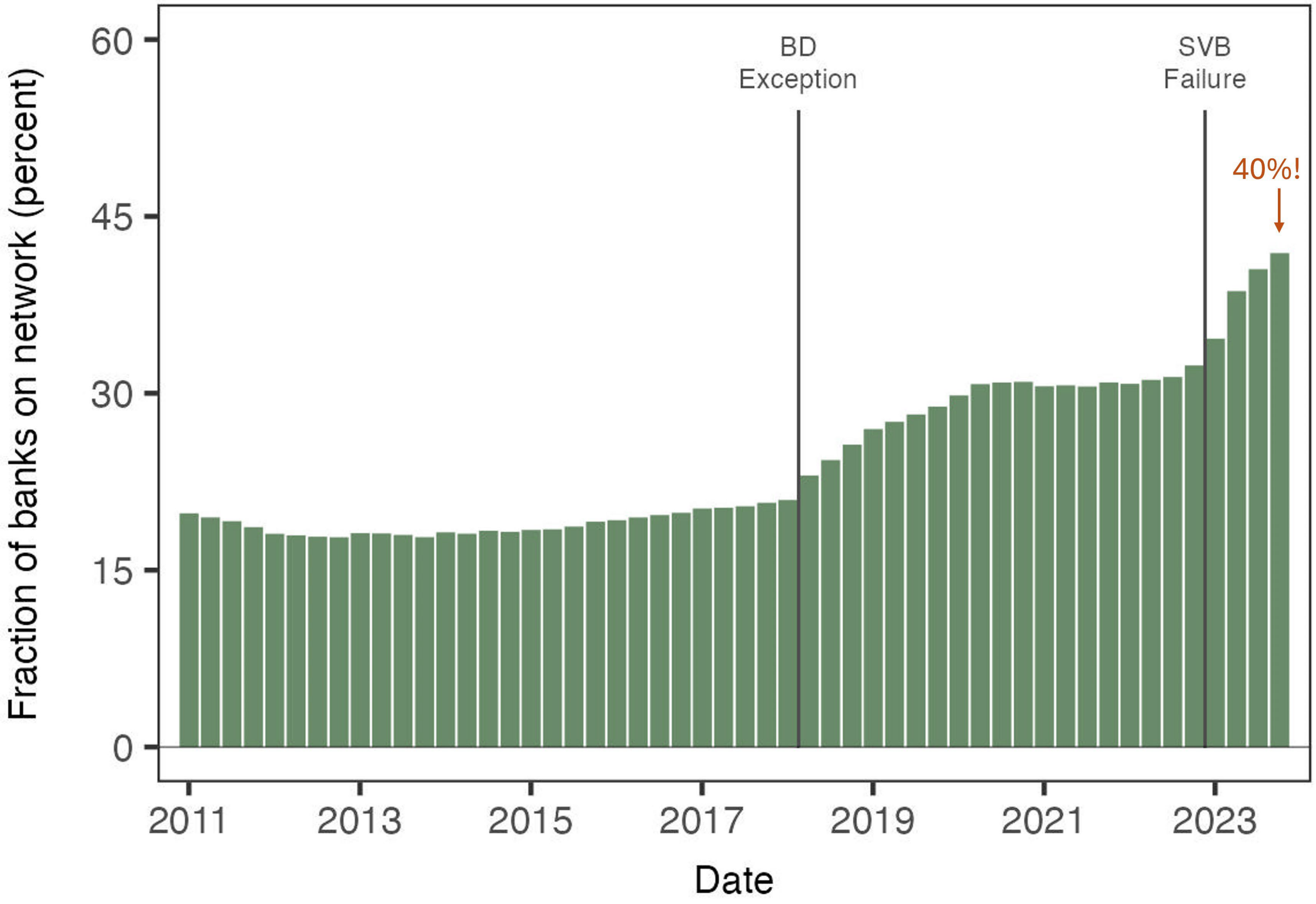
(b) Reciprocal Share (%)

<u>Key drivers:</u>

1. Regulatory change in 2018: RDs are not treated as brokered deposit up to a limit.
2. Public entities: local public entities required to back their deposits by insurance or collateral.
3. SVB crisis: concerns about uninsured deposits.

TEXAS McCombs

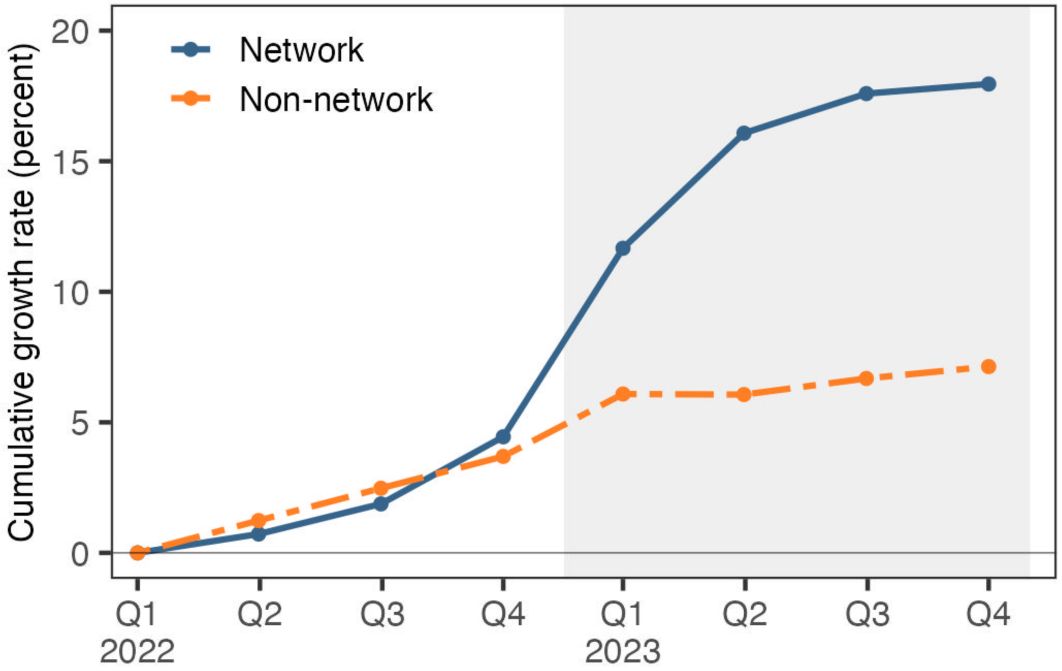
Network Participation is Growing



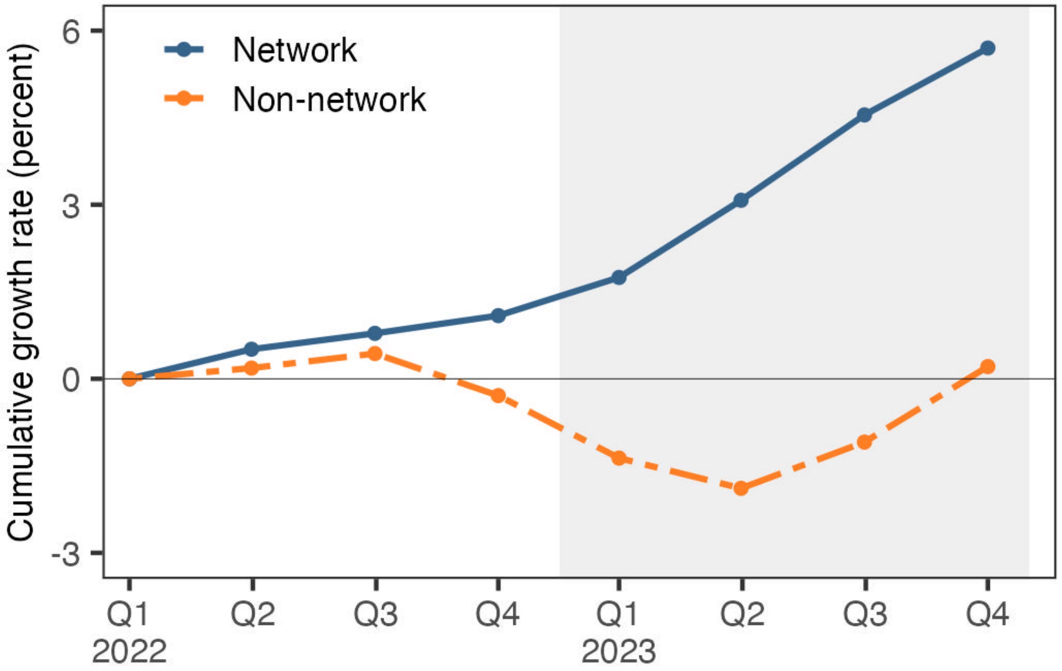
- In 2023, network participation rate increases from 30% to 40%

Cumulative Deposit Growth by Network Status

Network Status: Whether a bank is on IntraFi or not in 2002Q4. Sample: Bank size < $100 billion



(a) Insured Deposit Growth



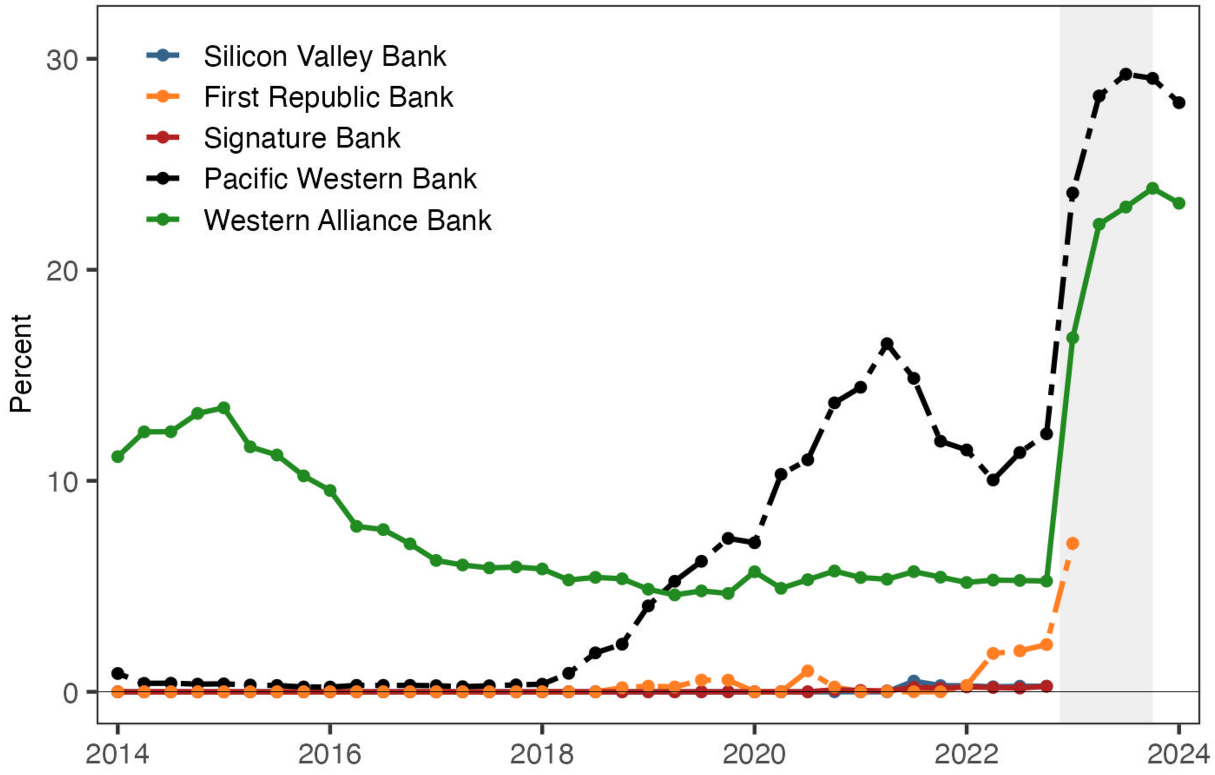
(b) Total Deposit Growth

- 10.8% gap in cumulative insured deposit growth (left)
- 5.5% gap in cumulative total deposit growth (right)

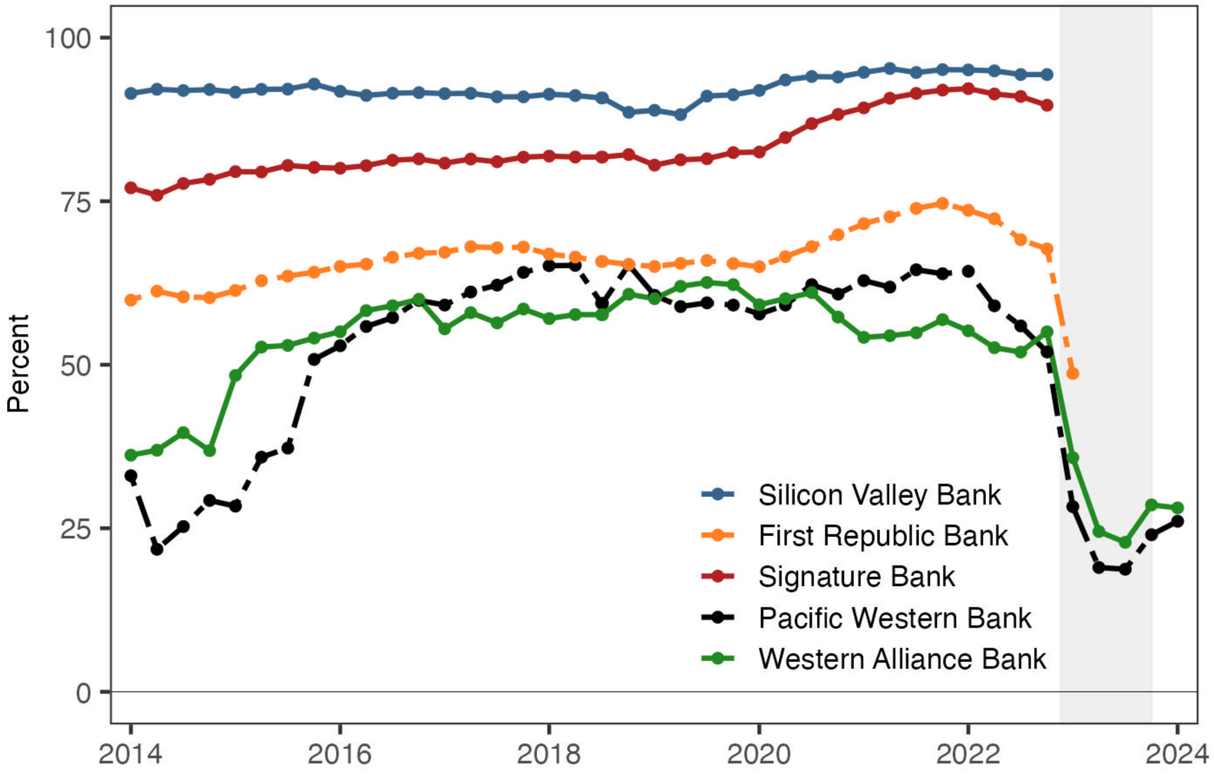
First key result: access to network -> no depositor run

TEXAS McCombs

Reciprocal Deposit Usage and Financial Stability



(a) Reciprocal



(b) Uninsured

TEXAS McCombs

Bank's Behavior & I.O. of Banking

1. Network Banks Paid 9-16 bps lower interest rates on insured CDs.

2. Network Banks Took on Additional Interest Rate Risk.
   Invested in longer duration securities

3. They gained market share in local deposit markets. Erodes TBTF advantage.

It gives us the opportunity to go after the bigger clients, where in the past they may have been afraid to put their money with us because we weren't a Bank of America Corp. or Wells Fargo & Co.
– ***Robert Kenney***, *CFO, Bankof Central Florida (July 2018)*

We're healthy, we're strong, but you don't even need to believe us because we're going to put you on IntraFi…Here's an actual guarantee, versus the implicit 'too big to fail' argument for big banks.
– ***Jay Tuli***, *President, Leader Bank(April 2024)*

TEXAS McCombs

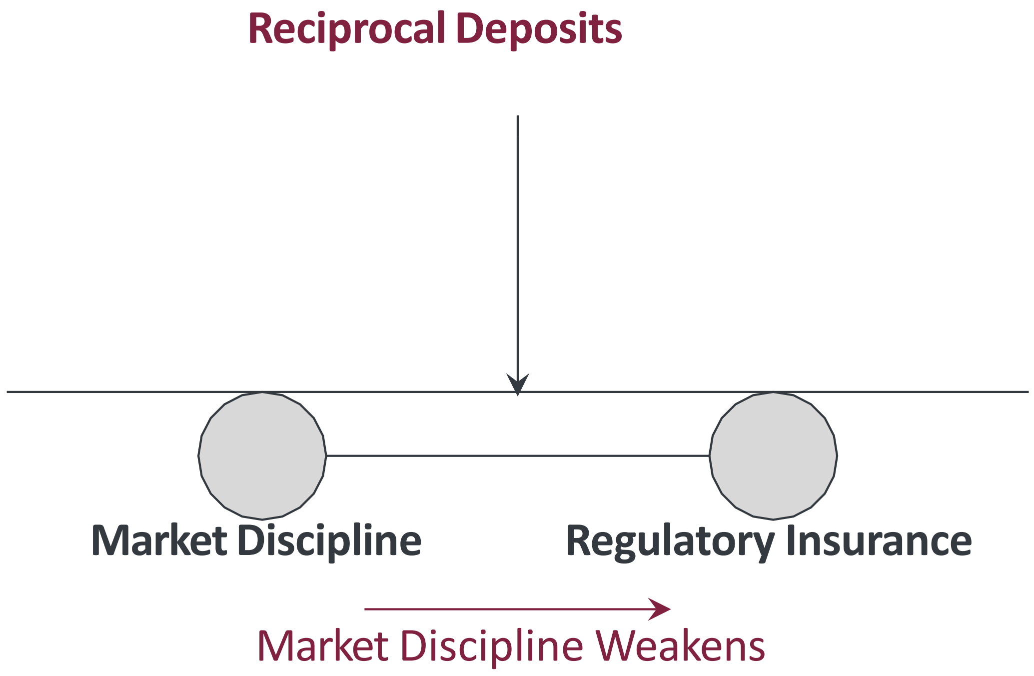
Implications for Deposit Insurance Design

Protecting small depositors, who hold most deposit accounts, has been a core objective of the deposit insurance system since its founding.

- With the rise of **reciprocal deposits**, the FDIC now insures larger depositors.

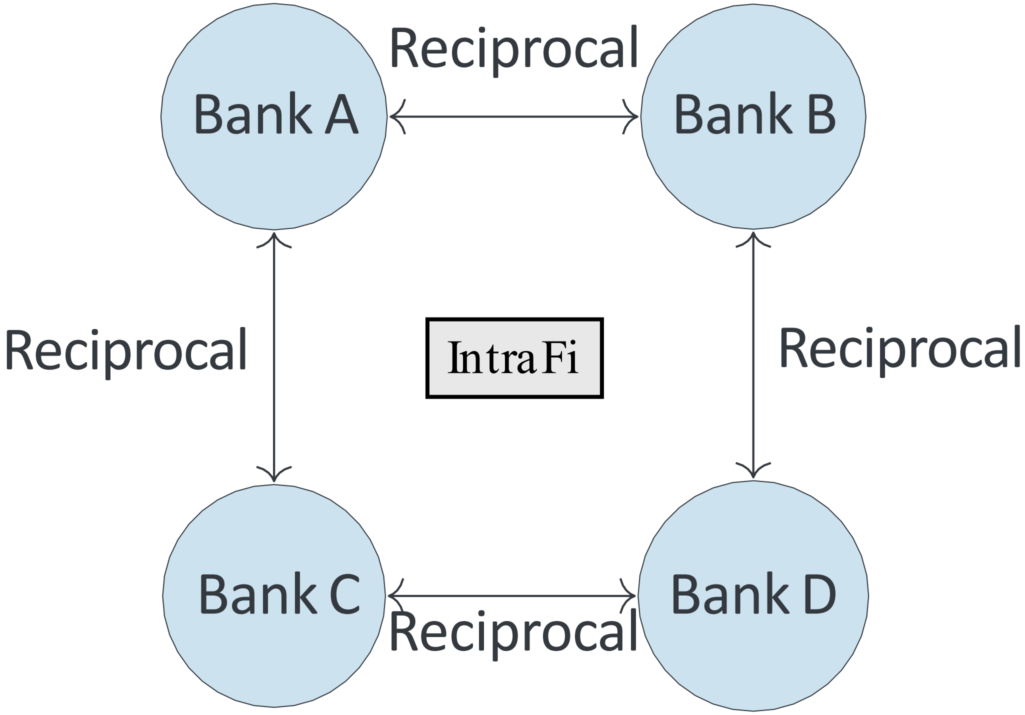
Key Questions:

1. Should insurance premiums for reciprocal deposits be higher given the potential increase in overall FDIC liability?
2. Should the Brokered Deposit exception limit be raised?
3. Is it time to increase the deposit insurance limit?
4. Can market discipline eliminate bad behavior?



Reciprocal Deposit Usage and Financial Stability

- **Reciprocal deposit usage was limited prior to SVB's failure… However, the market is rapidly growing**



- ***Why it matters:*** As reciprocal deposit networks grow, the risk of contagion increases (e.g., operational risk).
- Monitoring the structure of these networks can help track how interconnected banks manage liquidity and respond to shocks

TEXAS McCombs

Conclusion

Innovations in deposit insurance led by the private sector.

Need a better understanding of costs and benefits of these products.

An alternative form of insuring deposits that can enhance stability.

Need more scrutiny of interconnectedness, operational risk, and moral hazard.