GUARANTEEING ALL BANK DEPOSITS - THE LATEST

by Steve Brown

What the market needs right now is a capital gains tax cut, a recapitalization plan for banks, more transparency and a stiff drink of optimism. We are not sure what we are going to get, but be prepared for something new come Tuesday. The entire world will be awaiting the results of two meetings in Washington D.C this weekend - the meeting of the top financial leaders from the G7 and then the annual meeting of the International Monetary Fund/World Bank.

Unlike meetings in the past, this time, expect some definitive action that will result in more unprecedented coordination. We are confident that we will get some sort of bank recapitalization plan and have a strong possibility of getting insurance on all US bank deposits. Temporarily insuring all bank deposits has some interesting outcomes that community banks should contemplate in order to best take advantage.

To date, Ireland, Germany, Austria, Iceland, Greece and Portugal have all guaranteed the deposits of their banks. This is similar to what the U.K. is in the process of doing and it is now the topic du jour. We are not fans of the structure for a variety of reasons, the largest being that it creates more risk, not less (due to the moral hazard argument). More practically, we have not seen 100% guarantees work all that well, as "silent runs" can still take place (ala the Japanese bank failures of the late 1980's). This occurs when depositors move money out, because they don't want to hassle with delays and restricted access to funds. Regardless of our thoughts, since it is a very real possibility, banks should consider what to do if this happens.

The short run affect would be more deposit activity at a lower cost, since the problem with asymmetric information would be partially solved. Right now, since many depositors just don't know the status of some large banks reportedly under stress, they are not about to trust their money to those institutions. While full insurance wouldn't solve this problem, it would help. Another aspect is that the rates on brokered deposits and local deposits would move towards greater equalization, as some of the premium associated with the limit of insurance would go away. In some markets, this would lead to higher local prices, while in others (driven by demographics) prices would fall. The brokered and non-brokered markets would be closer to homogeneity, with only a slight premium required for brokered funds (due to the remaining "taint" of non-core funding).

Another major change that would affect banks would be in structured money market and CD products, such as our Portfolio Deposit Program or CDARs. These effectively would no longer be necessary, since there would be little need to reciprocate deposit insurance if all deposits were guaranteed. This will create a fire drill at many banks, but one that can be easily overcome.

After those changes, banks will need to figure out how to market this guarantee to the best of their advantage. Some banks will choose to play up the guarantee in order to grab every dollar they can, while others will choose to downplay the guarantee because they know it will eventually go away. Still another aspect to consider is how guaranteed deposits could be marketed against money market mutual funds (also temporarily guaranteed).

With no shortage of new ideas to discuss and a fluid market, smart bank management will rise to the top taking advantage of these monolithic changes.

BANK NEWS

Citi, Wac & Wells

Late Thursday, Citigroup dropped its $2.2B bid to acquire Wachovia, though is filing a lawsuit claiming $60B in damages.

Small Business

A survey of several hundred companies finds 40% said they have had their credit tightened in the past few weeks. As a result, 67% said they compensated by cutting back on hiring or reducing spending.

Retail Problems

A survey of CFOs at retail companies finds 41% have seen a tightening of credit from their lenders.

Banking Consolidation

A report from Bauer Financial (using 6/30 data) finds about 5% of all financial institutions in the U.S. (e.g. 426) are struggling with major problems. Meanwhile, analysis by a Stanford University analyst predicts 100 banks nationwide next year will fail.

Retirement Pressure

Public and private pension funds have reportedly lost $2T in the past 15 months as a result of market turmoil.

Economic Prediction

A new survey by the National Association for Business Economics finds about 70% of economists think the recession we have entered will last longer than a year.

Housing

A new study by the Census Bureau finds 12.5% of homeowners living homes built in the past 4Ys did not have a down payment. Even more disconcerting, the number jumped to nearly 17% for those who bought a home in 2006.