

Why Have Uninsured Depositors Become De Facto Insured?

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ABSTRACT

The recent failures of Silicon Valley Bank and First Republic have drawn attention to how rare it is for uninsured depositors at a failed bank to bear losses. In this paper, I show that ubiquitous rescues of uninsured depositors represent a recent phenomenon dating only to 2008: for many years prior to that, uninsured depositor losses were the norm. I also show that the rise of uninsured depositor rescues has coincided with a dramatic increase in FDIC costs of resolving failed banks, which I estimate resulted in at least \$45 billion in additional resolution expenses over the past 15 years.

The rise in uninsured depositor rescues has resulted from a shift by the FDIC to almost always resolve failed banks by selling them as a whole (including both insured and uninsured deposits) to an acquiror, generally with a generous subsidy provided by the FDIC. I present evidence to suggest that, despite the FDIC's statutory mandate to use the least-cost means of protecting insured depositors of a failed bank, these whole-bank sales are frequently not the most efficient means of resolving failed banks. Next, I present evidence for two causes of this shift. First, during the 2008 crisis, the FDIC may have initially been forced to sell whole banks to acquirors because it lacked capacity to handle the influx of failures through other means. This may have established an institutional inertia that has maintained the practice long after the exigencies that necessitated it have cleared. Second, I suggest that the FDIC may have experienced mission-creep, taking it upon itself to rescue uninsured depositors whenever possible, even though US law requires the FDIC to seek authorization from the US President whenever it deems it necessary to deviate from least-cost resolution methods. I show that such mission-creep has occurred twice in the past, and that Congress has successfully intervened to stop it in 1951 and 1991.

Finally, I present a series of reforms. I show that if the FDIC were to obtain Presidential approval for uninsured depositor rescues, as the law currently requires, then this approval would unlock far more cost-effective means of protecting uninsured depositors than the FDIC is currently using. Conversely, if the President declined to provide such authorization, and uninsured depositors returned to regularly bearing losses when banks fail, resolution costs would be even further reduced, while improving incentives of uninsured depositors to monitor the risks of the banks they deposit funds in.