The Financial Hazards and Risks Entailed in Extending Unlimited Federal Guarantees for Deposits in Transaction Accounts

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I. Introduction

In the aftermath of a financial crisis, policymakers often must determine how best to trade off future security from a similar crisis and future moral hazard. The more the government pledges to protect the value of the assets of financial institutions in a crisis, the greater the risks that those institution may take in search of higher profits. This moral hazard may increase the likelihood of a future crisis.

Since the 2008-2009 financial meltdown, U.S. policymakers have faced this trade-off in various forms. One particularly pure example is evident in the current debate over extending the "Transaction Account Guarantee" (TAG) program. This program was created in October 2008, at the height of the last financial crisis, to temporarily guarantee deposits held in non-interest-bearing transaction accounts, above the existing $250,000 limit. The higher coverage was voluntary, yet it proved to be very popular: 87 percent of banks and savings institutions that were part of the Federal Deposit Insurance Corporation (FDIC) system opted for the increased coverage. In the midst of the widespread sense of financial panic that prevailed in the first months of the crisis, the TAG program was intended to bolster confidence in financial institutions, and discourage customers from withdrawing their funds. With several large financial institutions bankrupt or sinking fast, it is unsurprising that most banks welcomed the new guarantee.

Once the immediate panic passed, however, the FDIC did not roll back the higher coverage. Instead, it extended the program. Then in 2010, the Dodd-Frank financial reform legislation replaced the original emergency program with two more years of mandatory coverage for transaction accounts, without a dollar limit, at all FDIC-insured institutions. This Dodd-Frank program is scheduled to expire at the end of 2012, sparking the current debate over whether the transaction account unlimited guarantee should end or become a permanent part of federal regulation.

When this section of Dodd-Frank expires on December 31, 2012, deposits held in transaction accounts exceeding $250,000 and totaling some $1.4 trillion will lose FDIC coverage. In response, some financial industry groups such as the American Bankers Association and the Independent Community Bankers of America have called for another

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extension.[2] Treasury Secretary Timothy Geithner has opposed another extension, testifying before the Senate Banking Committee that, "Our judgment so far has been it's not necessary to extend it. That's been the judgment of the relevant authorities so far."[3] The FDIC has not taken a formal position, stating only that, "Given the uncertainty in the current economic outlook, it is difficult at this time to anticipate the consequences of the program's expiration at the end of this year."[4]

Based on economic reasoning and analysis, we conclude that extending the current, unlimited transaction account guarantee would be harmful to the stability and competitiveness of the U.S. banking sector. Unlimited deposit insurance increases moral hazard and represents a threat to the nation's long-term financial stability. History has shown that unlimited deposit insurance increases the likelihood of banking crises. Emergency measures to increase deposit insurance during a financial crisis should therefore be removed as soon as possible. The transaction account guarantee is also unnecessary now that the U.S. banking sector has returned to pre-crisis levels of profitability. As we will show, claims that the guarantee is necessary to ensure a "level playing field" for small and large banks are also flawed. Since December 2008, non-TAG deposits have grown in banks of all sizes, including small institutions. Furthermore, extending this federal guarantee could send a negative signal to investors and the public that four years after the crisis has passed, Congress and the President still lack confidence in the security of the U.S. banking system.

II. Background

On October 14, 2008, FDIC chair Sheila Bair, Treasury Secretary Henry Paulson and Federal Reserve chairman Ben Bernanke jointly announced a set of new emergency initiatives to stabilize the financial markets and restore confidence in the U.S. banking system. One of these initiatives, the Temporary Liquidity Guarantee Program (TLGP) had two parts. The first provided government guarantees for new, senior unsecured debt issued by U.S. financial institutions. The second guaranteed all deposits held in noninterest-bearing transaction accounts, regardless of dollar amount.

The TLGP was intended to ease pressures in the credit markets, improve liquidity in the financial system, and boost confidence in banks and other financial institutions. The data suggest that the program achieved those goals. Evidence of the program's success can be seen in the movements of the Libor-OIS spread, a common measure of financial market risk. The three-month Libor rate is the interest demanded for three-month loans between banks, while the OIS is the "overnight indexed swap" rate which captures the market's expectations of the costs of borrowing overnight. The Libor rate includes an estimate of "counterparty risk," or the risk that

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[2] Reuters (2012, August 29).

[3] Geithner (2012, July 26).

[4] Gruenberg (2012, June 29).

a borrowing bank will fail to repay. The spread between the two rates, therefore, reflects the size of that risk.

Up to mid-2007, this spread averaged about 8 basis points, signifying very little risk. (See Figure 1, below) It began to rise in March and April of 2007 as the accelerating decline in U.S. housing prices forced many large financial institutions to begin to write down large losses from defaulting mortgages, the falling value of mortgage-backed securities (MBS) and, for a handful of large institutions, the prospects of having to pay off credit default swaps guaranteeing the holders of those MBS against their collapse. The Libor-OIS spread widened again in March 2008 with the near-failure of Bear Stearns, an investment bank that was heavily exposed to losses in the subprime mortgage market, and which suffered serious depositor runs before being bought by JPMorgan in a deal brokered by the federal government. The spread jumped again in late 2008 following the failures of Lehman Brothers, Merrill Lynch, WAMU and AIG; peaking at more than 350 basis points just before the FDIC announced the TLG program. Almost immediately, the spread declined sharply and settled back to pre-crisis levels by the fourth quarter of 2009. This suggests that most of the increase in the Libor-OIS spread before the TLG program reflected concerns about the solvency of U.S. banks.

Figure 1: Spread between the Three-Month Libor Rate and the OIS Rate, 2007-2011[5]

The financial pressures that led the FDIC to create the Temporary Liquidity Guarantee program had not been experienced since the Great Depression. Interbank lending had virtually shut down, as lenders did not know which financial institutions had serious exposure to subprime mortgages or how much an institution's mortgage-related assets and liabilities were worth. The repo market, another source of short-term funding that major investment banks relied on to fund day-to-day activities, was also severely strained, because institutional investors were demanding

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[5] Bloomberg, Financial Stability Oversight Council 2011 Annual Report.

much greater collateral or simply refusing to roll over their short-term positions with troubled institutions. In addition, the bankruptcy of Lehman Brothers on September 15, 2008 triggered a run on money market mutual funds, which were then providing hundreds of billions of dollars of liquidity to U.S. corporations. As investors withdrew their holdings from prime money market funds, those funds stopped buying commercial paper, which in turn made it difficult for even the most creditworthy corporate and financial borrowers to roll over their maturing short-term debt.

Up to this point, in mid-September 2008, the U.S. financial panic was focused mainly on major Wall Street investment banks. In the months before the Lehman Brothers bankruptcy, U.S. commercial banks had experienced few failures, the largest coming in July 2008 with the collapse of IndyMac, a mid-sized California-based mortgage lender with $19 billion in deposits. However, on September 15, the day of Lehman's collapse, Washington Mutual (WaMu), a major bank with $188 billion in deposits, experienced significant customer withdrawals. Over ten days, WaMu customers withdrew $16.7 billion in deposits, forcing regulators to seize the bank on September 25 and broker a sale of its assets to JPMorgan Chase. It was the largest bank failure in U.S. history.

While the run on WaMu began on September 15th, the bank had experienced a steady decline in its uninsured deposits for several months, suggesting that customers with accounts exceeding the FDIC's long-standing $100,000 limit had been withdrawing funds before the Lehman bankruptcy.[6] This phenomenon of depositors drawing down accounts which lacked a full FDIC guarantee, sometimes called a "silent run," was not limited to WaMu. The day after WaMu failed, Wachovia, the nation's fourth-largest bank, also experienced a run on its uninsured accounts, and its stock price plummeted 27 percent. This large outflow of deposits drew the attention of federal regulators. As Wachovia's large corporate clients continued to withdraw their funds, the bank began to negotiate with potential acquirers. The Fed and the FDIC initially brokered a purchase by Citigroup. Nevertheless, on October 3, 2008, Wachovia and Wells Fargo announced that they had negotiated their own deal for $11.7 billion. The same day, Congress temporarily raised the FDIC insurance coverage limit from $100,000 to $250,000, as part of the $700 billion Federal bank bailout, the Emergency Economic Stabilization Act of 2008.

The Temporary Liquidity Guarantee Program

These were the conditions prevailing on October 14, 2008, when the Treasury determined that the financial system faced a systemic crisis, and the FDIC announced the Temporary Liquidity Guarantee Program. Again, this program had two separate, voluntary components. Under the Debt Guarantee program (DGP), the FDIC guaranteed all newly-issued senior unsecured debt issued by banks, savings and loans, and bank holding companies through June 30, 2009. Under the Transaction Account Guarantee program (TAG), the FDIC guaranteed noninterest-bearing transaction accounts, regardless of dollar amount, through December 31, 2009.

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[6] Wilson (2008, September 26).

The DGP was intended to increase the liquidity of wholesale funding markets, which had largely stopped operating for several weeks. The program guaranteed certain debt securities with maturities of more than 30 days, including federal funds purchased, promissory notes, commercial paper, unsecured notes, certificates of deposit owed, and certain other bank deposits. It excluded certain other securities, including derivatives, revolving credit, and foreign deposits. These guarantees were financed through a fee assessed on a sliding scale based on the debt's maturity. While the program was scheduled to end on June 30, 2009, the FDIC extended the new coverage in March 2009 through October 31, 2009.

The TAG program was intended to stem the outflow of deposits from safe, well-capitalized institutions and, more generally, promote and support confidence in U.S. banks. The program guaranteed all noninterest-bearing transaction accounts at FDIC-insured institutions. While the guarantee was aimed at accounts held by businesses and government entities, including payroll and other payment processing accounts, it applied to individual accounts as well.[7] The program' also covered interest-bearing, Negotiable Order of Withdrawal (NOW) accounts, provided that the interest rate was 0.5 percent or less. Other interest-bearing deposit accounts such as money market deposit accounts were excluded. The new coverage was financed by a fee on participating banks of 0.1 percent of their eligible deposits over $250,000.

The banking industry broadly supported the Temporary Liquidity Guarantee Program, as evidenced by the comments submitted by company and industry representatives in the rulemaking process. For example, in November 2008, a representative from State Street Bank wrote, "State Street supports the TLG Program, and believes both the Debt Guarantee and Transaction Account Guarantee programs will provide significant benefits to the U.S. financial system."[8] Similarly, Deutsche Bank New York wrote, "We believe the TLGP is a positive step towards stabilizing credit markets and removing systemic risks from the financial system as a whole."[9] The TAG program, while voluntary, enjoyed high levels of participation. FDIC data show that when the program was launched in the fourth quarter of 2008, 87 percent of eligible institutions participated. (Figure 2, below) When TAG was extended, first through June 30, 2010, and then through December 31, 2010, and its fees were increased, some large institutions (banks with at least $10 billion in assets) opted out. Yet, participation remained above 70 percent through the end of 2010, when TAG was replaced with mandatory coverage under Dodd-Frank.

Figure 2. Participation Rates in the TAG Program, October 2008 - December 2010[10]

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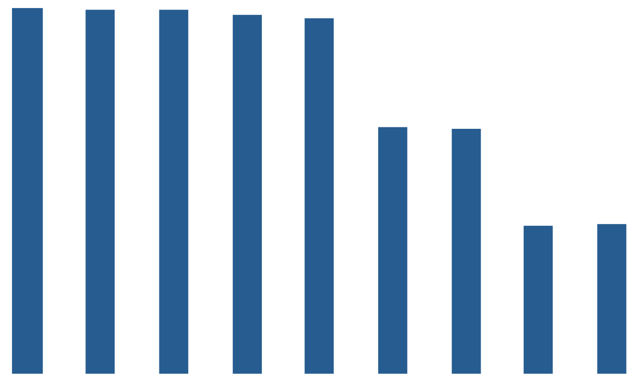
[7] It also covered Interest on Lawyers Trust Accounts (IOLTAs), which law firms hold on behalf of clients to direct the interest to law-related public services.

[8] Gavell (2008, November 13).

[9] Deutsche Bank (2008, November 13).

[10] FDIC (2008-2010). TLGP Data - Quarterly Banking Profile, Table I-C. Participation in Temporary Liquidity Guarantee Program.



Transaction account deposits also increased under the TAG program. FDIC data show that commercial banks and savings institutions held between $700 billion and $800 billion in transaction account balances from 2006 through the third quarter of 2008. (See Figure 3, below) When the program was established in the fourth quarter of 2008, these deposits immediately increased 14.5 percent. Since then, transaction account deposits have continued to rise steadily, reaching nearly $1.4 trillion in June 2012 or an increase of 69 percent compared to the balances held in those accounts before TAG was created.

Figure 3. Transaction Account Balances,
Commercial Banks and Savings Institution, 2006-2012[11]

[11] FDIC Statistics on Depository Institutions.

The Temporary Liquidity Guarantee Program is considered to be one of the most successful initiatives from the financial crisis. Testifying before the Senate Banking Committee in September 2010, Mark Zandi, chief economist of Moody's Analytics, noted that the program reversed the rising spread between the three-month Libor rate and the three-month Treasury bill rate (the TED spread), a measure of risk in the banking system much like the Libor-OIS spread:

> "The FDIC's Temporary Liquidity Guarantee Program (TLGP), begun on October 13, 2008, was also vital in ending the run on the financial system. The TED spread hit an all-time high of 458 basis points the day the program began. The TLGP… immediately assuaged investor concern and allowed the nation's critical banks to regain access to the capital markets and raise funds at a reasonable cost. Liquidity in the financial system immediately revived and the panic subsided.[12]

Similarly, Sheila Bair, chair of the FDIC, noted the critical role that the TAG program played in shoring up confidence in commercial banks, particularly among businesses and other large depositors. Writing in the *Wall Street Journal* in June 2009, she said that the program's guarantee "helped stabilize the system and it enabled banks to buttress their ability to lend and also prevented some failures of some otherwise viable institutions."[13] Further, the Financial Stability Oversight Council wrote in its 2011 annual report, that, "[t]he Transaction Account Guarantee Program (TAG) brought stability and confidence to deposit accounts that are commonly used for payroll and other business transaction purposes."[14] In sum, TAG, along with the other emergency measures undertaken to address the financial crisis, broadly succeeded in restoring confidence in the U.S. banking system.[15]

As noted earlier, TAG was initially due to end on December 31, 2009. In August 2009, the FDIC extended the program through June 30, 2010. In April 2010, the FDIC extended the coverage again, this time through December 31, 2010. Finally, in July 2010, Congress passed the Dodd-Frank "Wall Street Reform and Consumer Protection Act." In Section 343 of that Act, Congress extended the guarantee for transaction accounts for two more years, through December 31, 2012. Moreover, the coverage under Dodd-Frank was broader than the original, TAG program: The new coverage was no longer voluntary, but mandatory for all FDIC-insured institutions, although low-interest NOW accounts were excluded. The guarantee also was no

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[12] Zandi (2010).

[13] Crittenden (2009).

[14] Geithner (2012, July 26).

[15] Analysts have concluded that the other part of the TLGP, the Debt Guarantee Program, also was successful. A recent study by researchers from Pennsylvania State University and the University of North Carolina found that the Debt Guarantee Program significantly reduced yields on highly rated debt securities and thereby helped to restore liquidity to the financial sector. The authors concluded, "Our findings provide strong evidence that such policies, although temporary, effectively infuse the much needed liquidity and confidence into the banking system." Ambrose et al (2012).

longer financed through a separate assessment, but rather was rolled into the standard financing fees for FDIC coverage.

III. The TAG Program and Moral Hazard

The extraordinary initiatives undertaken in 2008-2009 were designed to help stem a systemic financial crisis by facilitating the transfer of assets from insolvent institutions to more healthy ones, by providing public capital to private institutions whose failure would trigger destructive consequences for relatively healthy institutions, and by promoting the gradual restoration of confidence in the financial system. None of these measures was designed for ordinary times, when normal market dynamics promote the health and stability of the financial system and the overall economy. In fact, adopting these approaches on a more permanent basis could harm the stability and health of the U.S. financial sector. The essential reason is that beyond times of crisis, such measures promote moral hazard and excessive risk-taking. To understand the significance of this dynamic for the TAG program, it may be helpful to review the purpose of deposit insurance and why its coverage is normally limited.

Banks normally attract short-term, liquid liabilities in the form of deposits, which they invest in longer-term, less-liquid assets through loans and securities. The resulting maturity mismatch between their assets and liabilities leaves banks vulnerable to failure. When economic developments or other events erode people's confidence in the value of a bank's assets, depositors concerned about the institution's short-term solvency may decide to draw down their accounts. In such cases, the bank is forced to liquidate assets to meet its depositors' demands, and if the withdrawals persist, the bank may fail. Such bank runs can be extremely destructive, because under a reserve system and leverage, a bank's liabilities almost always far exceed its capital. Bank runs, therefore, interrupt the investment process and, with it, growth. Consequently, a bank run can have economic effects far exceeding the volume of deposits withdrawn.

Bank runs are not limited to weak, poorly-managed banks. During times of financial panic, contagion can cause even safe banks to fail. The experience of these dynamics in the 19th century led first to the establishment of the Federal Reserve in 1913, as the lender of last resort to banks during such panics, and subsequently to the creation of the world's first national deposit insurance system, under the FDIC, following the widespread banks runs and failures of 1932-1933. Today, the FDIC guarantees the deposits of more than 7,000 banks and saving institutions in the United States. More than 85 other countries around the world provide similar deposit insurance for their financial institutions.

While deposit insurance can be very effective in preventing bank runs, it also involves certain risks, most notably the risk of moral hazard. Here, moral hazard describes a condition in which bank managers, knowing that their deposits are protected by the government, assume excessive risk in their investments. Depositors also may contribute to moral hazard, if the knowledge that their deposits are protected by a government guarantee leads them to disregard the creditworthiness of their banks.

Over several decades, banking regulators have developed a set of best practices for deposit insurance systems to mitigate the risks of moral hazard, including limits on the coverage of government insurance and adjustments in the premiums banks pay based on the riskiness of their investments or the depth of their capital. In 2009, the Basel Committee on Banking Supervision (BCBS) and the International Association of Deposit Insurers (IADI) published these best practices in *Core Principles for Effective Deposit Insurance Systems*.[16] Here, we briefly review the two core principles which apply most directly to the TAG program's coverage of transaction accounts.

Under Core Principle 9, "Coverage," a deposit insurance system's level of coverage should be "credible," cover "the large majority of depositors" and remain "limited." In principle, the limit on coverage should be high enough to prevent bank runs and low enough to discourage moral hazard. Or, as the International Monetary Fund (IMF) has argued, a deposit insurance system should cover a high percentage of total accounts, but a smaller percentage of the total value of those deposits. In this way, small, unsophisticated depositors are fully protected, while "the coverage limit [is] low enough to encourage large depositors and sophisticated creditors to discipline their bank."[17] With these limits, large sophisticated depositors with the capacity to assess the probity of financial institutions have an incentive to withdraw their funds from institutions that assume excessive risk, and banks which know that their large depositors are making those assessments have an incentive to limit the riskiness of their investments.

Consistent with this core principle, standard FDIC insurance covers deposit accounts up to $250,000, which represents 99.8 percent of all U.S. depositors and 78 percent of the total value of their bank deposits.[18] This level of coverage adheres closely to the best practices articulated by the BCBS and IADI. It covers all but 0.2 percent of individual depositors, but this small remaining group of large, sophisticated institutions account for the 22 percent of all deposits which are not guaranteed. The unlimited coverage of the TAG program violates this core principle. In so doing, it promotes moral hazard by weakening the incentives for large depositors to monitor the creditworthiness of their banks, and for banks to avoid excessive risks.

Research has confirmed that excessive deposit insurance coverage can increase the likelihood of banking crises.[19] A long line of analysis has found that while deposit insurance contributes to financial stability in economies subject to self-fulfilling depositor runs,[20] deposit insurance is also a source of moral hazard. Moreover, under certain conditions, this moral

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[16] Basel Committee on Banking Supervision and International Association of Deposit Insurers (2009).

[17] Garcia (1999, April).

[18] Hoelscher (2011).

[19] Demirgüç-Kunt and Detragiache (2002).

[20] Diamond and Dybvig (1983); Chari and Jagannathan (1988); Bhattacharya et al (1988).

hazard can drive a banking system into crisis. Drawing on data from 61 countries with deposit insurance systems over the period 1980 to 1997, researchers from the World Bank and the International Monetary Fund noted that,

> As their (banks') ability to attract deposits no longer reflects the risk of their asset portfolio, banks are encouraged to finance high-risk, high-return projects. As a result, deposit insurance may lead to more bank failures and, if banks take on risks that are correlated, systemic banking crises may become more frequent.[21]

Under Core Principle 10, "Transitioning from a blanket guarantee to a limited coverage deposit insurance system," the BCBS and the IADI recognize that a financial crisis may require a temporary, blanket guarantee on certain types of deposits. They write that blanket guarantees "may be unavoidable in periods of extreme financial distress to maintain domestic and international confidence in the banking system."[22] When the crisis passes, "the transition should be as rapid as a country's circumstances permit." The reason is that "blanket guarantees can have a number of adverse effects if retained too long, notably an increase in moral hazard … the longer the blanket guarantee, the more likely it is to give rise to additional moral hazard."[23] Similarly, the IMF noted in its Global Financial Stability Report issued on October 1, 2008, that, "Deposit insurance of individual retail accounts could be expanded beyond normal limits. However, expansion of deposit insurance limits or, if conditions deteriorate further, use of a blanket guarantee should only be undertaken as a temporary, emergency measure."[24]

These principles are also consistent with the findings by scholars that deposit insurance can actually increase a country's likelihood of experiencing a banking crisis. The researchers from the World Bank and IMF further found that this likelihood is sensitive to the particular features of a country's deposit insurance system. A banking crisis becomes more likely when the coverage from deposit insurance is more extensive, well-funded and run by the government, and when the government does not control interest rates.[25] Before the crisis, then, U.S. deposit insurance met all of these criteria except the first one: Pre-2008, FDIC guarantees covered only 78 percent of all deposits. Under TAG and other emergency initiatives, that coverage rose substantially, including 100 percent of transaction account deposits. Unless Congress allows TAG to expire on schedule, the United States will have a deposit insurance system with many of the features that increase the likelihood of another banking crisis.

The TAG program was created explicitly as a temporary measure for extraordinary times, following a determination of systemic risk by the Treasury under the systemic risk exception of

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[21] Demiguc-Kunt and Detragiache (2002).

[22] Basel Committee on Banking Supervision and International Association of Deposit Insurers (2009).

[23] *Ibid.*

[24] International Monetary Fund (2008, October). .

[25] Demiguc-Kunt and Detragiache (2002).

the Federal Deposit Insurance Act. Consistent with the core principles of banking regulation, the program's blanket guarantee should be wound down as quickly as possible, to minimize moral hazard and comply with the best practices of banking regulation.

IV. The TAG Program and Banking Sector Profitability

In addition to concerns about moral hazard, the data also show that a blanket guarantee for transaction account deposits is unnecessary: The U.S. banking sector has stabilized, and bank profits have returned to pre-crisis levels.

When the TAG program was created, the performance of U.S. banks had deteriorated significantly. The sharp decline in the value of housing and commercial real estate and, for a handful of large banks, the derivatives based on their mortgages, all contributed to several quarters of weak performance by U.S. banks -- as did the deep recession which followed the financial crisis. The housing crisis also led to unprecedented rates of delinquency and foreclosure among homeowners. As the losses on residential and commercial real estate loans (and, for some institutions, their derivatives) mounted in 2008 and 2009, banks tightened their lending standards and reduced the supply of credit to businesses and households. At the same time, deleveraging reduced consumer and business demand for loans. From the third quarter of 2008 to the fourth quarter of 2010, total loans outstanding at commercial banks dropped nearly 7 percent.

In addition, while banking sector revenues held up relatively well in the crisis, banking profits plummeted as many institutions were forced to set aside hundreds of billions of dollars to cover future losses on bad loans. These provisions for loan losses began to rise sharply in 2007 and peaked in the fourth quarter of 2008 at $69.4 billion. From 2008 to 2010, the industry set aside a total of $621 billion for loan losses, representing about a third of all banking net revenues. As a result, quarterly profits in banking fell from $36.7 billion in the second quarter of 2007 to average losses of $0.5 billion per-quarter throughout 2008 and 2009.

With deteriorating loan portfolios and persistent losses, banks began to fail at a rapid rate. In 2008, there were 25 bank failures and 252 "problem banks" with weaknesses that the FDIC determined threatened their continued financial viability. By 2009, the number of bank failures increased more than five-fold to 140, and the number of problem banks nearly tripled to 702. These numbers continued to increase in 2010 with 157 bank failures and 884 institutions deemed to be "problem banks."[26] In June 2009, a quarter in which the banking industry posted losses of $4.2 billion, the FDIC considered whether to extend the TAG program. While a number of large banking institutions including JPMorgan Chase, Wells Fargo and HSBC all favored the termination of the program, many smaller banks supported its extension. As the president of the Bank of Illinois put it to the FDIC, "The banking industry needs time to make profits again."[27]

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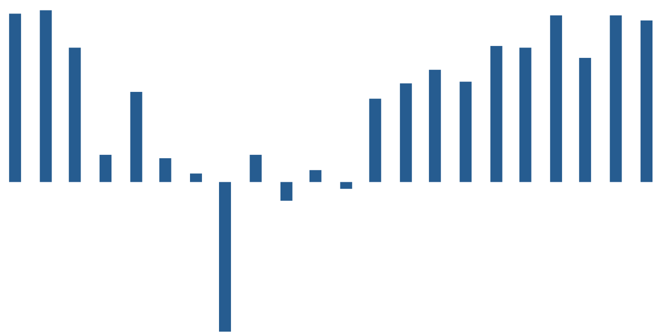
[26] FDIC (2011). Quarterly Banking Profile, Chart 8 - Number of FDIC-Insured "Problem" Institutions. and FDIC (2012). Failed Bank List.

[27] Maschhoff (2009, June 26). The Bank of Illinois would eventually be closed by the FDIC in March of 2010.

Those conditions no longer hold today. The banking sector has recorded 10 consecutive quarters of profits, reaching $34.5 billion in the second quarter of 2012.[28] These profits were less than 10 percent below the pre-crisis peak of $38.1 billion for the third quarter of 2006 (See Figure 4, below).

Figure 4. Quarterly Net Income or Losses by U.S. Banking Institutions, 2007-2012[29]



The FDIC also reports that nearly 90 percent of U.S. banks were profitable in the second quarter of this year, compared to 67 percent in the fourth quarter of 2009. If this trend continues, more than 94 percent of banks will be profitable by the end of 2012. (Figure 5, below)

Figure 5. Percentage of FDIC-Insured Banking Institution Reporting Profits, 2006-2012[30]

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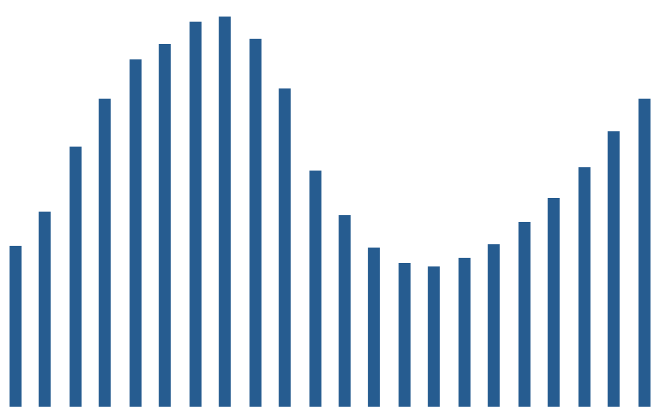
[28] FDIC (2012, August 28)..

[29] FDIC Quarterly Banking Profile.

[30] FDIC Quarterly Banking Profile.

Today, banks are lending again, businesses and households are borrowing, and the economy is slowly recovering. Since the third quarter of 2010, business loans outstanding have increased by 22 percent. (Figure 6, below) To be sure, the U.S. banking sector faces many challenges, including a housing market that remains depressed, tepid economic growth, and high unemployment. Furthermore, while larger banks have returned to profitability, some smaller institutions continue to struggle, particularly those with large commercial real estate portfolios. Nevertheless, with so many indicators returning to or near their pre-crisis levels, the claim that the TAG program is necessary to stabilize the financial sector is no longer valid. Maintaining this temporary, emergency government support program would send a signal to investors and the public that the government lacks confidence in the stability and health of U.S. banks.

Figure 6. Outstanding Commercial and Industrial Loans,
U.S. Commercial Banks, 2007-2012[31]



[31] Assets and Liabilities of Commercial Banks in the United States, Federal Reserve Board.

V. The TAG Program and the Term of Competition in the U.S. Banking Industry

In the absence of new legislation, Section 343 of the Dodd-Frank Act will expire on December 31, 2012. In that case, full FDIC coverage will end for the 0.2 percent of transaction accounts with balances of more than $250,000, on their balances exceeding that level. Those "excess" balances represent $1.4 trillion in deposits or 22 percent of all transaction account balances. Many customers will accept this risk in exchange for the benefits of retaining their current bank accounts and relationships, and in many cases lower bank fees through an earnings credit rate (ECR) that provides discounts on other bank services. Other transaction account customers may decide that without full FDIC coverage, they should shift some of their balances to other short-term investment vehicles that earn interest, such as money market funds and U.S. Treasury securities. Already, there may be some early signs of this type of shifting: In the first quarter of 2012, transaction account deposits leveled off after growing by nearly 50 percent over the preceding 18 months.[32]

However, some banks and industry groups have called on Congress to extend the TAG program again. As we will see, many of their arguments are flawed. As we have shown, the conditions which gave rise to the program have passed, and maintaining the program under normal conditions would introduce serious problems of moral hazard. Nevertheless, some advocates of extending the TAG program now claim that its purpose was not to help restore confidence in banks and stabilize the financial system, but to strengthen the competitive position of smaller banks. This argument holds that since the large banks that are "too big to fail" have an implicit government guarantee, the TAG program should be made permanent to "level the playing field" for banks that lack this implicit government support.

There are two problems with this argument. First, the TAG program was not designed to "level the playing field" between large and smaller banks. When the program was announced in October 2008, in the midst of large financial failures and widening financial panic, FDIC chairman Sheila Bair made a point of describing it as "a temporary solution to a temporary problem."[33] The TAG program was intended to help stabilize the financial system, not affect the terms of competition between large and smaller banks.

Second, the notion that extending TAG would "level the playing field" in this respect implies that the businesses and local governments which hold large transaction accounts are currently pursuing a strategy built around too-big-to-fail, government guarantees, and bailouts. The businesses and government agencies who own these accounts are responsible for evaluating their investment options and choosing those that provide the desired combination of security,

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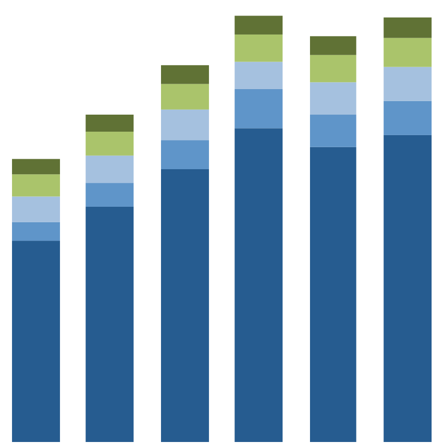
[32] FDIC Statistics on Depository Institutions.

[33] Wutkowski (2008, October 14).

liquidity and returns. In any case, state laws in many states require that bank deposits be fully insured or collateralized with government paper.

In a related argument, some industry groups that favor extending the TAG program claim that small community banks depend on these large transaction account deposits to finance their lending activities, including loans to small businesses. Again, there is no evidence to support this claim: FDIC data show that these accounts represent only 6 percent of total deposits in small banks (banks with less than $1 billion in assets). By contrast, these accounts represent more than 16 percent of all deposits in the nation's large banks. (See Figure 7, below)

Figure 7: Transaction Accounts Exceeding $250,000, By Bank Size[34]



The American Bankers Association has argued that allowing the TAG program to end on schedule would be "disruptive" and a source of "uncertainty."[35] Similarly, in a recent letter to members of the House of Representatives, a group of state banking associations expressed their support for extending the guarantee, claiming that "allowing it to lapse abruptly would be a

[34] FDIC Quarterly Banking Profile.

[35] Keating (2012, August 2).

needless and unacceptable risk."[36] However, neither the ABA nor the state banking associations provide evidence of potential disruption or risk associated with ending the program, designed as it was as a temporary support for a financial crisis which is now over. And the notion that its expiration in December of this year would be "abrupt" ignores the fact that the expiration date has been in place for more than two years.

The end of the TAG program could possibly harm some small, community banks. But extending a temporary government guarantee to avert those market results is not the appropriate policy response. In fact, using the TAG program to keep some banks on life support could well harm the economic recovery. A recent study from the Federal Reserve Bank of San Francisco found that weak community banks – those with FDIC composite ratings of 3, 4, or 5, out of 5 – were responsible for most of the decline in loans to small businesses in 2011.[37] A recent analysis of FDIC data by Reuters drew a similar conclusion, finding that a significant number of small community banks have scaled back their loan portfolios, to less than 50 percent of deposits, while increasing their investments in securities.[38] These findings suggest that allowing small, weak banks to fail could free up capital for productive small business lending and thereby strengthen the economy for the long term.

Moreover, banks of all sizes as measured by assets, including small banks, are attracting new deposits not covered by the TAG program (Figure 8, below). While the largest banks, as expected, have seen the fastest growth, the non-TAG covered deposits of the smallest banks, as of June 30, 2012, were about 7 percent higher than on December 31, 2008.

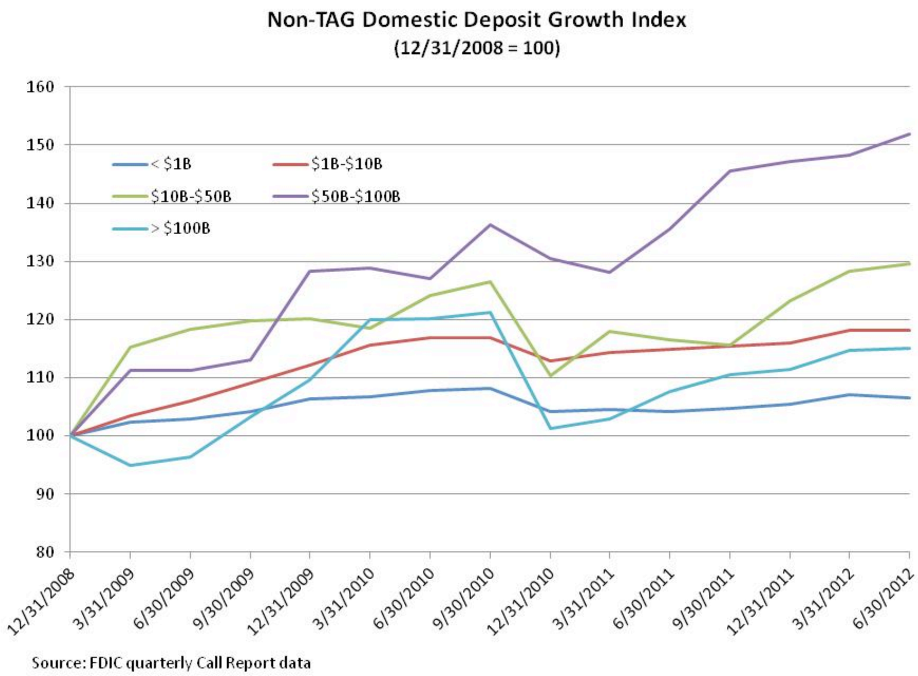
Figure 8: Growth in Non-TAG Domestic Deposits, by Size of Bank Assets[39]

[36] Letter sent to the U.S. House of Representative by a group of 80 state banking associations, August 29, 2012 , http://www.icba.org/files/ICBASites/PDFs/ltr082912.pdf .

[37] Laderman (2012).

[38] "Ranks of tight-fisted community banks surge," Tim McLaughlin, Reuters News, July 9, 2012.

[39] FDIC Quarterly Banking Profile, Second Quarter 2012, http://www2.fdic.gov/qbp/2012jun/qbp.pdf; FDIC Statistics on Depository Institutions, Call Report data: Total assets (RCON2170), Noninterest-bearing transaction deposit accounts over $250,000 (RCONJ944), Domestic deposits (RCON2200).



Small, community banks have an important role in the U.S. banking system, in providing loans and other banking services to businesses and farms in small cities and rural communities. Many of these small banks face a challenging environment: Since January of this year, 41 U.S. banks have failed in 2012, most of them with only $100 million or $200 million in deposits. While lending by large banks has nearly returned to pre-crisis levels, lending by small banks (less than $1 billion in assets) has continued to decline and remains 18 percent below its 2008 peak. (See Figure 9, below) These are the results of market dynamics, and government support in the form of extending the TAG program should not be seen as an appropriate, long-term response. In fact, extending the TAG program could damage the competitiveness of the U.S. banking industry and even possibly weaken the economic recovery.

Figure 9. Loans Outstanding at U.S. Banks and Savings Institutions, By Bank Size, 2008-2012[40]

[40] FDIC Statistics on Depository Institutions.

VI. Conclusion

Milton Friedman famously said that there is nothing so permanent as a temporary government program. The TAG program was created to help solve a temporary problem. In the FDIC's August 2009 final rule extending the program for six months through June of 2010, the FDIC wrote "The TAG program, like the DGP was always intended to be temporary." The FDIC went on to say that it was "committed to providing an orderly phase-out of the TAG program." When the TAGP was extended for another six months in April 2010, the FDIC advised its members not to allow these accounts to become too large. "Because of the temporary nature of the TAG Program," the FDIC warned, "participating IDIs [insured depository institutions] should not use the extension period to aggressively market or grow their TAG-related accounts."

The FDIC was correct in extending this temporary program in six-month increments, rather than the one-year or two-year extensions which some banks pressed for. Longer extension would have encouraged moral hazard by allowing banks and investors to build greater risk into their investment decisions. By extending the TAGP only six months at a time, the FDIC was able to help fully stabilize the banking system without distorting its behavior. Unfortunately, the Dodd-Frank Act extended the unlimited coverage for non-interest-bearing transaction accounts for two years. The result: Deposits in these accounts, which grew at a steady rate of 8 percent per-year from the time TAG was established to Dodd-Frank, have grown at a 23 percent annual rate since then.

Now, some banks have called for extending the program's guarantee for two more years or longer. There is no compelling economic basis for yet another extension. Confidence in the U.S. financial system has been restored, and U.S. banks have returned to their pre-crisis level of profits. Extending an emergency government support program under these conditions would send a negative signal to investors, the banking industry and the public, suggesting that Congress still has little faith in America's financial system. Nor was the TAG program designed to "level the playing field" between large and smaller banks. In recent decades, the market has largely set the terms of competition between large and smaller banks, and should continue to do so. Even if the policy goal here were to "level the playing field" for small community banks, the TAG program would be a very inefficient and ineffective way of doing so.

The most important reason for ending the TAG program, however, remains the increased moral hazard which it imports into the U.S. financial system. All deposit guarantee systems entail moral hazard. As a result, international regulators as well as academic experts all agree that deposit insurance system must have limits. Ideally, it should cover most depositors, but not all of their deposits. Before TAG, the FDIC met those criteria for transaction accounts: The coverage limit of $250,000 per-account covered 99.8 percent of all non-interest-bearing transaction accounts, but only 78 percent of the total value of those accounts. As an emergency measure to shore up depositor confidence during the nation's worst financial crisis since the 1930s, the FDIC and the Treasury suspended those limits. Now, the crisis has passed, and the United States should return to the best practices of deposit insurance systems. The alternative, if Congress does extend the TAG program guarantees yet again, is that United States will have embraced a deposit insurance system with more moral hazard and, with it, a greater likelihood of another banking crisis.

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