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TAG: you're it--is your bank ready?

By Matthew D. Pieniazek
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TAG, the temporary Transaction Account Guarantee program stemming from Dodd-Frank, is scheduled to expire at the end of this year.

Providing full FDIC insurance coverage of demand deposit accounts, this program represents a modified extension of a similar program enacted by FDIC in late 2008 that was extended twice from Dec. 31, 2009 to June 30, 2010 to Dec. 31, 2010. The potential expirations spurred spirited discussion then, and the pending expiration is eliciting similar debate now.

With TAG's demise on the way, bankers need to address some of the more pertinent issues surrounding the program and to adopt a logical frame of reference for thinking through the current and future realities surrounding likely behavior among demand deposit customers in a "TAGless" world.

My belief is that TAG can still do the industry some good, and that it should be extended for another two years and then be eliminated (or phased out).

Some may think that this is little more than "kicking the can down the road." However, there is good reason to continue to address the concerns that were the original catalyst for instituting TAG and its predecessor efforts in the first place. There is also good reason for banks to ready themselves for an eventual and appropriate end to TAG.

TAG: yes, no, maybe?

Depending on what side of the bed I wake up on, I can argue for why TAG should or should not be eliminated as scheduled. Therein lies the challenge: there is no clear answer that is necessarily obvious to all interested parties.

It is important to remember the premise behind both the FDIC and Dodd-Frank TAG programs. The rationale was to strengthen confidence and encourage liquidity in the banking system; thereby facilitating the availability of lower cost credit as well as minimizing the potential for needless liquidity crises (especially important for community banks under stress that could experience deposit withdrawals from large transaction accounts).

Those in favor of TAG point to issues such as the unfair advantage that would accrue to larger banks, given what appears to be a prevailing belief that "Too Big

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To Fail" (TBTF) is alive and well. This implied/perceived FDIC insurance raises concerns that community banks would experience disintermediation as well as have a tougher time growing larger core transaction account relationships, once TAG expires.

Community banks favoring the elimination of TAG tend to express concerns that are reminiscent of the Rolling Stones' "Under My Thumb." They want to minimize the extent to which the industry is beholden to Washington politics and regulatory threats, and allow market forces to determine the outcome.

Regardless of one's view, it is informative to stand back and examine the realities of TAG economics from the eyes of a depositor.

<u>TAG: the customer has spoken</u>

In theory TAG is an insurance policy for businesses and consumers that protects their core operating funds from bank failure. There is a premium paid, effectively, by the customer for that insurance; it comes in the form of an opportunity cost vs. alternative "investments" (e.g. interest bearing deposits) and/or service charges.

Given historically low rates of interest, the cost of this insurance has been and continues to be quite inexpensive. At the same time the potential for loss of uninsured deposits (real or perceived) has been at an elevated level given the financial distress and uncertainties prevalent in the banking industry since 2008. Therefore, rational expectations would suggest an increase in the purchasing of low cost insurance policies that provide valuable and substantial protection. And that is exactly what happened in 2008 through 2011.

- All FDIC Insured Banks: Total deposits increased 27%, DDA increased 48%.
- FDIC Insured Banks < $5 billion Assets: Total deposits increased <4%, DDA increased 27%.

Even factoring in the potential for some "noise" in the data, the trends are quite clear. Also, and given that total deposit share for banks less than $5 billion in assets declined from 22.3% to 18.3% during the last four years, it appears that TBTF (or at least the perception that bigger is safer) has had some influence on depositor behavior. This is despite all the high profile negative press heaped on the larger banks during that timeframe.

From the above one can conclude that there is a meaningful risk of material deposit shifting should TAG be eliminated prior to a further substantial improvement in overall domestic and global uncertainties that continue to suppress business and consumer confidence in general, and banking industry stability in particular.

In other words, if the cost of "insurance" is held constant (rates remain low for an extended period of time) but the risk of loss suddenly increases (elimination of TAG), one would expect that uninsured monies would shift to alternatives with a lower probability of loss.

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Assuming away coffee cans and mattresses, this would imply that some portion of large uninsured deposits would move to TBTF banks and other banks perceived to be "the best of the rest" (stronger capital, better asset quality, lack of formal regulatory agreements, etc.). Additionally, it would be reasonable to expect that some deposits would leave the banking system altogether (direct treasury investment, selected mutual funds, etc.) or seek insurance in some other form such as pledged customer repurchase agreements or sweep products.

At the very least, deposits would shift out of non-interest bearing into alternative deposits, thereby reducing bank profitability.

The concern here is that each of these customer behaviors has negative consequences (liquidity and/or earnings, as well as potential for additional bank failures) at a time when the last thing the industry needs is any more negativity, especially from avoidable fronts.

This observation is at the root of my belief that TAG should be extended until the economy has moved much further away from the depths of the financial crisis and much closer to some semblance of a truly more fully recovered state.

TAG: an insurance policy in a state of constant flux

Given that TAG is an insurance policy, the cost of this insurance will increase when higher short-term interest rate levels materialize. This is due to the fact that the opportunity cost associated with a non-interest bearing account becomes more pronounced as the foregone yield on alternative deposits/investments grows.

Therefore, even if risk remains constant (i.e. TAG remains in place) some component of uninsured deposits will exit DDA products for the simple reason that the insurance premium is deemed too expensive relative to the expected value (probability) of loss.

Again, this in and of itself could result in uninsured deposit shifts from zero-rate DDA at weaker banks to interest bearing accounts at the stronger banks, or those deemed TBTF. Regardless, corporate treasurers and cash managers will once again begin to seek a higher return on excess liquid balances as the related opportunity cost becomes more material. In both cases customer behavior patterns will likely change, with or without TAG, as interest rates rise.

If one adds to this the assumption that any significant increase in short-term interest rates will likely be preceded or accompanied by a vastly improved/improving economy and overall state of the banking industry, then the risk of loss for uninsured deposits would presumably decline meaningfully.

Accordingly, any element of rational expectations for customer behavior would lead to the conclusion that fewer depositors (or balances) will pay an increasingly expensive "premium" for an insurance policy associated with a continually declining risk. *The improving economy will begin to neutralize any perceived*

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advantage from TBTF and reduce the likelihood of unintended consequence "deposit runs" on the improving but weaker end of the community bank food chain.

In other words, in the next business cycle TAG will experience a natural gravitational pull towards irrelevance. This observation is at the root of my belief that TAG should be eliminated at the appropriate time, following an additional temporary extension.

TAG sunset: not If, but when

To avoid the Law of Unintended Consequences for a still-fragile banking industry, there is real merit to extending the TAG program for another two-year timeframe in order to buy additional time for an improving economy and strengthening banking industry. Such a scenario will allow for the logical sunset of TAG that coincides with the sunset of the concerns that gave rise to TAG in the first place.

As an alternative to going "cold turkey," a phasing out of TAG could be considered that incorporates an opt in/out feature. For an additional insurance fee banks could choose to retain TAG for the extension period (perhaps providing an opt-out opportunity quarterly or semi-annually within that period). This would allow banks with potential liquidity or other concerns to "buy" some additional time.

It is interesting to note that during the FDIC TAG program 15% of banks did not participate from the beginning, with that number increasing to 26% opting out during the final phase that ended December 2010. Anecdotally, we at DCG are not aware of any material consequences for banks that elected to go without the added FDIC insurance. Given that these opt-out banks included many with strong financial positions and/or larger total assets, it seems to support customer willingness to forego insurance when perceived risk is not high.

Finally, and irrespective of TAG, banks must ready themselves for a reality that will impact 100% of financial institutions. ALL banks will have deposits that leave them in the next economic cycle. ALL banks also have deposits hiding in non-maturity balances that will shift back into CDs.

For some, that number can be as high as 15%-20% of non-maturity deposits looking for some alternative home, including outside of their particular bank and even the banking industry. It continues to surprise me how few banks have yet to pay any kind of serious attention to getting a handle on the potential impact of this inevitability on their particular institution.

Which leads me to a final thought: If the indefinite continuation of a governmental program that did not exist four years ago is deemed critical to the long-term success of community banks, then the community banking sector is in very real trouble. *I do not believe this to be the case.*

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