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An Overview of the Transaction Account Guarantee (TAG) Program and the Potential Impact of Its Expiration or Extension

Updated November 27, 2012

Congressional Research Service
https://crsreports.congress.gov
R42787

CRS REPORT
Prepared for Members and
Committees of Congress

Summary

The Federal Deposit Insurance Corporation's (FDIC's) initial Transaction Account Guarantee (TAG) program provided unlimited deposit insurance for noninterest-bearing transaction accounts (NIBTAs). A NIBTA is an account in which interest is neither accrued nor paid and the depositor is permitted to make withdrawals at will. NIBTAs are frequently used by businesses, local governments, and other entities as a cash management tool, often for payroll transactions. In spite of a loss of confidence in other parts of the financial system, the insured banking sector saw few bank runs during the financial crisis. The establishment of TAG in addition to the existing deposit insurance may have helped bolster depositors' confidence in banks as reliable counterparties and prevented them from suddenly withdrawing their deposits.

The second TAG program, which was established by the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203), was a temporary extension of the original program with some changes. This TAG program is set to expire on December 31, 2012. If the program expires, the $1.4 trillion currently insured by TAG in NIBTAs would no longer have unlimited deposit insurance but would have the $250,000 standard maximum deposit insurance amount. Changes to the FDIC's authority made by the Dodd-Frank Act make it unlikely that the FDIC could act to extend the program under its own authority. An extension may require congressional action.

Opinions are divided on the merits of extending the program. Underlying the divergent policy views are contrasting opinions about the state of the economic recovery and the role of the government in guaranteeing bank liabilities and in determining the size of the traditional banking system.

If the TAG program expires, depositors could keep their deposits in the traditional banking system, or they may decide to transfer some or all of their deposits to nonbank investment options. TAG deposits that remain in the banking system may migrate to the largest or most interconnected banks if large depositors view these as safer, or TAG deposits could move away from the largest banks in response to changes made by the Dodd-Frank Act. TAG deposits that go to nonbanks may flow to money market funds, which are often cited as one of the most popular short-term investment options. A decrease in deposits could affect the liquidity position of a given bank—the ability of the bank to meet its liabilities—but the overall liquidity of the banking system has increased since 2008.

If the TAG program is extended, the resulting risk exposure could put additional strain on the FDIC's Deposit Insurance Fund. In addition, a TAG extension could increase moral hazard by neutralizing market mechanisms that penalize the banking system for taking on additional risk. A TAG extension could take multiple forms, ranging from a permanent extension to a temporary, voluntary extension with a short phase-out period.

On November 26, 2012, Senator Harry Reid introduced S. 3637, a bill to temporarily extend the TAG program for two years.

Contents

Overview of the TAG Program 1
Potential Impacts If TAG Expires 4
Deposits Could Stay in the Traditional Banking Sector 5
Uninsured Deposits at Same Institution 5
Insured Deposits 5
Uninsured Deposits at Safer or Larger, More Interconnected Banks 5
Uninsured Deposits at Non-TBTF Institutions 7
Deposits Could Leave the Traditional Banking Sector 7
Potential Impacts If TAG Is Extended 10
Legislative Proposal 12

Figures

Figure 1. St. Louis Federal Reserve Financial Stress Index 2
Figure 2. Amount Guaranteed by the TAG Program 3
Figure 3. TAG-Insured Funds by Asset Size of Bank 6
Figure 4. Allocation of Short-Term Investments 8
Figure 5. Nonfinancial Businesses' Use of Checkable Deposits and Money Market Funds 9
Figure 6. Bank Failures and Banks on the Problem List 11

Tables

Table 1. NIBTA Statistics 7

Contacts

Author Information 12

Overview of the TAG Program

In September 2008, ongoing financial turmoil escalated into a financial panic—large financial institutions, such as Lehman Brothers and AIG, were failing, the stock market was falling, and credit markets seized up as lenders became unwilling to extend or roll over short-term loans. The federal government responded with a series of lending and guarantee programs to mitigate the economic damage.[1] Among the many policy responses, the Federal Deposit Insurance Corporation (FDIC) established the Temporary Liquidity Guarantee Program (TLGP) on October 14, 2008, to strengthen confidence and to encourage liquidity in the banking system. TLGP had two parts: a Debt Guarantee Program (DGP)[2] and a Transaction Account Guarantee (TAG) program.[3] Although the DGP is no longer guaranteeing new debt, TAG continues to apply to new deposit balances.

The TAG program currently provides unlimited deposit insurance for $1.4 trillion in noninterest-bearing transaction accounts (NIBTAs).[4] NIBTAs are accounts that do not pay interest and allow the depositor to make withdrawals without giving advanced notice to the bank. NIBTAs are frequently used by businesses and local governments as a cash management tool, often for payroll transactions, but any depositor whose account meets the eligibility criteria receives unlimited deposit insurance coverage.[5] In spite of a loss of confidence in other parts of the financial system, the insured banking sector saw few bank runs during the financial panic. The establishment of TAG, in addition to the existing deposit insurance and other measures taken by regulators, may have bolstered depositors' confidence in banks as reliable counterparties.

Deposit insurance brings stability to the banking sector by giving depositors confidence that if their bank fails, they will not lose the money in their insured accounts. Deposit insurance, however, also reduces the incentive of depositors to monitor their banks and ensure that their banks are not assuming unnecessary risks. Deposit insurance can potentially create moral hazard by neutralizing market mechanisms that penalize the banking system for taking on additional risk. In addition to other regulatory efforts taken to minimize moral hazard, deposit insurance has historically had an upper limit on the amount insured to minimize this loss of market discipline.[6]

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[1] This section was prepared using material from CRS Report R41073, *Government Interventions in Response to Financial Turmoil*, by Baird Webel and Marc Labonte and CRS Report R40843, *Bank Failures and the Federal Deposit Insurance Corporation*, by Darryl E. Getter.

[2] The Debt Guarantee Program guarantees bank debt, including commercial paper, interbank funding debt, promissory notes, and any unsecured portion of secured debt. The program originally applied to debt issued before June 30, 2009, but was extended in March 2009 to apply to debt issued before October 31, 2009. The guarantee remains in effect until December 31, 2012.

[3] The FDIC established the program using its systemic risk exception to the least-cost resolution requirement of the Federal Deposit Insurance Act. See CRS Report WSLG37, *Extending the FDIC's Transaction Account Guarantee Program Given the Uncertain Economic Outlook?*, by M. Maureen Murphy. For the initial announcement of the TLGP, see Federal Deposit Insurance Corporation, "FDIC Announces Plan to Free Up Bank Liquidity," at http://www.fdic.gov/news/news/press/2008/pr08100.html.

[4] The $1.4 trillion total refers to the total amount of deposits in TAG accounts that is above the $250,000 standard maximum deposit insurance amount. See Federal Deposit Insurance Corporation, *Quarterly Banking Profile, Second Quarter 2012*, June 2012, at http://www2.fdic.gov/qbp/2012jun/qbp.pdf.

[5] Not all accounts at an insured depository are insured; FDIC insurance only applies to certain types of accounts and usually up to a $250,000 standard maximum deposit insurance amount. See Federal Deposit Insurance Corporation, *Your Insured Deposits*, at http://www.fdic.gov/deposit/deposits/insured/.

[6] See FDIC, "Options for Addressing Moral Hazard," at http://www.fdic.gov/deposit/deposits/international/guidance/guidance/moralhazard.pdf.

During the financial crisis, policymakers reassessed the tradeoff between the stability and the moral hazard created by deposit insurance. Extending deposit insurance to some uninsured accounts through TAG may have strengthened the banking system by discouraging some borrowers from withdrawing their deposits during the height of the financial stress.[7] **Figure 1** shows the St. Louis Federal Reserve Financial Stress Index, an index composed of 18 data series that provides one measure of financial stress. According to this index, financial stress in 2012 is elevated compared with the lows of 2006 and 2007, but has fallen from the high points of the financial crisis in 2008 and 2009 and is closer to the historical average of the late 1990s and the early 2000s.

Figure 1. St. Louis Federal Reserve Financial Stress Index

Source: Federal Reserve Bank of St. Louis, at http://research.stlouisfed.org/fred2/series/STLFSI.

Notes: For more on the methodology of the St. Louis Financial Stress Index, see http://research.stlouisfed.org/publications/net/NETJan2010Appendix.pdf. Shaded areas indicate U.S. recessions.

The TAG program established by the FDIC expired on December 31, 2010, and was replaced on the same day by the TAG program as established by Section 343 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203; the Dodd-Frank Act). The "TAG program," therefore, refers to two similar but distinct programs. Though both TAG programs provided unlimited deposit insurance to NIBTAs, they also differ in several ways. The TAG program created by the FDIC was a voluntary program in which eligible financial institutions were automatically registered to participate unless they opted out.[8] The Dodd-Frank Act, however, made all FDIC-insured banks part of TAG by temporarily changing "the definition of insured deposits to include the entire balance of noninterest-bearing transaction accounts."[9] The TAG

[7] Some have described the 2008 financial panic as a bank run on parts of the financial system that are outside of insured depositories. For example, see Gary Gorton, "Slapped in the Face by the Invisible Hand: Banking and the Panic of 2007," May 9, 2009, at http://www.frbatlanta.org/news/CONFEREN/09fmc/gorton.pdf.

[8] For more on the FDIC's assessments and how they are calculated, see CRS Report R41718, *Federal Deposit Insurance for Banks and Credit Unions*, by Darryl E. Getter and Victor Tineo.

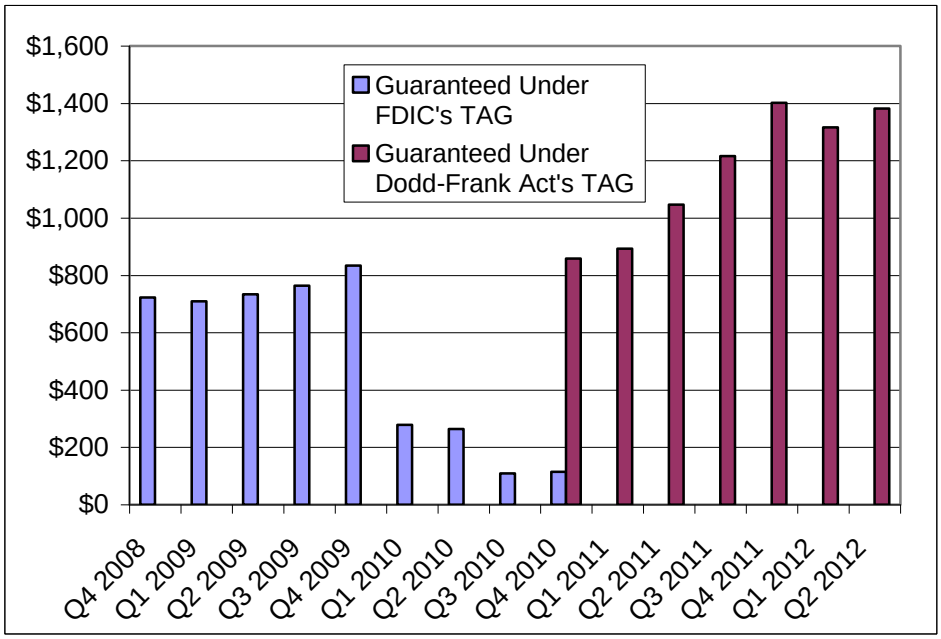
[9] See Letter from Martin J. Gruenberg, FDIC acting chairman, to Honorable Shelley Moore Capito, chairman, Subcommittee on Financial Institutions and Consumer Credit, Committee on Financial Services, House of Representatives, June 29, 2012, at http://www.aba.com/Issues/Index/Documents/FDICResponsetoCapitoonTAG.pdf.

program created by the Dodd-Frank Act also had a more restrictive definition of NIBTA than the FDIC program.[10]

Since TAG was first established, the amount of deposits insured by TAG has increased, as shown in **Figure 2**. On December 31, 2008, shortly after TAG was implemented, the program guaranteed approximately $722 billion. When the FDIC extended TAG at the end of 2009, participating institutions were given the opportunity to exit the program. Many of the largest banks opted out, causing a large drop in the amount of deposits insured by TAG.[11] On December 31, 2010, the Dodd-Frank Act's change to the definition of insured deposit became effective; all eligible NIBTAs were covered, increasing the amount of deposits insured by TAG to approximately $1.4 trillion (on December 31, 2010, there was a one-day overlap of the original FDIC TAG program and the Dodd-Frank TAG program, as illustrated below in **Figure 2**).

Figure 2. Amount Guaranteed by the TAG Program

$ in billions



Source: Federal Deposit Insurance Corporation, *Quarterly Banking Profile,* at http://www2.fdic.gov/qbp/2012jun/qbp.pdf.

What is a noninterest-bearing transaction account?

The Dodd-Frank Act defines a noninterest-bearing transaction account as

> a deposit or account maintained at an insured depository institution (1) with respect to which interest is neither accrued nor paid; (2) on which the depositor or account holder is permitted to make withdrawals by negotiable or transferable instrument, payment orders of withdrawal, telephone or other electronic media transfers, or other similar items for the purpose of making payments or transfers to third parties or others; and (3) on which the insured depository institution does not reserve the right to require advance notice of an intended withdrawal.[12]

The Dodd-Frank Act's changes to the definition of insured deposits are temporary and due to expire on January 1, 2013; the unlimited deposit insurance for NIBTAs expires on that date and

returns to the FDIC's $250,000 standard maximum deposit insurance amount. As explained by Maureen Murphy in CRS Legal Sidebar WSLG37, *Extending the FDIC's Transaction Account Guarantee Program Given the Uncertain Economic Outlook?*,

> although section 1105 of Dodd-Frank provides the FDIC with authority to institute a widely available program of emergency assistance, it is limited to situations involving a liquidity crisis. Invoking the authority to institute a broad program requires a detailed determination by the FDIC and the Board of Governors of the Federal Reserve System (Fed Board) that a liquidity event exists and that failure to take action would have serious adverse effects on U.S. financial stability or economic conditions. Additionally, the authority appears to be limited to guaranteeing debt obligations rather than expanding deposit insurance coverage.

Though the FDIC established TAG in 2008, changes to the FDIC's authority made by the Dodd-Frank Act may prevent the FDIC from having the option of extending TAG. An extension of TAG, therefore, may require congressional action.

On November 26, 2012, Senator Harry Reid introduced S. 3637, a bill to temporarily extend the TAG program for two years.

Potential Impacts If TAG Expires

NIBTAs constitute one of several cash management tools used by businesses, non-profits, governments, and other entities. They provide depositors with easy access to their money, allowing them to make transfers and to write checks to pay their vendors and employees. If TAG expires, however, depositors may change their perception of the safety of NIBTAs, causing them to reevaluate how they allocate their money across the various options in the financial system. As is discussed in the following sections, the use of NIBTAs could return to pre-TAG levels if TAG expires. Changes in the financial and regulatory environment since 2008, however, could also result in a different allocation than the pre-TAG levels.

Three factors are typically important to depositors when determining where to place their money: safety, liquidity, and yield.[13] Depositors would prefer to have more of all three, but face trade-offs. For example, generally speaking, there is a trade-off between safety and yield on an investment; the more at risk an investor's money is, the higher the possible return if the risk does not eventuate. There is also a trade-off between yield and liquidity. To have a higher return, an investor may have to sacrifice liquidity (the ease with which an asset can be converted into cash). Certificates of deposit, for example, may pay a higher interest rate than a typical savings account, but there are restrictions on when the money can be withdrawn.

Depositors' preferences for safety, liquidity, and yield will determine how they allocate their money across the various options they face. If TAG expires, the options available to depositors can be simplified to two general choices: (1) depositors could leave some or all of their money in

[10] The TAG program as established by the Dodd-Frank Act does not include Negotiable Order of Withdrawal (NOW) accounts, which were part of the FDIC program. Interest on Lawyer Trust Accounts (IOLTAs) were not included in the original Dodd-Frank Act definition of NIBTA but were added to TAG by P.L. 111-343.

[11] See FDIC, "Temporary Liquidity Guarantee Program Opt-Out Lists," at http://www.fdic.gov/regulations/resources/TLGP/optout.html.

[12] P.L. 111-203, Section 343.

[13] See Bank of America Merrill Lynch, "Life After Full FDIC Insurance," at http://corp.bankofamerica.com/documents/10157/67594/LifeAfterFDIC.pdf.

the traditional, insured banking sector or (2) they could move some or all of their money out of the traditional banking sector.

Deposits Could Stay in the Traditional Banking Sector

Uninsured Deposits at Same Institution

If TAG expires, depositors may choose to leave their deposits as uninsured deposits at their existing banks.[14] NIBTAs have grown by approximately $1 trillion from $1.3 trillion in the third quarter of 2008 (before TAG was implemented) to $2.3 trillion in the second quarter of 2012.[15] NIBTAs were used at relatively high rates before TAG and their growth may not be due solely to the guarantee offered by TAG; changes in economic and financial conditions since TAG was introduced may make NIBTAs an appealing choice. The expiration of unlimited insurance may increase the risk of NIBTAs, but even without TAG, the high degree of liquidity offered by NIBTAs may incentivize some borrowers to keep their money as uninsured deposits.

Insured Deposits

Depositors who place a high value on safety may transfer their uninsured deposits to various accounts in different insured banks so that each account is under the maximum insured level. Although this option may minimize risk, it would increase the transaction costs for the depositor—there would be more accounts to keep track of and possibly more types of fees to be aware of at different banks.[16]

Uninsured Deposits at Safer or Larger, More Interconnected Banks

Some depositors may attempt to recapture the safety they would lose if TAG expires by shifting their deposits to safer banks, which for some may mean to one of the largest or most interconnected banks. Safer banks, such as those with higher capital levels or with less concentration in a risky asset class, may be perceived as less likely to fail and, therefore, less likely to cause depositors with uninsured deposits to lose some of their deposits.

Depositors may move their accounts to one of the largest or most interconnected[17] banks if they believe those banks are in practice "too big to fail" (TBTF). A bank is said to be TBTF if policymakers are likely to judge that its failure would cause unacceptable disruptions to the overall financial system and would act to prevent failure.[18] If a depositor thinks policymakers would not allow a particular bank to fail, then the depositor may view their uninsured deposits as safer than if the deposits were in a bank that would be allowed to fail. **Figure 3** illustrates the

[14] In addition to leaving all of their uninsured deposits in a single account, depositors could set up a sweep account in which some amount of money is swept into an interest-bearing account at the end of the day. For more on sweeps, see http://www.fdic.gov/deposit/deposits/unlimited/faq.pdf.

[15] Alec Phillips, Goldman Sachs Global Economics, "FDIC Deposit Guarantees: Another Year-End Risk."

[16] To facilitate managing different accounts, a depositor can hire a financial services provider to manage the division of accounts across multiple banks. For example, see PrimeVest Financial Services Inc., at http://www.primevest.com/individual-investors/PV-9005_F.pdf. Financial management services can reduce, but not eliminate, transaction costs.

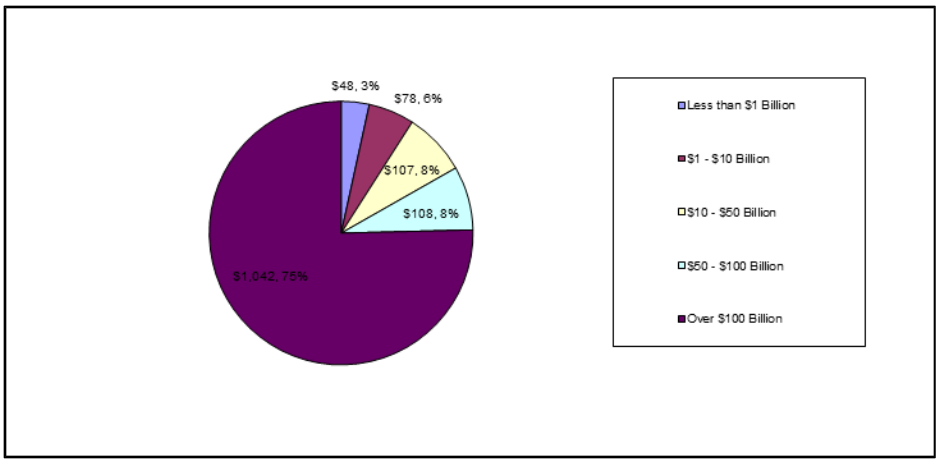
[17] An institution may pose a systemic risk due its interconnectedness with other firms. For an analysis of different types of systemic risk, see Governor Daniel K. Tarullo, Board of Governor of the Federal Reserve System, "Regulating Systemic Risk," at http://www.federalreserve.gov/newsevents/speech/tarullo20110331a.htm.

[18] For more on the regulation of TBTF institutions in the Dodd-Frank Act, see CRS Report R42150, *Systemically Important or "Too Big to Fail" Financial Institutions*, by Marc Labonte.

current distribution of TAG funds by bank size. Approximately 75% of TAG funds are in the 19 banks with more than $100 billion in assets, though those 19 banks account for 61% of total assets in the insured banking system.[19] **Table 1** shows statistics on TAG accounts by bank size. The largest banks have more accounts per institution and higher average account balances than smaller banks. Even with TAG in place, the largest banks hold a disproportionately large share of TAG accounts. The expiration of TAG may increase the concentration of deposits in the largest banks.

Figure 3. TAG-Insured Funds by Asset Size of Bank

$ in billions



Source: Federal Deposit Insurance Corporation, *Quarterly Banking Profile,* at http://www2.fdic.gov/qbp/2012jun/qbp.pdf.

[19] FDIC, "Statistics on Depository Institutions," at http://www2.fdic.gov/SDI/.

Table 1. NIBTA Statistics

Asset Size of Bank	Average NIBTA Size ($000)	Average Number of NIBTAs Per Institution
Less than $1 billion	$714	16
$1 - $10 billion	$974	202
$10 - $50 billion	$1,460	1,240
$50 - $100 billion	$1,939	3,775
Over $100 billion	$2,788	21,602
Total	**$2,029**	**107**

Source: Federal Deposit Insurance Corporation, *Quarterly Banking Profile,* at http://www2.fdic.gov/qbp/2012jun/qbp.pdf.

A potential indicator of the different views of large and small banks about the usefulness of TAG is the percentage of each group that opted out of the FDIC's TAG program when given the option. As mentioned previously, the original TAG program established by the FDIC was optional; at certain points banks were given the ability to opt out. When the FDIC version of TAG expired on December 31, 2010, 31% of banks with assets over $10 billion were still participating in TAG, whereas 75% of banks with less than $10 billion in assets were in the program.[20] The higher participation rate by smaller banks may signal that they believed they needed the program to attract funds, whereas the larger banks were less likely to view the program as necessary. Others may argue that decisions to participate in TAG may not have been driven by the actual usefulness of the program as much as by a possible stigma associated with participating in a program developed in response to the financial crisis. Either way, it is possible that since the end of 2010, both large and small banks may have changed their views on the value of the program.

Uninsured Deposits at Non-TBTF Institutions

Although some deposits may migrate to the largest institutions due to a perception of their implicit guarantee, it is also possible that deposits may migrate away from those institutions due to regulatory changes made by the Dodd-Frank Act. For example, the Dodd-Frank Act created a special resolution regime administered by the FDIC for failing firms that pose a threat to financial stability.[21] Some market participants may view the steps taken by the Dodd-Frank Act to remove TBTF status as credible and think they would recover even less of their uninsured deposits at a large firm than at a smaller or less interconnected institution. In that case, uninsured depositors may move their TAG deposits away from large institutions and use smaller banks.

Deposits Could Leave the Traditional Banking Sector

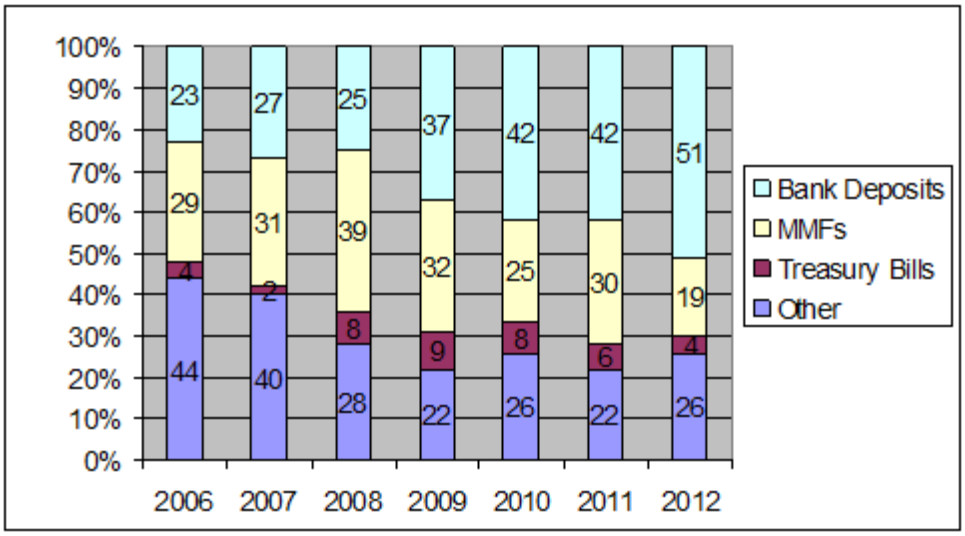
FDIC-insured institutions comprise the traditional banking sector. The traditional banking sector, however, is not the only place depositors can deposit their money. Depositors can effectively "deposit" their money in other nonbank options by buying shares in a money market fund (MMF), by buying U.S. Treasuries, or by choosing one of the many other available options, such as commercial paper, Fannie Mae and Freddie Mac securities, repurchase agreements, enhanced cash funds, and municipal securities. As shown in **Figure 4**, money market funds are the second-

[20] FDIC, *Quarterly Banking Profile, Fourth Quarter 2010*, p. 23, at http://www2.fdic.gov/qbp/2010dec/qbp.pdf.

[21] CRS Report R42150, *Systemically Important or "Too Big to Fail" Financial Institutions*, by Marc Labonte.

most popular individual form of short-term investment according to a survey of financial professionals and will be the focus of this section.

Figure 4. Allocation of Short-Term Investments



Source: Association for Financial Professionals, *2012 AFP Liquidity Survey*.

Notes: May not sum to 100% due to rounding. The "Other" category includes commercial paper, Fannie Mae and Freddie Mac securities, repurchase agreements, enhanced cash funds, municipal securities, and several other options. For the complete list, see the *2012 AFP Liquidity Survey*.

Money market funds are mutual funds that invest in money market securities. Money market securities are short-term financial instruments with relatively high liquidities and short maturities of between several days and about a year. They are instruments of short-term borrowing and lending. Examples of money market securities include negotiable certificates of deposit (CDs),[22] bankers' acceptances,[23] U.S. Treasury bills, commercial paper,[24] debt issued by municipalities, and repurchase agreements (repos).[25] Money market funds, therefore, act as intermediaries between shareholders who demand liquid investments and borrowers who desire short-term funding.

Money market funds attempt to keep a stable net asset value (NAV) on their shares, typically of $1.00. A stable NAV gives shareholders the impression of a high degree of safety similar to deposits but offering a higher return.[26] If a money market fund falls below a $1.00 NAV, then the fund is said to "break the buck," and part of the fund's shareholders' invested principal is in jeopardy. Investors could actually lose money. Breaking the buck is a rare occurrence, though it

[22] A CD is a negotiable certificate issued by a bank in return for a deposit of money.

[23] A banker's acceptance is a short-term credit investment where the repayment of principal and payment of interest is guaranteed by a bank.

[24] Commercial paper is short-term unsecured debt issued by companies in the form of promissory notes as an obligation of the issuer.

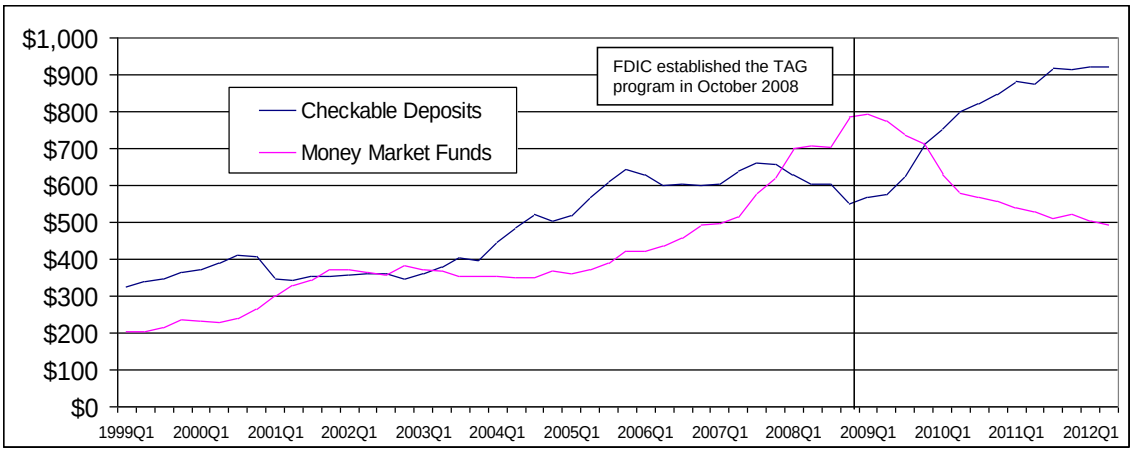
[25] A repo is a contract in which the seller of securities agrees to buy them back at a specified time and price.

[26] See Securities and Exchange Commission, *Roundtable on Money Market Funds and Systemic Risk,* at http://www.sec.gov/spotlight/mmf-risk/mmf-risk-transcript-051011.htm.

happened in September 2008.[27] In response, many withdrew their money from money market funds and deposited it in banks, as seen in **Figure 5**.

Figure 5. Nonfinancial Businesses' Use of Checkable Deposits and Money Market Funds

$ in billions



Source: Data from the Federal Reserve System, *Flow of Funds Accounts of the United States*, Table L. 101, at http://www.federalreserve.gov/releases/z1/. The figure is modeled off of a similar chart by Alec Phillips, Goldman Sachs Global Economics, "FDIC Deposit Guarantees: Another Year-End Risk."

Note: Checkable deposits may include other types of deposits besides noninterest-bearing transaction accounts.

Figure 5 shows that since the financial crisis peaked in 2008, non-financial businesses have increased their holdings of checkable deposits and decreased their holdings of money market funds. If one of the reasons that money flowed to deposits was the presence of TAG, it is possible that the expiration of TAG could lead to a partial reversal. However, one of the often cited benefits of money market funds is that they have traditionally earned a higher yield than bank deposits;[28] but money market funds are currently earning historically low returns, lowering the opportunity cost of holding noninterest-bearing deposits.[29] There is also uncertainty surrounding the future regulation of money market funds. The Financial Stability Oversight Council (FSOC),[30] a council of financial regulators that is charged with monitoring systemic risk in the financial system and coordinating several federal financial regulators, has identified structural vulnerabilities in money market funds which could affect financial stability.[31] It is unclear if the Securities and Exchange Commission (SEC), the primary regulator of money market funds, will impose additional regulation.[32] Although deposits could flow to money market funds if TAG

[27] See CRS Report R41073, *Government Interventions in Response to Financial Turmoil*, by Baird Webel and Marc Labonte.

[28] See Securities and Exchange Commission, *Roundtable on Money Market Funds and Systemic Risk*, at http://www.sec.gov/spotlight/mmf-risk/mmf-risk-transcript-051011.htm.

[29] Investment Company Institute, *2012 Investment Company Fact Book, Ch. 2: Recent Mutual Fund Trends*, at http://www.icifactbook.org/fb_ch2.html.

[30] For more on the FSOC, see CRS Report R42083, *Financial Stability Oversight Council: A Framework to Mitigate Systemic Risk*, by Edward V. Murphy.

[31] Financial Stability Oversight Council, *2011 Annual Report*, p. 13, at http://www.treasury.gov/initiatives/fsoc/Documents/FSOCAR2011.pdf.

[32] Securities and Exchange Commission, "Statement of SEC Chairman Mary L. Schapiro on Money Market Fund

expires, the uncertainty about future regulation and the low yields makes it unclear how much would leave TAG accounts.

Potential Impacts If TAG Is Extended

Some have raised concerns about what effect an extension of TAG would have on the FDIC's Deposit Insurance Fund (DIF).[33] Under the program as established by the Dodd-Frank Act, TAG insurance functions as part of the FDIC's traditional insurance. FDIC institutions pay an insurance premium into the DIF based on their risk—financial institutions that pose more risk to the DIF are assessed higher deposit insurance premiums relative to those that pose lower risk. If a member institution fails, the proceeds in the DIF are used to prevent insured depositors from losing any of their insured deposits.[34]

For a risk-based insurance system to function effectively, the entity setting the insurance premium must accurately forecast future risk or be able to recoup losses ex post. If the FDIC can successfully estimate the future cost that TAG funds would impose on the DIF, then the premiums could be set to cover the expected losses. However, problems may arise if the insurance is underpriced due to an underestimation of future losses. If future losses cause the DIF to become depleted, the DIF may have to borrow from the Treasury to protect depositors, putting taxpayers at risk.[35] Although predicting the future cost of TAG to the DIF (which is a function of the number of future bank failures, the size of banks that would fail, and the amount of TAG funds in failed banks) is beyond the scope of this report, looking at the effect of TAG on the DIF since the beginning of 2011 can inform thinking about the future cost if TAG is extended. The FDIC estimates that, for

> the 108 banks that failed in 2011 and the first quarter of 2012, TAG deposits amounted to 3 percent of deposits on average. Allocating DIF losses between these deposits and other deposits would result in an estimated TAG cost over these five quarters of about $270 million, or about 3 percent of the total $9.3 billion estimated cost of failures during this period.[36]

Figure 6 shows that the number of bank failures has fallen from its peak in 2010 whereas the number of institutions on the FDIC's "problem list," which is one potential indicator of the number of banks that are at risk of failing in the future, is still elevated. Most of the bank failures since January 2011 have been smaller banks which, as mentioned previously, had relatively few TAG deposits. If either the number of banks that fail or the type of banks that fail in the future is

Reform," press release, August 22, 2012, at http://www.sec.gov/news/press/2012/2012-166.htm. In the press release, Chairman Schapiro stated, "I—together with many other regulators and commentators from both political parties and various political philosophies—consider the structural reform of money markets one of the pieces of unfinished business from the financial crisis." At the time of the press release, the SEC had not reached a consensus on possible reforms.

[33] See Letter from Martin J. Gruenberg, FDIC acting chairman, to Honorable Shelley Moore Capito, chairman, Subcommittee on Financial Institutions and Consumer Credit, Committee on Financial Services, House of Representatives, June 29, 2012, at http://www.aba.com/Issues/Index/Documents/FDICResponsetoCapitoonTAG.pdf.

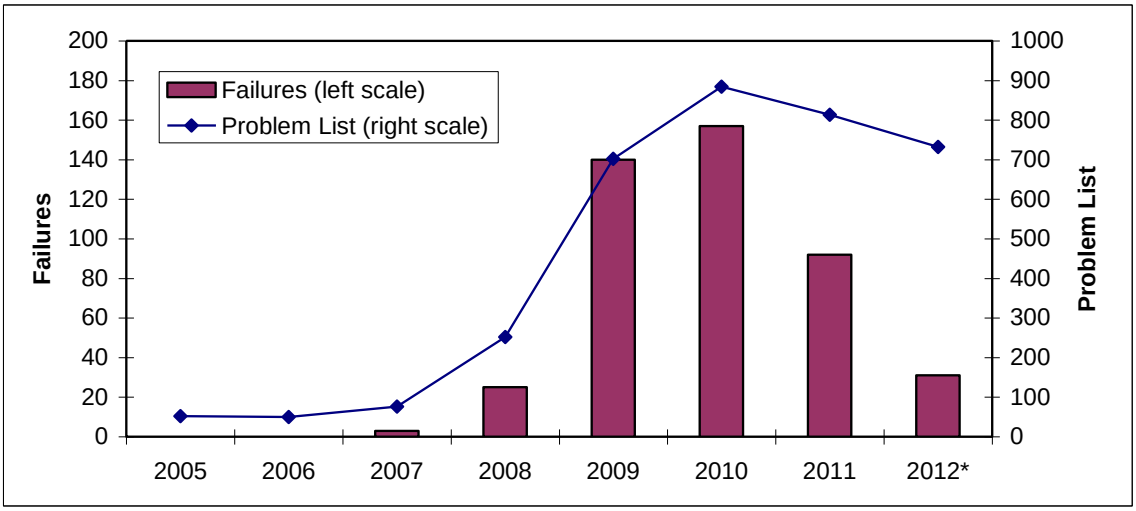
[34] See "Insurance Fund(s) Insolvency and Taxpayer Risk" in CRS Report R41718, *Federal Deposit Insurance for Banks and Credit Unions*, by Darryl E. Getter and Victor Tineo.

[35] Ibid.

[36] See Letter from Martin J. Gruenberg, FDIC acting chairman, to Honorable Shelley Moore Capito, chairman, Subcommittee on Financial Institutions and Consumer Credit, Committee on Financial Services, House of Representatives, June 29, 2012, at http://www.aba.com/Issues/Index/Documents/FDICResponsetoCapitoonTAG.pdf.

different, then estimates of future losses based on the past losses of TAG to the DIF would be inaccurate.

Figure 6. Bank Failures and Banks on the Problem List



Source: Federal Deposit Insurance Corporation, *Quarterly Banking Profile,* at http://www2.fdic.gov/qbp/2012jun/qbp.pdf.

Notes: The columns represent the total number of bank failures in a given year, though 2012 only includes the first two quarters. The series represents the total number of banks on the problem list at the end of the given year, though 2012 includes the banks on the problem list at the end of the second quarter.

Although extending TAG may impose additional costs on the DIF, the benefit of extending TAG, on the other hand, may be that it maintains confidence in the banking system and prevents future bank failures that would have required drawing on the DIF. The counterfactual cannot be known with certainty, making it difficult to estimate the costs and benefits of extending TAG.

An additional potential cost of extending TAG would be the moral hazard associated with deposit insurance. In the context of deposit insurance, moral hazard can manifest itself in two ways: "first, explicit deposit insurance gives insured banks incentives to pursue added risks because they can capture any profits but shift any losses to the government. Second, explicit deposit insurance reduces incentives by depositors and shareholders to monitor their banks."[37] Banks' additional incentive to take further risks and the depositors' reduced incentive to monitor could increase the likelihood that some banks may fail. More immediately, moral hazard could impair the quality of credit intermediation decisions in the economy. The reduced market discipline caused by deposit insurance could incentivize banks to issue loans that do not accurately price the underlying risk.

Moral hazard can be minimized through at least two different channels. First, a bank may have other creditors who do not have insured deposits. Those creditors would still have the incentive to monitor the bank for excessive risk-taking, though having fewer uninsured depositors may potentially reduce the effectiveness of the monitoring. Second, bank regulators examine banks and attempt to prevent them from acting in a way that could put insured deposits at risk.[38]

[37] Patricia A. McCoy, "The Moral Hazard Implications of Deposit Insurance: Theory and Evidence," February 18, 2007, at http://www.imf.org/external/np/seminars/eng/2006/mfl/pam.pdf.

[38] CRS Report R40249, *Who Regulates Whom? An Overview of U.S. Financial Supervision*, by Mark Jickling and Edward V. Murphy.

Regulators are supposed to take prompt corrective action against institutions as necessary to minimize losses to the DIF.[39]

Legislative Proposal

On November 26, 2012, Senator Harry Reid introduced S. 3637, a bill to temporarily extend the TAG program until December 31, 2014.[40] S. 3637 would instruct the FDIC to estimate the expected losses due to the program's extension for each calendar year and to collect an amount equal to the expected losses by September 30 of each calendar year. The assessments would be in addition to the assessments that the FDIC would otherwise collect.

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[39] See FDIC, "Formal Administrative Actions," at http://www.fdic.gov/regulations/safety/manual/section15-1.pdf.

[40] Section 2 of S. 3637 would extend the Insured Credit Union Transaction Account Guarantee Program until December 31, 2014. For more on the credit union program, see National Credit Union Administration, "NCUA Letter to Credit Unions," at http://www.ncua.gov/Resources/Documents/LCU2012-03.pdf.