Be Prepared for the TAG Expiration, Part II

Understanding Cross-Holdings Exposure and Yield Impact

Abstract

Deposits at the 20 largest U.S. banks are generally concentrated in banks with Tier 2 ratings, many of which are just one step away from BBB status. Significant cross-concentration of bank names also exists in large prime money market funds. The dominance of bank exposure in corporate portfolios through deposits and money market funds may be reduced through customized separate account solutions given the trend of increased non-financial issuance.

The expiration of the TAG program may bring a demand shock to money market funds, resulting in even lower yields than the current historical lows, anchored by accommodative monetary policies. Customized separate account solutions may broaden investment opportunities for, and provide yield relief to, corporate portfolios.

Introduction

Last month, we discussed the abnormal relationship between domestic deposit growth and deposit ratings migration among the 20 largest U.S. bank holding companies (BHCs) since 2007. We concluded that reduced government support assumptions and deteriorating bank credit strength should compel treasury professionals to diversify their deposit holdings once the FDIC transaction account guarantee (TAG) program expires on December 31, 2012.

In this follow-up writing, we continue the discussion by examining the cross-concentration risk in money market mutual funds with deposits. We also are mindful of the yield impact of the TAG expiration on general money market rates. We again emphasize the benefit of integrating money market funds and separate account solutions for more efficient risk management and yield enhancement.

Concentration in Lower Tier Banks

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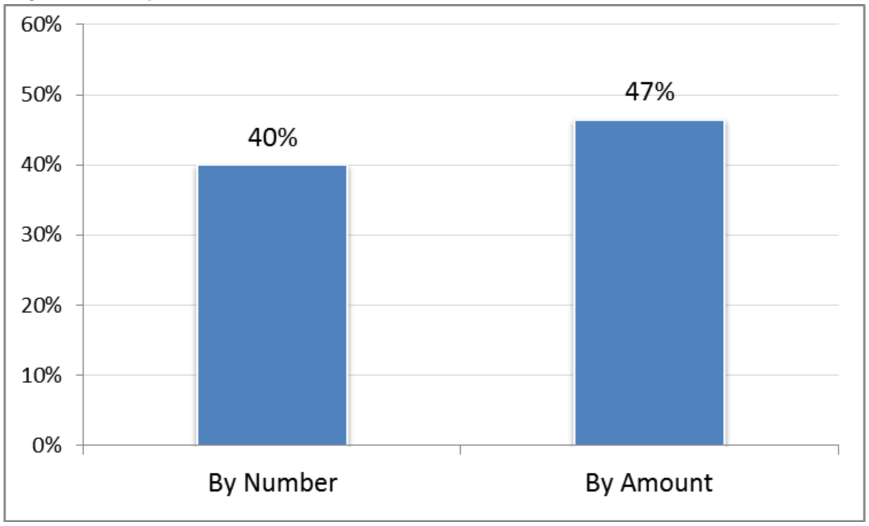
In our last study, we showed that the banking industry, as represented by the 20 largest BHCs, has largely migrated from AA ratings on average to single-A ratings. What perhaps is more striking is the fact that eight of the 20 BHCs are rated A3 or lower (See Appendix A for the list of banks and deposit ratings).

We observe two significant takeaways from Figure 1 below. First, 47% of the deposits already are rated P-2. In many corporate investment policies, commercial paper and other short-term instruments rated below P-1 normally would not qualify as eligible holdings. Although deposits technically are not investments, firms with a Tier-1 (A-1/P-1) investment mandate should carefully consider whether unguaranteed deposits rated P-2 are consistent with their risk tolerance.

Figure 1: Deposits in Banks Rated A3 (P-2) or Below



Source: See Appendix A.

The second takeaway is that most of those 47% of deposits currently are just one ratings notch above BBB, a ratings category long shunned by many treasury investment policies. Again, treasury practitioners need to consider the impact of an event risk associated with negative ratings actions. We also should note that Moody's currently maintains a negative outlook on the U.S. banking industry, meaning that credit ratings are more likely to fall than to rise.

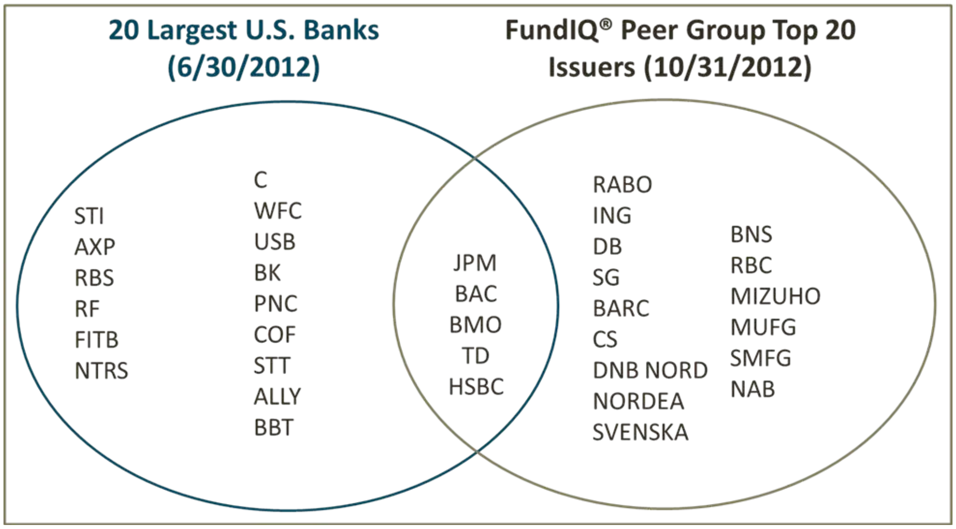
Cross-Concentration in Large Banks

As we discussed in the earlier study, one of the logical alternatives for the $1.6 trillion of TAG deposits after the program's expiration is to invest part of it in money market mutual funds. We caution investors to be mindful of the cross-concentration risk between deposit and fund holdings. To illustrate this point, we present in Figure 2 the 20 largest holdings in the 15 FundIQ® peer group funds next to the 20 largest banks in the deposits market.[1]

Figure 2 shows that, of the 20 largest banks, five also are among the top 20 issuers in the money market fund universe: JPMorgan, Bank of America, Toronto Dominion, HSBC and Bank of Montreal. Figure 3 shows that these five banks represent 28% of U.S. domestic deposits and an additional 11% in AAA-rated U.S. prime money market funds, as measured by FundIQ®.

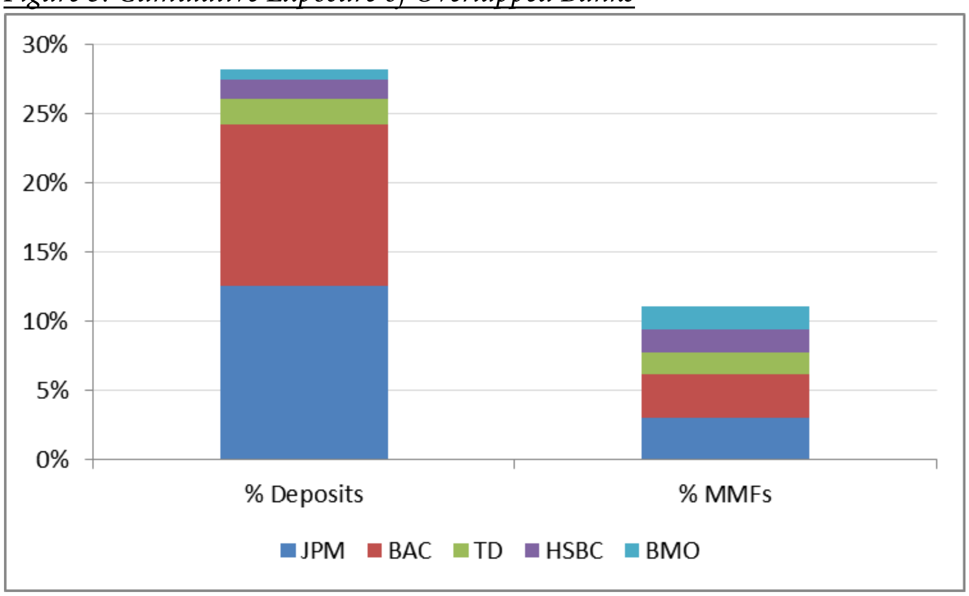
We believe that the numbers presented in Figure 2 and Figure 3 are indicative of deposits and money market funds in aggregate. In practice, individual deposits and money market funds may be more concentrated in a few large banks, whether for convenience or relationship reasons, so cross-holdings of deposits and funds may be even higher for some investors.

Figure 2: Overlapped Banks in Deposits and Money Market Funds



Source: FundIQ® database as of 10/31/12. FDIC deposits data as of 6/30/12.

Figure 3: Cumulative Exposure of Overlapped Banks



Source: FundIQ® database as of 10/31/12. FDIC deposits data as of 6/30/12.

Concentration in Financial Issuers

Another observation from Figure 2 is that both the 20 largest deposit institutions and the 20 largest money fund issuers are exclusively banks. On one hand, this simply states the obvious, because banks tend to be the largest borrowers in the cash markets. On the other hand, it highlights corporate cash portfolios' heavy exposure to bank credit and the need to monitor, diversify and minimize such exposure.

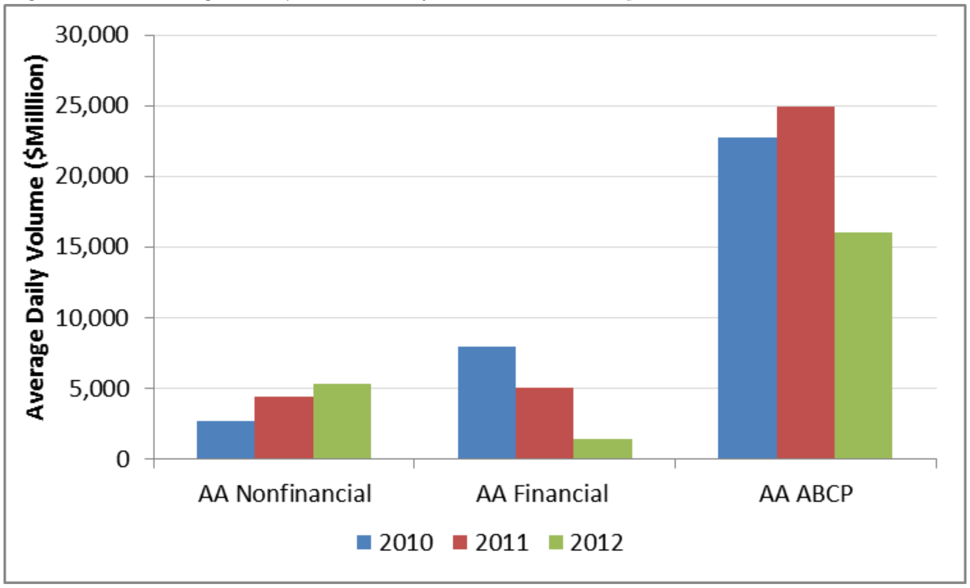
Except for a brief period just before the financial crisis, banks typically have had lower credit ratings than their non-financial counterparts. Their spread lending business model typically means highly levered and illiquid balance sheets, mismatched assets and liabilities, opaque loan books, volatile capital markets activities and sensitivity to interest rate and economic cycles. The FDIC insurance protects retail savers from the boom-bust bank credit cycles and resulting bank runs, although large depositors also benefit from fewer bank failures as their balances typically exceed the guarantee limits.

Under TAG, institutions were shielded from the financial concentration risk for the last four years. After TAG expiration, prime money market mutual funds appear to be viable, but not sufficient, diversification tools for cash portfolios due to their relatively high exposure to financial issuers. Treasury professionals, thus, need to look further into reducing this concentration risk.

Changing Market Dynamics

We noted in recent writings that issuance from non-financial firms has increased steadily. Average commercial paper volume statistics presented in Figure 4a and Figure 4b provide further support that both the amount outstanding and the number of issuers labeled "AA Nonfinancial" grew steadily from 2010 through 2012, while both "AA Financial" and "AA ABCP" issuers saw significant declines.

Figure 4a: Average Daily Volume of Commercial Paper Issuance

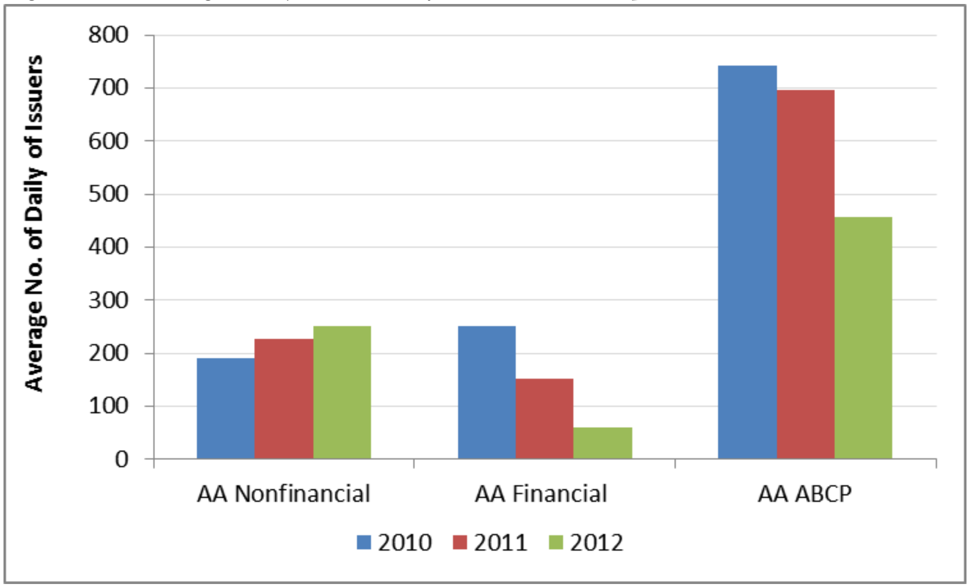


Source: Federal Reserve's commercial paper volume statistics as of November 26, 2012

We think that there are at least three explanations for this trend:

1. Financial firms reduced their CP issuance due to either deleveraging of their balance sheets or to the loss of high ratings;
2. Non-financial firms increased issuance to take advantage of positive investor acceptance and lower funding costs; and
3. The negative ratings differential between corporate borrowers and their banks increased their incentive to borrow directly from the markets.

Figure 4b: Average Daily Number of Commercial Paper Issuers



Source: Federal Reserve's commercial paper volume statistics as of November 26, 2012

For corporate cash portfolios, this development provides much needed supply relief to diversify away from their high concentrations in financial issuers. However, as Figure 2 illustrates, investors have not realized this benefit through money market fund investments, as none of the top 20 issuers in the funds are from non-financial industries. A more customized and active solution may help close the gap.

Yield Impact from TAG Expiration

One TAG expiration topic that has not received as much attention is the likely yield impact on cash instruments. Since the Federal Reserve's highly accommodative monetary policy may remain in effect at least through mid-2015, the market may have limited capacity to absorb the $1.6 trillion in TAG deposits if depositors switch over to money market funds and other short-term vehicles.

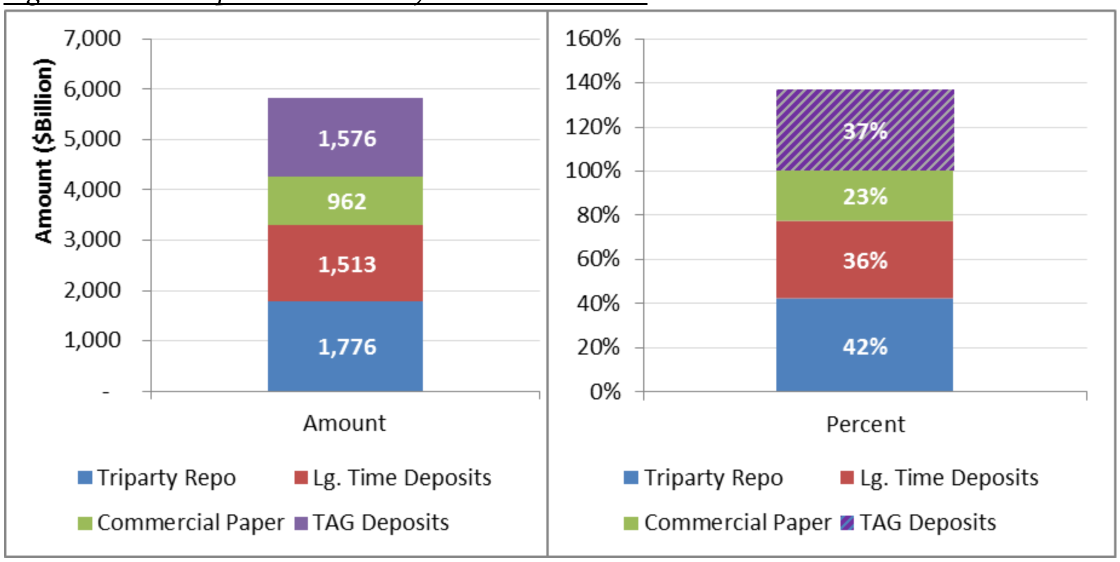
Although the $1.6 trillion of TAG deposits represents a modest 18% of total U.S. domestic deposits ($8.9 trillion at 6/30/12), it is a far larger figure when compared with the $4.3 trillion in money markets. Figure 5 shows the combined money markets as represented by tri-party repo, large time deposits and commercial paper segments.

It is reasonable to expect that the potential 37% demand expansion in the money markets may severely depress yields without the supply side also growing to match it. While it is possible that banks may tap the money markets to make up the amounts they lost, their tarnished credit ratings may hamper their ability to capture the difference.

Even if just a fraction of the $1.6 trillion enters the money markets, we believe that additional yield compression could be in store. Also consider that while the official Eurozone short-term deposit rate already is at zero, there is still a chance that the Fed may lower its interest on excess reserves (IOER), currently at 0.25%, which would add to downward pressure on yields.

Corporate cash portfolios again need alternatives to break out of the yield conundrum without compromising on credit quality.

Figure 5: TAG Deposits and Money Market Securities



Source: SIFMA Research Statistics US Money Market Debt Outstanding (6/30/12) and US Tri-party Repo (7/11/12) Data

Customized Solutions

The combination of the impending TAG expiration and the cross-concentration of financial issuers calls for more customized strategies to actively manage portfolio exposures. While money market funds provide a partial solution, a fully customized separate account strategy may be more effective. Such a strategy also may allow investors to venture beyond money markets and take advantage of yield opportunities unavailable to money market funds.

Readers may refer to our October 1, 2012, publication Diversifying Money Market Fund Risk with Separately Managed Accounts for a simulation study on account customization. We present its conclusions here to highlight the benefits of a portfolio simulator as a useful portfolio planning tool.

Separate Account Simulator™ Results[2]:

1. A portfolio limited to 50% exposure to financials with a 60-day WAM may provide approximately the same yield potential as the MMF portfolio, while reducing the risk to financial issuers by 50%.
2. The yield give-up of investing 100% in MMF credits vs. 100% in un-MMF™ is roughly 0.05% at a 60-day WAM.[3]
3. The exposure to the top five credits in the FundIQ® composite may be reduced from 21.4% to less than 10% by allocating 60% to the un-MMF™ portfolio.
4. The MMF portfolio yield may be replicated by as little as 40% exposure to the un-MMF™ portfolio with a WAM as short as 90 days and may produce a meaningful reduction in financial risk.

Conclusion

In this follow-up study, we showed that deposits at the 20 largest U.S. BHCs have high concentrations in banks rated Tier-2, a significant portion of which are just one step above BBB status. We showed significant cross-concentration of bank names in large prime money market funds and the dominance of bank names in corporate portfolios in general. Recent volume statistics of commercial paper issuance provided opportunities to diversify away from financial exposures, but the most direct means to benefit from this trend may be customized separate account solutions.

We also discussed potential demand shock to money markets from expired TAG accounts and the resulting yield impact. Customized separate account solutions, again, may enable corporate portfolios to broaden yield opportunities beyond money market securities.

Appendix A:
20 Largest Banks in the United States (as of 9/30/2012)

		Total Assets	Domestic Deposits		Moody's Deposit Ratings		
Rank	Bank	6/30/2012	12/31/2007	6/30/2012	10/31/2012	12/31/2007	Change
1	JPMorgan Chase	2,290,146	740,728	1,115,886	Aa3	Aaa	-3
2	Bank of America	2,162,083	806,345	1,036,753	A3	Aaa	-6
3	Citigroup	1,916,451	826,230	914,308	A3	Aa1	-5
4	Wells Fargo	1,336,204	347,396	929,364	Aa3	Aaa	-3
5	U.S. Bancorp	353,136	131,445	241,316	Aa2	Aa1	-1
6	Bank of NY Mellon	330,490	118,232	221,257	Aa1	Aaa	-1
7	HSBC North America	317,482	165,099	119,512	A1	Aa2	-2
8	PNC Financial	299,712	82,754	207,045	A2	Aa3	-2
9	Capital One	296,698	82,991	214,058	A3	A2	-1
10	TD Bank	207,333	43,756	169,429	Aaa	Aaa	0
11	State Street Corp	200,369	95,792	143,771	Aa2	Aa1	-1
12	Ally Financial	178,560	15,281	46,210	B1	Ba3	-1
13	BB&T	178,529	86,766	126,059	A1	Aa2	-2
14	Suntrust Banks	178,307	117,843	128,453	A3	Aa2	-4
15	American Express	146,890	15,397	40,636	A2	Aa3	-2
16	RBS Citizens	129,314	102,445	93,122	A3	Aa2	-4
17	Regions Financial	122,345	94,783	95,101	Ba1	Aa3	-7
18	Fifth Third Bancorp	117,543	75,619	84,537	A3	Aa2	-4
19	Bank of Montreal	112,166	29,741	70,057	Aa2	Aa1	-1
20	Northern Trust	94,456	51,213	76,996	Aa3	Aa3	0
	Total	10,968,214	4,029,854	6,073,870	A2	Aa2	-3
	Industry	14,031,000	6,912,000	8,914,000			
	% of Industry	**78%**	**58%**	**68%**			

Note: This list is based on the FDIC's Top 50 bank holding companies as of 9/30/2012 from data as of 6/30/2012. The following companies are removed from the list due to limited deposit balances despite their BHC status: Goldman Sachs, MetLife, Morgan Stanley, Principal Financial and Ameriprise.

[1] FundIQ® is a registered trademark of Capital Advisors Group, Inc. Capital Advisors Group rates 15 of the largest AAA-rated institutional prime money market funds. These funds are not necessarily the largest funds within this category, rather they are funds that we believe are representative of the AAA- rated prime fund market.

[2] Separate Account Simulator™ is a trademark of Capital Advisors Group, Inc.

[3] Un-MMF™ is a trademark of Capital Advisors Group, Inc.