Be Prepared for the TAG Expiration

Understanding Deposit Strength Transitions since the Financial Crisis

Abstract

The expiration of transaction account guarantees requires actions from treasury cash managers. While essentially all of the $2.0 trillion growth in domestic deposits since 2007 went to the 20 largest banks, the banks' deposit credit strength declined by almost three ratings notches over the same period. Although 13 of the 20 had Aaa deposit ratings in 2007, only one maintains that rating today. A major cause for declines in deposit strength has been reduced government support for large banks which could lead to losses for uninsured depositors.

We urge treasury practitioners to carefully evaluate the standalone credit strength of their current banks and make proper deposit diversification decisions. Money market funds and separately managed accounts also may be viable alternatives in dealing with TAG expiration.

Introduction

In two short months, treasury management professionals will face a major milestone, the expiration of the Transaction Account Guarantee (TAG) program on non-interest-bearing bank deposits. Recently, the program has received a lot of publicity over the possibility that it will be re-extended, leaving practitioners having to prepare for both scenarios – continued guarantees or a reversion back to uninsured deposits.

In this context, we think that it is important to understand how bank deposit strength has changed since the financial crisis began five years ago. For depositors who may choose to remain in uninsured deposits after the TAG expiration, the standalone credit strength of the deposit-taking banks will become their primary credit protection.

Background on the TAG Program

The Federal Deposit Insurance Corporation (FDIC), along with the U.S. Treasury Department, created the TAG program on October 13, 2008, to encourage liquidity in the banking system by providing full insurance coverage on non-interest-bearing transaction accounts, regardless of dollar amount. Described as an Interim Rule, the program originally was scheduled to end on December 31, 2009. On August 26, 2009, the FDIC extended the program for six months, through June 30, 2010. It again extended the program on May 26, 2010, through December 31, 2010.

The deposit guarantee program currently in place is a similar, but legally separate, program authorized by a section of the Dodd-Frank Wall Street Reform and

November 1, 2012

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Consumer Protection Act. Officially known as the Dodd-Frank Deposit Insurance Provision, the new guarantee program replaced the FDIC's TAG program and provides coverage on non-interest-bearing transaction accounts through December 31, 2012.[1]

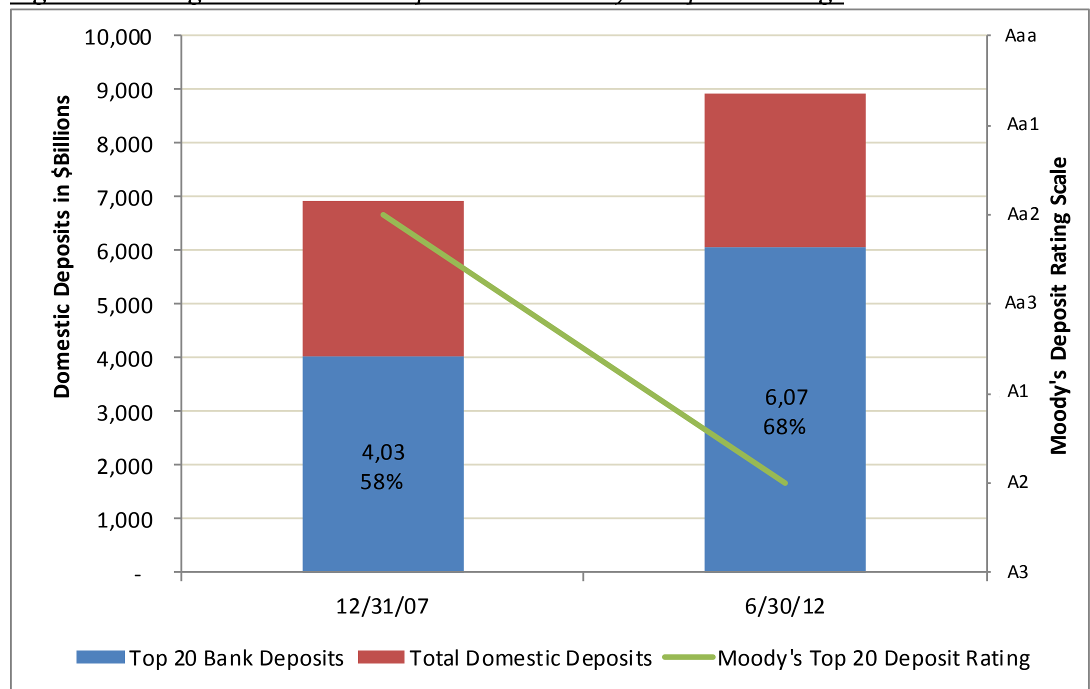
It is important to note the difference between the FDIC and the Dodd-Frank Act programs. Although the FDIC may decide administratively to bring back TAG on an optional, pay-to-participate basis, the U.S. Congress must approve an extension of the existing program. Generally, it is believed that, in the former case, only smaller commercial and community banks may ask for optional coverage. For the latter, the political hurdles in an election year may be too high for legislators to contemplate an extension.

In short, we believe treasury professionals should use the remaining two months to prepare for the expiration of the TAG program due to the low likelihood that institutional depositors will be covered by a program extension.

Changes in Deposit Landscape since TAG's Implementation

The TAG program proved to be an important stabilizing factor in the challenging financial environment over the last five years and resulted in a rapid accumulation of domestic deposits. As shown in Figure 1, domestic deposits grew by $2.0 trillion, or 29%, since the end of 2007.

Figure 1: Changes in Domestic Deposits and Moody's Deposit Ratings



Source: Federal Financial Institutions Examination Council, Moody's Investor Services

Figure 1 also shows that deposit growth at the 20 largest banks, including U.S. subsidiaries of foreign banks, was **$2.04 trillion**, exceeding the growth in the entire industry.[2] In other words, the increase in total domestic deposits since 2007 can be attributed to the 20 largest banks, while smaller banks actually lost deposits, on balance.

On the other hand, Figure 1 shows that the average credit quality of bank deposits, as measured by Moody's long-term deposit ratings, **declined close to three notches, from an average of Aa2 to A2**, in the same period. (Altogether, there are 10 "investment grade" notches from Aaa to Baa3 in the Moody's ratings scale.) Note that these are the deposit ratings of the actual banks accepting deposits, not the credit ratings of their holding companies, which generally have lower credit ratings.

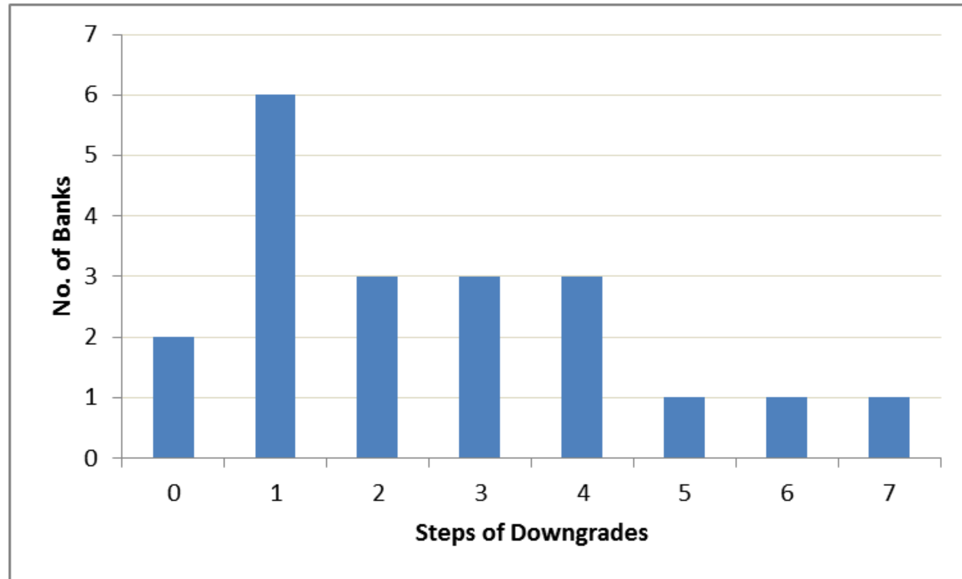
In summary, the banking industry has attracted $2 trillion in new deposits since 2007, all of which were placed with the 20 largest banks that came out of the financial crisis with materially weaker credit profiles. We think this seemingly illogical trend may be explained by the TAG program, which insulated depositors from the credit risks of deposit-taking banks.

The question is – after the guarantees expire, will depositors remain confident in the banks and leave their cash uninsured as they did five years ago?

Understanding Ratings Transitions and Lower Government Support for Banks

To help our readers answer this question, we take a closer look at the ratings transitions of the 20 largest banks (see Appendix A). As Figure 2 indicates, 18 of the 20 banks were downgraded by various notches. One bank (Regions) was downgraded seven notches, followed by Bank of America and Citibank, which lost six and five rating notches, respectively. Ratings on most other banks dropped two to four notches.

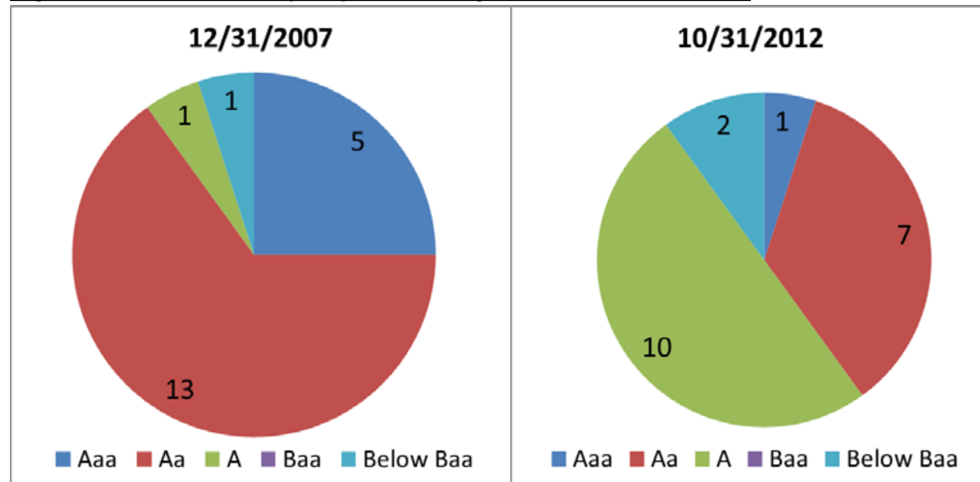
Figure 2: Distribution of Deposit Ratings Downgrades (12/2007 - 10/2012)



Source: Moody's Investor Services

The comparison of deposit ratings distribution in 2007 and today is provided in Figure 3. It shows that, before the financial crisis, the majority of the large banks were rated at least Aa, with five banks rated Aaa. Today, the group is clearly more dominated by single A-rated banks, with only one bank (TD Bank) having the coveted Aaa deposit rating (TD Bank was placed on review for downgrade on 10/26/2012).

Figure 3: Distribution of Deposit Ratings (12/2007 – 10/2012)



Source: Moody's Investor Services

It is apparent, that despite their ability to attract deposits (thanks in part to TAG), the fundamental credit strength of the largest banks as a group has weakened significantly. Although one may expect bank credit to get stronger after the credit cycle improves,

structural changes have made it much harder to return the industry to Aa or Aaa status (refer to Figure 3).

Chief among the structural changes that resulted in bank ratings downgrades has been the lower probability of government support in the event of a bank failure. The failures and near failures of Bear Stearns, Lehman Brothers, Countrywide, Washington Mutual, Citigroup and Wachovia led to the new financial regulatory framework for "too big to fail" banks. The formation of the Financial Stability Oversight Council (FSOC), the requirement for banks to draw up "living wills" and the appointment of the FDIC as the single receiver of failed banks all resulted in a higher probability of debt holders and uninsured depositors sharing losses in the event of a large bank bailout.

Options for Treasury Practitioners

In recent months, we published several articles discussing the need to be prepared for the TAG expiration. Here, we refer our readers to Comprehensive Cash Investment Strategies published on August 1, 2012. The article discusses the pros and cons of three broad categories of cash vehicles: deposits, asset pools and direct purchases. Let us review these options in the context of TAG expiration.

1. Deposits

As a practical matter, most institutions likely will have substantial balances for operating and liquidity purposes above the $250,000 FDIC deposit guarantee limit. In deciding on where and how much to place in uninsured deposits, treasury managers should carefully evaluate the standalone credit strength of their banks and adjust their relationships accordingly. Remember that size no longer implies safety in the post-financial crisis world.

Institutional depositors may consider further diversifying their deposits among more credit worthy banks to reduce credit concentration risk. For depositors who, because of TAG, stood by the former bellwether names that experienced significant credit deterioration, this may be the time to fine-tune their allocations.

As a side note, the requirement of leaving cash in non-interest-bearing transactional accounts to qualify for TAG also ends when the guarantee expires. Cash managers may consider moving a portion of their uninsured deposits to certificates of deposits and savings accounts to better capture yield opportunities.

2. Asset Pools

Compared to uninsured deposits at individual banks, regulated assets pools have the advantage of instant risk diversification. In particular, money market funds continue to

be logical alternatives to deposits as funds are managed to maintain $1.00 net asset value and provide daily cash availability. The Security and Exchange Commission's recent decision to not vote on a reform proposal temporarily removed the industry's regulatory uncertainty.

Other regulated asset pools, not all of which are managed to stable net asset values, also may be viable, albeit to a smaller group of institutional investors. These instruments may include ultra-short-term bond mutual funds, bank short-term investment funds, local government investment pools and exchange-traded funds.

The shared nature of pooled investments means that investors also share the downside risk, chief among which is shared liquidity, or the lack thereof, during market disruptions. Transparency of investments may be limited, and shareholders need to be vigilant in keeping apprised of the latest developments on the regulatory front.

3. Direct Purchases

Direct purchases of high quality and liquid securities, either by internal staff or through a separately managed account (SMA) manager, are a third option to deal with TAG expiration. SMA managers may help treasury professionals diversify their credit exposures, manage their liquidity needs and deliver yield objectives consistent with their risk tolerance.

Only after the recent financial crisis did the benefits of customized solutions and risk transparency of the SMA approach become more widely acknowledged by the treasury community. The use of direct purchases, in concert with deposit accounts and money market funds, may allow cash managers more flexibility in dealing with TAG expiration and alleviate yield constraints in the low interest rate environment.

However, direct purchases may involve more work on the part of practitioners as they will have to select an investment manager, as well as monitor a portfolio of individual securities. They also may require more accurate projections of cash flows to maximize yield potential. Other challenges may include selling securities prior to maturity and additional accounting requirements. Treasury managers should balance these challenges with the diversification, customization and performance benefits of an SMA before deciding on a course of action.

Conclusion

The expiration of the Transaction Account Guarantee program requires action from treasury cash managers. While essentially all of the $2.0 trillion growth in domestic

deposits since 2007 went to the 20 largest banks, the group's deposit credit strength declined by close to three ratings notches during the same period.

While deposit ratings among many of the 20 banks dropped two to four notches, one bank saw a seven-notch decline. Back in 2007, 13 of the 20 banks had their deposits rated Aaa, the highest possible rating from Moody's. Only one bank from this group retains a Aaa rating today. It is apparent that the strength of deposits has declined from mostly Aaa- and Aa-rated banks to A-rated over the last four and a half years. A major cause for this decline has been an industry-wide adjustment which assumes lower government support for large banks and higher loss probability to uninsured depositors in a bailout situation.

While there still may be a last minute push to extend the current guarantee program, we think there is very little likelihood that this will occur. We thus urge treasury practitioners to carefully evaluate the standalone credit strength of their current banks and make diversification decisions wisely. Money market funds and separately managed accounts also may be viable alternatives in dealing with TAG expiration.

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] See the FDIC's website "Temporary unlimited FDIC coverage for non-interest-bearing transaction accounts (including IOLTA accounts)." http://www.fdic.gov/deposit/deposits/unlimited/implementation.html

[2] Refer to Appendix A for the list of 20 largest bank holding companies. Data is from the FDIC's Top 50 holding companies as of 9/30/2012. http://www.ffiec.gov/nicpubweb/nicweb/Top50Form.aspx In addition to the FDIC's bank holding company performance reports, deposits and ratings data comes from Capital IQ and Moody's Investor Services, both of which require subscriptions to access.

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