JP Morgan, Bruno Iksil and the FDIC TAG Program

Submitted by Christopher Whalen
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Mattapoisett, MA -- I am heading out this week for the annual fishing trip to Leens Lodge in Grand Lake Stream, ME, with David Kotok of Cumberland Advisors and 50 of our friends. But first I want to reflect on the latest developments in the fight over whether to renew the FDIC's Transaction Account Guaranty or "TAG" program and how this government subsidy for banks may have led to the trading debacle at JPMorgan Chase.

The TAG program was begun as an emergency measure in 2008 and embedded in the Dodd Frank Act until December 31, 2012. The FDIC fully insures all non-interest bearing transaction account deposits above the standard $250,000 coverage limit. The program currently provides FDIC, and ultimately U.S. government, backing to more than $1.3 trillion in large corporate and institutional deposits, the vast majority of which are held by the top five banks.

During his testimony before Congress, JPM CEO Jamie Dimon specifically stated that the bank's deposits had swelled by hundreds of billions of dollars in recent years, putting pressure on the bank to seek higher returns. In fact, according to the FDIC, non-interest bearing deposits for the top five banks have swelled enormously, by over 100%, since 2008 when the FDIC put in place the emergency deposit insurance program known as TAG.

Dimon noted that his bank's deposit base has swelled by four hundred billion dollars since the start of the financial crisis. This big increase in the deposits of the largest banks covered by TAG is secular and reflects the fear of investors in holding any type of risk assets. At the end of Q2 2012, JPM had about $750 billion in interest bearing deposits and $350 billion in non-interest bearing deposits, up $100 billion or some 5% of total JPM assets just in a single year. The growth in deposits at Citigroup and the other TBTF banks is of similar magnitude. That is an amazing statistic that has gone almost unnoticed by the financial media and Sell Side analysts.

What is interesting about looking at the growth in JPM's non-interest bearing deposits is that the increase in free funding almost perfectly tracks the period when the treasury of the bank increased its rogue speculative activity. Specifically, the size and risk profile of the London trading operations of Bruno Iksil and the JPM CIO office seems to have increased at the same time that the supply of excess funds due to TAG at JPM was peaking, from 2010 through until today. Figure that TAG accounts for $200 billion of JPM's deposit base or about 10% of total assets, so that additional cash provided a big incentive for JPM management to add risk. Remember, JPM must keep asset and equity returns at least stable atop a much larger balance sheet thanks to TAG, thus more risk.

Now Jamie Dimon has already indicated in sworn testimony before Congress than the bank was unable to deploy these increased deposits via lending, thus the liquidity instead was invested in corporate bonds via the CIO office. Is it reasonable to suppose that there was a connection between the increased trading activities of Iksil and the CIOs office generally, and the surfeit of funding flooding into JPM via TAG deposits at the same time? I am told by people in the know that the answer is "yes." Thus my question to Jamie Dimon during the JPM earnings call regarding TAG renewal. But of course Dimon played dumb regarding TAG during the Q&A.

One of the long standing rules of Wall Street is that all things start with funding. Funding creates the need for earning assets. But in banks already under margin pressure due to zero interest rate policy by the Fed, a flood of funding encouraged by the FDIC's emergency TAG insurance for non-interest bearing deposits may be the cause of great mischief. Thus the law of unintended consequences kicks in with a vengeance and we see TBTF zombie banks do even more stupid things than is normal and customary.

If you figure that $200 billion (or 10% of total assets of JPM) is attributable to TAG, then the question of how to deploy this funding in a safe and sound fashion would seem to be front and center with regulators and Congress. But instead, like trained circus dogs, our esteemed members of Congress are playing the role of shill for the TBTF zombie banks. While singing a happy song about new jobs and economic growth, MCs like Barney Frank (D-MA) and other liberals rejoice at creating yet another corporate subsidy to help the Democratic Party survive in future. It's all about the money, don't forget.

Senate Banking Committee Chairman Tim Johnson (D-SD) just wrote a letter supporting extension of the TAG program, hardly a surprising position given that most of Citigroup's banking operations are located in his state. Johnson was joined in this selfless act of statesmanship by Sherrod Brown (D-OH), one of the Senate's leading lights. Mediocrities like Johnson and Brown help to confirm that everything ever written by Mark Twain about the national Congress is severely understated.

Read my earlier comment about how much of C's earnings come from TAG: "Citigroup Earnings, NIM and the FDIC TAG Program." Johnson is easily one of the most friendly members of the Senate when it comes to pandering to the big TBTF banks. I have already noted in the previous post, that the TBTF banks benefit disproportionately from TAG. For every $1 in funding a small bank gains via TAG, the large banks gain $4 per dollar of assets.

Indeed, whereas small banks had a funding advantage over the big banks prior to the financial crisis, today the large banks have the upper hand in terms of funding – in part because of the FDIC's TAG program. Indeed, since 2005, the proportion of TAG-eligible deposits held by the largest banks has almost doubled. At the end of Q1 2012, more than 75% of the $1.3 trillion in TAG deposits were held by banks with assets greater than $100 billion. Less than 4% of this amount was held by small community banks with assets of less than $1 billion.

Just how exactly, Senator Johnson, is the TAG program helping to spur economic growth and job creation? Remember that the TBTF banks, on net, take resources from the US economy and contribute nothing to real job creation and economic growth. The TAG program is a multi-billion dollar give away to the big banks engineered by the likes of Barney Frank and Tim Johnson. The only question now is whether the Republicans in the House and Senate will dig in their heels to oppose this act of public theft by the big banks.

Far from supporting economic growth as supporters of TAG suggest, the FDIC insurance for TAG eligible deposits actually spurs unsafe and unsound banking practices by the largest banks. In the case of JPM, the result of the nearly 10% increase in total assets caused by the "flight to quality" encouraged by TAG was a significant increase in risk taking via the CIOs office. The need to generate returns on the flood of funding pouring into JPM actually resulted in a breakdown in internal systems and controls, leading to a significant financial and reputational loss to one of the largest banks in the US. How does this help the US economy?

In the case of Wells Fargo, to take another example, the similar magnitude increase in non-interest bearing deposits at that large banks has allowed this money center to engage in illegal anti-competitive practices in the market for residential mortgages. Today WFC reportedly has almost 40% market share in the new mortgage origination sector, an astounding figure than was encouraged because of the vast funding advantage the FDIC TAG program gives to WFC over smaller lenders. The half-point spread differential between WFC and other mortgage lenders implies that this giant bank will take a loss on this new residential production over time, but this quarter's gain-on-sale is all that matters at WFC, right boys?

So contrary to what you may hear in the media or from the American Bankers Association or the Independent Community Bankers Association, the extension of the FDIC TAG program is not about economic growth or jobs. TAG is simply another act of government intervention in the US economy, this under the guise of protecting the banking public. The winners are the largest banks, while the smaller institutions and the public are net losers. The remarkable fact that the

Washington trade associations for both the large and smallest US banks support a further extension of TAG illustrates the pervasive influence of the TBTF banks in all aspects of American political life.

The TAG program is an odious subsidy for the largest banks and one that has caused JPM and WFC, for example, to engage in unsafe and unsound banking practices. The FDIC TAG program is a case in point to why government intervention in the US economy produces bad results. TAG ought to be allowed to expire at the end of 2012, but people like Barney Frank and Tim Johnson will be working to preserve this corporate subsidy for their clients among the large banks regardless of the deleterious effect on the US economy.

Tight lines. See you next week.