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TAG: Phase Out Unlimited Bank Deposit Guarantees

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In 2008, in the midst of a financial crisis, federal regulators extended bank deposit guarantees beyond the statutory $250,000 limit to cover all "transaction," or checking, deposits. Later codified by Congress, the Transaction Account Guarantee (TAG) program is due to expire on December 31, 2012. Congress is considering a two-year extension. It should not do so.

TAG is bad policy, and it should be phased out over the shortest time possible without causing undue damage to smaller banks. During that phase-out period, TAG should be made a voluntary program financed with a separate Federal Deposit Insurance Corporation (FDIC) assessment to cover its costs. In addition, Congress should both deal with the continued threat of too-big-to-fail financial institutions and consider how smaller banks can better compete against them.

Background. TAG was a product of the 2008 financial crisis. Originally intended to last two years, it was extended for another two years in 2010. The program was started to calm businesses' worries that if their banks failed, the firms would lose any checking account balances they held in those banks that exceeded the normal $250,000 FDIC cap. The program worked, and corporate fears disappeared.

While the FDIC guarantees most bank accounts up to a maximum of $250,000, the TAG program provides unlimited coverage for checking deposits (known technically as transaction deposits) well above the $250,000 maximum so long as the accounts pay no interest. This mainly applies to the transaction accounts held by major corporations. Currently, in aggregate, about 13 percent of all deposits (about $1.4 trillion) are covered by the TAG program.

Despite its past need, TAG is potentially very dangerous. Transaction accounts can move very quickly. Once interest rates start to rise (as they inevitably will), corporations could move their money into interest-bearing accounts or other investments, leaving banks that depend on these deposits to finance lending in serious trouble. The sooner this market distortion ends—responsibly—the better. However, the legitimate concerns of smaller banks need to be taken into consideration when a decision is made.

Justified Small Bank Concerns. Smaller banks are justifiably worried that if TAG ends suddenly, larger corporate checking accounts will move to larger banks as larger banks are seen by corporate money managers as safer than smaller banks. Bank customers believe that huge banks that run into trouble are likely to be bailed out while smaller banks would be allowed to close, with the depositors potentially losing money. As smaller banks, relying on the current law, use a proportion of their TAG-covered deposits to fund lending in their communities, loss of those deposits would reduce their abilities to meet customers' credit needs.

Small banks have a good reason to be concerned. Since 2007, virtually all the growth in bank deposits occurred at larger banks. Small bank deposits have actually fallen slightly. A sudden and unexpected end to TAG could strengthen this trend.

"Too Big to Fail" Is the Real Problem. While TAG is the focus of Congress for now, the real problem that needs to be resolved is the

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continued threat of too-big-to-fail banks to the economy. While the Dodd–Frank bill claimed to end bank bailouts, it really made them more likely. As long as the market believes that the government will not allow big bank depositors to suffer losses if their banks run into trouble, they will have an unfair competitive advantage over all of their various competitors.

As soon as possible, Congress needs to develop a responsible policy that deals with too-big-to-fail banks. This policy should set up a realistic way for them to fail and be closed or sold through a bankruptcy process and create an escalating capital requirement for larger banks that forces them to have sufficient reserves to cover the added risks their size imposes on the overall financial system.

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