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The Conservative Case for Unlimited Deposit Insurance

Why Congress must act now.

by Lawrence B. Lindsey
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AMONG THE LIST of virtues that conservatives believe in are security, efficiency, and the facilitation of private commerce. Although just the name "Federal Deposit Insurance Corporation" is enough to conjure up images of big government, in practice the FDIC provides a function that conservatives should embrace.

Consider the question of security. One of the cornerstones of any smoothly functioning modern economy is that there should be a place where one can keep one's hard earned money and know that it is safe. We usually think of that as a bank. But deposit insurance is limited to $100,000. To most people that seems like more than enough, but they are thinking more about their everyday lives than about real life events that actually affect them but may not be on the forefront of their experience.

The most important depositor who needs more than $100,000 is an employer. A small business with perhaps 15 or 20 employees absolutely needs more than $100,000 in the bank just to meet payroll, pay vendors, and cover the rent and electric bills. Imagine if the FDIC had to close a bank on which a company's payroll checks were drawn. The company and the workers would be out of luck because those checks would bounce, and it is unlikely that the company could carry the extra money needed to pay its workers.

But middle class people also run up needs for more than $100,000 of protection. Recall the last time you closed on a house, for example.

But in today's financial crisis, everyone is looking for a safe place to put their money. When money is not deposited in a bank it is not available for lending; that includes the money of the well-to-do as well. The country has a choice: let those people deposit their funds in a safe place, where it can be relent to fund American economic activity, or see those funds go elsewhere in the global marketplace. We would be foolish to turn away people seeking a safe haven for their funds, and the wealthy have the ability to find a safe place elsewhere though they might prefer to keep it at home.

Then there is the issue of efficiency. The original justification for limits on deposit insurance is that large depositors would provide discipline to the bank to prevent them from engaging in risky lending practices. Sounds great in theory, but do you know whether your bank is engaging in risky practices? The time and trouble it would take to find out could not be easily justified, poring through the bank's 10-ks and other SEC filings, even if that material could be trusted. Or should you trust a rating agency to tell you whether your bank is safe? Those institutions proved to have a dismal track record in the recent experience.

No, by far the most efficient mechanism is to treat "bank safety" as a public good. That is why the government regulates the banks in the first place. The government has better information than anyone else, including the private market place, about the condition of the banks. It is therefore far more efficient for them to be the judge of their safety and soundness (something they would do anyway) than to have each individual depositor try and replicate what large federal bureaucracies already do.

The final issue is the promotion of commerce. This actually stems from the points made above. Central to the economy is something that is known as "the payments system." The payments system lifts us out of the need to barter my chicken's eggs for your cow's milk. It is the prerequisite for there being such a thing as commerce. At first, payments were all in coins made of precious metal. That works, but a $40,000 car would cost you about six pounds of gold coins, surely enough to put a hole in your pocket. Or we could all use cash--in this case a wad of 400 $100 bills.

The fact is banks provide a very essential function in sparing us the need for these cumbersome media of exchange. We write checks. We use electronic payment systems. Even our credit cards are ultimately paid through a bank deposit. It is essential that the transaction accounts that make those deposits should be safe, for if they are not, by definition the transaction itself is not safe. Once that happens, commerce itself breaks down.

It now appears that the Congress is likely to raise the deposit insurance cap at the FDIC from $100,000 to $250,000. Both presidential candidates supported such a move today. That is a positive step. But, it is not taking the obvious step of going for no limit at all--a move that clearly meets the conservative principles of security, efficiency, and the promotion of commerce.

To bring this point home to the politicians who are deciding the issue, I urge them to consider their own campaign accounts. Both John McCain and Barack Obama have roughly $85 million to spend. To get under the current deposit insurance limits and to assure that there money is safe, they would have to deposit it in 850 separate banks. Raising the limit to $250,000 would cut the number of banks to a mere 340. Of course neither man would be so foolish--it would be inefficient and certainly impede the efficient payment of the campaign's bills. They doubtless keep it in one or two banks.

Now let's imagine that sometime between now and November 4 the bank that either of those candidates has their campaign cash in is taken over by the FDIC. The campaign would be allowed to spend $100,000 and then would have to wait for the bank to taken over or its assets sold to get the rest. By then Election Day would have come and gone a long time ago. Anybody think that would be a fair election? Actually the consequences for our democracy would be horrific.

Every businessman in the country now faces the same prospect. At any time they could find their entire business made illiquid and see their checks bounce if the FDIC happens to close their banking institution at the wrong time. For the people involved that would be as devastating as denying one presidential candidate access to his money would be. It is time for politicians to stop arguing that raising deposit limits is something that benefits only the rich and start thinking the way that the folks who actually run the businesses that create the jobs and pay the bills have to think every day. Unlimited deposit insurance is the only way.

Lawrence B. Lindsey, a former governor of the Federal Reserve, was special assistant to President Bush for economic policy and director of the National Economic Council at the White House. His most recent book is What a President Should Know . . . but Most Learn Too Late *(Rowman and Littlefield).*