

WSJ Print Edition

More deposit insurance means more moral hazard and taxpayer risk.

How to Make Banks Less Safe

REVIEW & OUTLOOK

Bad ideas never die, but they do get worse. An example is the embrace by the Trump Administration and some Republicans of the Elizabeth Warren idea to expand federal bank deposit insurance.

Sens. Bill Hagerty (R., Tenn.) and Angela Alsobrooks (D., Md.) have teamed up on legislation to raise the Federal Deposit Insurance Corp. (FDIC) limit for non-interestbearing transaction accounts. Treasury Secretary Scott Bessent signaled support this month.

"This essential reform strengthens regional and community banks' central roles in the financial system of the future," says Mr. Hagerty. "A stronger and safer banking system will benefit all Americans." The truth is that a higher insurance limit will increase moral hazard and make the banking system less sound, which will hurt all Americans.

The legislation would raise the Federal Deposit Insurance Corp. limit to \$10 million from \$250,000 except for global systemically important banks (G-SIBs) like JPMorgan Chase, Citigroup and Bank of America. Credit unions and midsize banks say they need a higher insurance limit to compete with the goliaths.

It's true the 2010 Dodd-Frank Act entrenched the biggest banks as "too big to fail." But they are also required to comply with stricter regulation, including liquidity and capital standards and regular stress tests. Capital requirements for most midsize banks are about 7% versus upward of 10% for most giants.

Many midsize banks experienced runs during the spring 2023 panic as uninsured depositors moved their money to giants perceived as safer. Silicon Valley Bank, Signature Bank and First Republic Bank failed in part because of bank runs. But they also lost deposits because they had poorly managed interest-rate risk.

Well-run banks weathered the panic better and lost fewer deposits. This belies the argument that most uninsured large depositors can't be expected to distinguish between wellrun and poorly-run banks and thus the government must protect them.

The existing \$250,000 limit protects more than 99% of deposit accounts and most small businesses. The typical small business holds about \$12,100 in its deposit account on any given day. Raising the guarantee to \$10 million would mainly benefit large businesses. This would ease their imperative to do due diligence before parking money at a bank.

It would also encourage more risk-taking since banks will have to worry less about runs. This increases moral hazard, a concept Republicans once understood, and risk hasn't vanished. Shares in two regional banks plunged last week after they reported potential fraud by a borrower that could result in loan losses.

Even if a higher insurance limit reduces the risk of bank runs, it won't prevent deeply insolvent banks from failing. But the FDIC tab will be greater because more deposits will be insured. If the higher guarantee encourages more recklessness, financial losses across the banking system could be greater. That means a bigger FDIC cleanup.

The FDIC will also have to increase its assessment on banks by tens of billions of dollars to pay for the expanded insurance. But under the FDIC assessment formula, most of the cost will be paid by the biggest banks. Midsize banks will get significantly more coverage at little cost. That's not how insurance is supposed to work.

By the way, the share of deposits held by the five largest banks has remained flat since 2010. The share for community banks has declined by about 13 percentage points, but this owes mostly to consolidation and growth by midsize and

regional banks.

The Trump Administration can help small and midsize banks compete with the giants by easing needless regulation and the Biden-era blockade on mergers. Banking regulators in April approved Capital One's merger with Discover Financial Services, which Biden officials held up. Fifth Third Bancorp this month announced a merger with Comerica.

Midsize banks should be careful what they lobby for. During the 2023 panic, Sen. Warren backed a higher limit in return for more regulation. "We have to do this," she said, "because these banks are under-regulated, and if we lift the cap, we are requiring—or relying even more heavily on the regulators to do their jobs."

Regulators failed in the runup to the 2008 and 2023 panics. Democrats want to replace market discipline with regulation that could limit lending. Democrats will undoubtedly use a higher insurance limit the next time they're in charge as an excuse to impose more shackles on banks. We will get more moral hazard and less economic dynamism. Have Messrs. Hagerty and Bessent thought all this through?

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