November 2007 *MoneyMinute* – How Does FDIC Insurance Work?

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Bank failures conjure up images of the Great Depression. Back then, depositors had no guarantee they could get their money out in case their bank went under. The first rumor of trouble would start a bank run. Remember that scene at Bailey Building & Loan in "It's a Wonderful Life" when Jimmy Stewart faces down a crowd of angry, scared depositors?

Today when we put money in the bank, we're confident the money will be there when we need it. That's due to federal bank deposit insurance, one of the reforms following the financial devastation of the Great Depression.

But bank runs aren't limited to black & white movies and newsreels. Just this month, E-Trade Bank took a giant step toward insolvency when it announced that many of the home equity loans it made in recent years have already gone bad. Its parent company may not have enough cash to keep the bank in business if things get worse. E-Trade stock has dropped from the mid-$20s down to $3 or so in the past four months.

That's not all. In September, NetBank, an online bank that was once a high-flyer in the dot.com boom, went under in the biggest US bank failure in 14 years. NetBank was the first bank to fail in the subprime lending crisis, which started earlier this year. Just like at E-Trade, NetBank made too many high-risk loans, and too many of those loans went bad.

What kept that bank failure from being a disaster for its customers was the Federal Deposit Insurance Corp. The NetBank customers who followed the FDIC rules didn't suffer. A quick refresher course can keep you out of trouble too, even if your bank goes under:

Most people know that depositors at any FDIC-insured bank are covered up to $100,000. That amount is per depositor, not per account. The same depositor can also have additional coverage of joint accounts. Beyond that, IRAs get additional protection. An example from the FDIC shows how it works:

Consider a married couple doing business at one bank:

— The wife has $100,000 in her name in several savings accounts.
— The husband has $100,000 in his name in several savings accounts.
— They have $25,000 in a joint checking account.
— They have $175,000 in a joint CD account.
— Each of them has an IRA, with $250,000 in each account.

In this example, FDIC insurance covers all $900,000.

In another example, consider a couple with a joint account held by their living trust. Coverage would work like this: Each trustee (the couple) is covered for $100,000. Then each trustee has coverage for each of their three children – that's $300,000 times two. Total coverage on that one

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account is $800,000.

FDIC rules specify that the trust beneficiaries must be close family members – such as children, parents or siblings. The same rules apply to pay-on-death accounts.

With custodial accounts for children, the coverage is for the child. Estate accounts are covered for the deceased person. So one person can have up to $300,000 in coverage for their own account, a child's account, and the estate account of a deceased person for whom they are executor.

But business accounts owned by sole proprietors can be counted toward that person's $100,000 individual limit. So self-employed business owners, beware.

As you can see, the rules can be more complicated than they appear. Visit the FDIC website at http://www.fdic.gov/deposit/index.html or call 1-877-ASK-FDIC, especially if you have a trust account, business account, or control an account on behalf of someone else. ***Note:*** *Credit unions have the same type of insurance, administered through the National Credit Union Administration (NCUA).*

If you need to keep large amounts of cash in bank CDs, rather than open accounts at multiple banks, consider buying FDIC-insured CDs through a brokerage account. That's an easy way to shop for the best rates, as well as keeping paperwork to a minimum.

If you get caught in a bank closure, you won't suffer as long as you follow the rules. The FDIC will get your money to you within a few days.

And who pays for all this insurance? Not the taxpayer. Rather, every insured bank pays into the FDIC fund. The more cash reserves the bank has, the lower the percentage fee is. So there's no free lunch for flaky banks: They pay the highest premiums.

At ICM, we often recommend online banks to clients who need to park cash. Among the most frequently mentioned are INGDirect, EmigrantDirect and HSBC Direct. These online banks are covered by their parent banks' FDIC insurance. Of these, only HSBC has announced large subprime loan losses. However, because its parent company is one of the world's largest financial firms, HSBC Bank doesn't appear to be at risk.

Bottom line: More likely than not, we'll see more bank failures before the subprime crisis ends. If you have more than a little cash in banks, you need to check right now that your deposits are covered.

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