COMMUNITY BANKING

Private-sector deposit insurance is reemerging. Can it work?

By Kevin Wack

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- **Key insight:** The Community Bankers Insurance Alliance is seeking to revive private-sector deposit insurance, which has largely gone by the wayside.
- **What's at stake:** The plan is being sold to small banks as a way to counteract the "too big to fail" advantage held by larger banks.
- **Supporting data:** The effort's organizers say that in order to launch, they need $200 million of equity capital, and they currently have commitments for $125 million.

A new consortium of community banks says it's devised a way to counteract the widely acknowledged "too big to fail" advantage held by larger banks. But the effort is also reviving an old question: Can deposit insurance work without the federal government's backing?

The Community Bankers Insurance Alliance, which plans to provide private-sector insurance on deposits exceeding the Federal Deposit Insurance Corp.'s $250,000 limit, is aiming to launch this month.

Its backers say the need for excess deposit insurance for community banks became more obvious during the 2023 mini-banking crisis, which cemented the perception that the government will protect uninsured depositors at larger banks.

Believing they were operating at a greater disadvantage than ever, community banks turned to Congress for help. But deposit-insurance reform has gone nowhere.

"It was clear to us that Congress wasn't going to act," said Donald Musso, chairman, president and CEO of FinPro, the consulting firm that's organizing the consortium. "And we needed to solve the problem."

Private-sector deposit insurance has existed before — both prior to and after the establishment of the FDIC during the Great Depression — but has rarely established a track record of long-term success.

Today community banks seeking to reassure large depositors that their money is safe do have an option beyond the FDIC. Reciprocal deposits have long been available from companies that charge banks a fee to spread large deposits in chunks across a network of FDIC-insured banks.

But Musso argues that excess deposit insurance will be less expensive on an ongoing basis than reciprocal deposits.

"The risk premium is going to be between two and five basis points," he told American Banker. "So we are cheaper than FDIC insurance, and we're about half the cost of — or even less — than traditional reciprocal deposits."

How the consortium will work

Still, there will be substantial upfront costs for participating banks. In order to get off the ground, the Community Bankers Insurance Alliance will need $200 million of equity capital, according to the organizers, or an average of $2 million from 100 members.

That cushion would provide equity capital equal to 1.35% of uninsured deposits, which is the same reserve ratio the FDIC targets.

To get there, the consortium is charging one-time membership fees that range from $500,000 to $10 million, depending on the bank's volume of uninsured deposits, and subject to annual adjustments. As of Sept. 2, at least 33 banks had signed letters of intent, accounting for membership fees totaling $125 million, according to FinPro.

FinPro Chairman, President and CEO Don Musso *FinPro*

Most of the equity capital will be routed back to the banks as deposits, the consortium's organizers said.

To be eligible to join, banks are required to have less than $10 billion of assets. No more than 50% of their deposits can be uninsured. They must also have a Tier 1 capital ratio of at least 8% and meet certain other criteria.

Altogether, more than 3,300 U.S. banks are eligible for membership, according to a presentation circulated by FinPro.

The premiums that participating banks pay will be based on a risk score that's calculated quarterly. The banks deemed the least risky will pay two basis points on their uninsured deposits, and those judged more risky will pay up to five basis points.

If a bank's risk score exceeds a specified threshold, a risk-mitigation team will be brought in to help remediate the problems, according to the organizers.

"At our cost, we're going to put a risk-mitigation team in, showing them how to get their risk profile back down," Musso said. "It's in our best interest to do that because we don't want to have banks fail. We don't want to have to spend insurance dollars."

In situations that become more dire, the consortium plans to require the bank to build out a data lake that can be used to identify and correct loan deficiencies.

The plan for resolving a failed bank

Nonetheless, there looms the scenario where a bank that's a member of the private-sector consortium fails.

"If the bank still moves to failure, for every member we will have pre-identified other members that would make an all-bank, all-deposit bid," Musso explained. "We'll already have all those bidders qualified through the FDIC, the whole nine yards."

If the FDIC doesn't receive any bids that include uninsured deposits — that's happened four times in recent years when small banks have failed, according to Musso — the community-bank consortium will be on the hook to pay out uninsured deposits.

Musso said he wants to reach a standing agreement with the FDIC that provides certainty about how much the consortium will be paid to assume those uninsured deposits. He threw out a hypothetical number — 97.5 cents on the dollar — while acknowledging that the FDIC hasn't agreed to any particular figure.

In this scenario, if a failed bank that's a member of the consortium has $100 million of uninsured deposits, and the consortium agrees to assume those deposits for $97.5 million, the consortium would take a $2.5 million loss.

Musso argues that this kind of pre-negotiated process would allow uninsured deposits to be resolved over a single weekend, following a bank's failure on Friday evening, rather than over a more extended time period.

"It will no longer carry out over three years. It's a known number," he said. "That number has not been finalized with the FDIC yet, and that takes some doing. But we've got a year or two before we have to get that finished, because we're not worried about our member banks failing right away."

"And then if all that process fails," he added, "we then will just pay out the insurance."

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Musso contends that the consortium's process — including its use of analytics to provide early warnings about troubled banks — will result in fewer bank failures.

He also says the consortium will help member banks generate more precise calculations about which of their deposits lack FDIC insurance. Such calculations can be trickier than the FDIC's $250,000 limit alone suggests. Among the complicating factors: the fact that trust accounts are insured up to $250,000 for each beneficiary, up to a maximum of $1.25 million.

Greater accuracy should reduce the costs when banks do fail, Musso argues.

"No bank has the data that is required to be able to calculate FDIC insurance with precision," Musso said. "If you look at the call report, it says 'estimate' of uninsured. It's crazy."

What participating bankers are saying

Margaret Nightengale, the president and CEO of Grant County Bank in Ulysses, Kansas, said that she's interested in offering private deposit insurance, even though the $298 million-asset bank has earned the trust of customers over its 119-year-history.

"We've got good, longstanding relationships with our customers, and our customers are comfortable leaving their money with us," said Nightengale, who has agreed to serve on the Community Bankers Insurance Alliance's board. "But that doesn't mean that we don't have questions with them when we exceed the $250,000 FDIC insurance level."

Grant County Bank, which is located in Southwest Kansas, faces less competitive pressure from the "too big to fail" banks than many other community banks do. Nightengale said that Wells Fargo and Bank of America don't have branches within three hours of her community.

Yet even in rural areas, customers have options in the age of online banking. Also relevant to Grant County Bank is the fact that Heartland Tri-State Bank, located about an hour southwest of Ulysses, failed in 2023.

"I think that probably, more than anything, was in the back of people's minds, saying, 'Hey this happened in Southwest Kansas not that long ago. It is something that I need to be concerned about,'" Nightengale said.

Chris Black, the CEO of Nashville, Tennessee-based Thread Bank, is also on the nascent consortium's board.

In an interview, he noted that community banks will need buy-in from their regulators if they're going to find a private-sector solution to the disadvantage they face versus "too big to fail" banks.

But he also pointed out that Congress has had ample opportunity to address the issue. Legislation authored by Sens. Bill Hagerty, R-Tenn., and Angela Alsobrooks, D-Md., which would expand deposit insurance for noninterest-bearing transaction accounts, has failed to get off the ground.

"It would make no sense for anybody to wait around for the government to come up with a solution when we have the ability to do it ourselves," Black said.

A spotty track record

Skeptics say the history of non-FDIC deposit insurance is checkered, at best.

After a financial panic in 1907, eight states, mainly in the Midwest, created mutual deposit insurance systems, but they all failed by 1931, according to a 2007 study by the FDIC's staff.

Following the establishment of the FDIC, which didn't initially cover all banks in the U.S., at least 30 nonfederal insurance plans were developed. But most of them had failed or ceased operations by the S&L crisis of the 1980s, the FDIC found.

In the years prior to the global financial crisis, a Berkshire Hathaway subsidiary called Kansas Bankers Surety Company was offering excess deposit insurance to banks in many states.

But at the height of the crisis in September 2008, the Topeka, Kansas-based firm notified its bank customers that it would stop offering its deposit guaranty bonds. A company executive said at the time that the firm could not find reinsurance.

"A review of the failed record of private deposit insurance systems in the U.S. reveals that insufficient confidence in the private deposit insurance guarantee in the past rendered the systems unable to prevent panics," FDIC staffers wrote in the agency's 2007 report.

Unlike private-sector deposit-insurance schemes, the FDIC can borrow from the U.S. Treasury in the event that the Deposit Insurance Fund proves insufficient to pay for a rash of bank failures.

The authors of the FDIC's 2007 report concluded that "developing a vibrant private sector excess deposit insurance market would require an FDIC risk-sharing protocol of some type."

The May 2023 failure of First Republic Bank, which followed the collapses of Silicon Valley Bank and Signature Bank, helped cement the perception that uninsured deposits at larger failed banks will get government protection. *Adobe Stock*

Todd Phillips, a former FDIC official who is now a director at the Klaros Group, told American Banker that he has doubts about the long-term viability of private-sector deposit insurance. "It has been tried since the early 1800s, and these deposit-insurance regimes just always tend to fail. The reason they tend to fail is because banks don't fail stochastically, they fail together in a crisis. And when you have a whole bunch of banks failing at once, it's going to deplete the insurance company's resources."

Phillips said he understands why the consortium led by FinPro is taking action. But he added: "It's just, if it doesn't have a government backstop, it will face the same problems as prior private deposit-insurance schemes."

Another concern voiced by skeptics of private-sector deposit-insurance plans is that the stronger banks have an incentive to exit when the economic cycle turns and the weaker banks start failing. That can lead to adverse selection.

Musso said the consortium is dealing with that issue by establishing three-year contracts with participating community banks; by requiring them to provide 90-day notice before leaving; by establishing that exiting banks may not receive a rebate for up to one year; and by barring the departing banks from rejoining the consortium for three years.

There is one example of a private deposit-insurance plan that's stood the test of time: the Massachusetts Deposit Insurance Fund, which was established by the Massachusetts Legislature in 1934. The fund is open to savings banks and cooperative banks chartered in the Bay State, and it currently has more than 60 members. It provides private insurance above the FDIC's $250,000 limit.

The organizers of the Community Bankers Insurance Alliance say they modeled parts of their own plan on the Massachusetts DIF, and they cite the Massachusetts program's 92-year existence as evidence that a larger, multistate effort can work.

The Massachusetts Deposit Insurance Fund's president and CEO, Judith Javidpour, did not respond to an interview request. But the fund's website states: "Since the DIF was established, no depositor has ever lost a penny in any Massachusetts savings or cooperative bank."

Fight to sign up small banks

The Community Bankers Insurance Alliance's recent efforts to sign up community banks as members have sparked a behind-the-scenes battle with providers of reciprocal deposits.

The reciprocal-deposit firms — the most prominent of which is Arlington, Virginia-based IntraFi — have long offered their services to small banks. Such banks have recently received emails from investment bankers, arguing that the Community Bankers Insurance Alliance offers them a better deal.

Norm Plumstead, the president and CEO of Honor Bank in Michigan, said that the bank currently passes along the cost of reciprocal deposits to its customers, which results in a less attractive rate. He added that there's an operational burden on the $443 million-asset bank in connection with the daily balancing activity that reciprocal deposits require.

Norm Plumstead, president and CEO of Honor Bank *Honor Bank*

Plumstead, who has agreed to sit on the Community Bankers Insurance Alliance's board, said that Honor Bank will likely stop offering reciprocal deposits once the community-bank consortium is operating. He acknowledged that his bank will have to get buy-in from its large-balance customers.

"So there would be an onus on us, as the bank, to explain the CBIA and make sure that they have a comfort level with it," Plumstead said.

It remains to be seen whether the consortium's arguments will persuade a significant number of community banks to change course. So far, the banks that have signed letters of intent with the private-sector deposit-insurance plan represent only about 1% of the more than 3,300 that are eligible to join.

Meanwhile, the reciprocal-deposits industry is a formidable competitor. IntraFi says that its members include more than 3,000 banks. And a federal law enacted in July offers community banks an additional incentive to offer reciprocal deposits, since it allows a larger percentage of those funds to be classified as non-brokered.

Jill Castilla, the chairman, president and CEO of Oklahoma-based Citizens Bank of Edmond, said that reciprocal deposits give her $432 million-asset bank the ability to offset the perception that larger banks would provide additional security to larger depositors. She also said that automation has made offering reciprocal deposits an economical proposition for her bank.

She wasn't familiar with the Community Bankers Industry Alliance's fledgling product, but said, "Market competition is always, I think, good."

Kevin Wack

Banking Editor

Kevin Wack is the Banking Editor at American Banker, leading the publication's coverage of large, regional and community banks. He also writes... Read full bio

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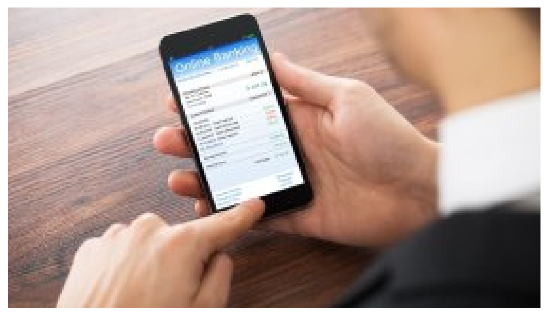

Bankers, particularly at the midsize and regional level, should be on the lookout for more opportunities to develop networked solutions to common problems, such as know-your-customer operations and fraud detection.

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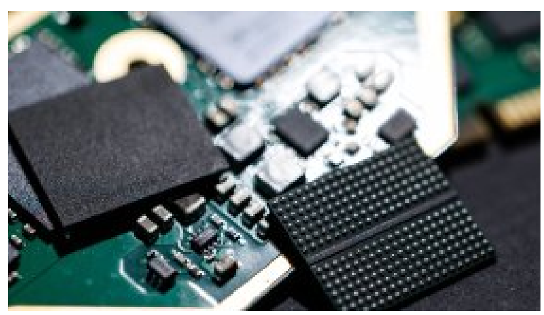

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