THE NEW GUARANTEE AND DEPOSIT RECLASS

by Steve Brown

If we are putting lipstick on farm animals, one area of the Treasury's plan that could use a little rouge is the simple, yet seductive aspect of guaranteeing non-interest bearing deposits. Of all the Treasury's rescue efforts, the act of FDIC support of 100% non-interest deposits is one of the most popular with community bankers. In fact, from last week's survey we find that 52% of banks are planning to take the additional coverage and 28% are undecided. The decision to pay an extra 10bp for coverage really boils down to the structure of a bank's DDA accounts. Banks with a material amount of DDA balances over $250k (presumably, mostly commercial accounts) should take the coverage to protect these balances, as well as have a basis to capture new money.

All is well and good, with the exception of the approximately 1,100 banks that use a deposit reclassification utility to lower reserve requirements at the Federal Reserve. Here, banks do an end of day reclassification from checking into savings and back again the next day. This allows more working liquidity for a bank and has worked beautifully for the past 10Ys. Despite the new changes allowing interest to be paid on reserves, there may yet be a need for such a deposit reclassification utility. However, with the added twist that banks can pay for additional insurance on their DDA accounts, there may be a tough decision for some banks to make.

To be fair, as of last week, the FDIC did not know how it was going to treat banks that utilize a deposit reclassification application. However, last week we learned two bits of information. The first data point is fairly clear in that interest bearing accounts can't be covered. The question then comes up, what about a 0% interest savings or interest free NOW account? From a well placed source we learned that these accounts would most likely not be covered, as the FDIC will be looking at insured account coverage based on "classification." We take this to mean Call Report classification, but we are guessing here (it could mean financial statement classification which would then give banks some additional leeway, but we doubt it). The 2nd bit of information that we learned was the fact that the FDIC clarified how it would handle sweep utilities for banks that move DDA balances into a repo or money market mutual fund. Here, the FDIC is reportedly close to ruling that any guarantee would take place after monies are swept. In other words, monies swept from an insured bucket to an uninsured category (i.e. a mutual fund) at end of day would not be insured (unless the mutual fund is guaranteed). Presumably, if we apply the same logic, this would mean that deposit reclassification would be treated the same way as sweep and reclassified balances would go from insured to uninsured (above the $250k limit).

Let's leave the marketing aspect of this aside and look at the math. As one of the leaders in deposit reclassification, our data shows that the average bank utilizing a relass utility will have to increase their reserves by almost $10mm (as DDA balances will require more reserves). If you can get around the operational complexities of adjusting the utility, banks could exclude accounts over $250k. For the average bank, this would still mean a reserve increase of about $6.5mm and a potential net income hit of up to $50k per annum. For about 70% of banks, this will still be worth it, as additional deposits and retention of larger DDA accounts occurs. However, for about 30% of banks (those that either face marketing, leverage or liquidity issues) the cost of turning off deposit reclass simply to get expanded FDIC insurance may be significant.

For banks, reserve requirements are illiquid assets (which is ironic). Therefore, to improve liquidity in the system, the Fed is heading in the wrong direction with regard to this issue, as it should be looking to lower reserve requirements, not raise them. Now while the Fed could do any number of things to alleviate this conundrum, this is an area that clearly needs more makeup.

BANK NEWS

CU Coverage

The NCUA will provide full insurance coverage on non-interest bearing accounts.

Rates

Following the Treasury's equity buying and bank debt guarantee, investors began purchasing existing bank debt and selling GSE mortgage backed debt. This increased mortgage rates by 50bp in the long end to 6.74%.

IL

The state of IL will deposit $1B in financial institutions operating within the state.

Flu Pandemic

The updated report from the World Bank that a flu pandemic could have greater consequences that first thought, is still in line with many bank's contingency plans. Most banks use baseline estimates that has economic activity dropping 5%, operating costs go up 20% and 50% of the workforce cannot make it into the office/branch.