

Banking 101

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Charlie Munger, who at the age of 99 is the senior half of the nonagenarian duo that run Berkshire Hathaway, is famous for his quip that runs, “Show me the incentive and I’ll show you the outcome.” It chimes with Upton Sinclair’s remark that “It is difficult to get a man to understand something, when his salary depends on his not understanding it.”

Banking is typically one of those subjects that is all around us but when asked to explain how banks work, we are surprised how difficult it is to do. Engineers and scientists will tell you that as systems gain in complexity, the risks of catastrophic failure increase exponentially. This is true in spades with respect to the banking system. We were at a seminar many years ago when the then Chairman of the International Standards Accounting Board, Sir David Tweedie, roundly declared that “bank balance sheets were impenetrable and that nobody understood them.”

Originally, banks were called by another name, they were called, “Acceptance Houses.” The banking institutions “accepted” the liability of your deposit because from the banking perspective that is what it is, a future claim on the assets of the accepting institution.

There were no guarantees that the bank would be able to honour your deposit at the time you turned up to collect it because that is where the other, “asset” side of the banking equation comes into play; what assets did the bank buy with your deposit. Moreover, could the bank sell the asset at the right price in a timely fashion to give you back your money when you wanted it.

There you have the root of all financial crises; banks accept deposits then create assets with those funds that may or may not have the appropriate characteristics and value to meet their liabilities at some unspecified date in the future.

Two risks can befall a bank. The first is a “liquidity” crisis where a bank has sufficient assets but not enough cash to meet demands for the return of customer deposits. In a worst-case scenario, as recently happened with SVB Bank in the US, this can morph into a “solvency” crisis, where the withdrawal of funds by some depositors sparks a further and escalating dash for the exits as more and more depositors seek to retrieve their funds.

These classic bank runs and bank failures caused real misery and deprivation in the 1930s depression era resulting in the creation of the deposit insurance schemes we see today: in the US the first \$250,000 of your deposit is federally insured and in the UK, the first £85,000.

In practice, as we saw with SVB and the failure of Credit Suisse, depositors were protected in whole even though there was no legal obligation to do so.

This, though, causes problems of its own.

In the US, there are (or were) over 2000 banks. In a time of stress, big tends to become bigger leading to an effective oligopoly of massive institutions and a simultaneous rise in “moral hazard.”

Taking the first point; the average bank in the long tail of the US banking system has assets of less than \$1 billion. The largest bank, JP Morgan Chase, has assets of £2.48 trillion (equivalent to UK GDP) and the top 25 banks i.e. 1.25% of the total banking universe control assets of \$13.43 trillion dollars or more than half of US GDP.

That is a vast amount of market concentration. It means that the big institutions do not have to “bid” for deposits by paying high rates of interest and nor do they face particularly harsh competition in the pricing of loans. Thus loan spreads are higher than they otherwise would be in a fully competitive market.

The second point with regard to “moral hazard” is simply that if depositors are “effectively” 100% insured then there is no “incentive” to control risk, returning to Charlie Munger’s opening quote at the top of this article.

Much of bank regulation can be read as an attempt, often half-hearted, to rein in the most egregious profit-making motives of the banking executive C-suite to protect the utility function of the banking sector to the broader economy.

So, what does this mean for investors.

We tend to think of bank failures as unusual and rare. But, they are clearly not, and indeed some commentators now regard bank failures as a “feature not a bug”.

What banks don’t do, though many argue they should, is to park your money in a safe place for you to retrieve it at a later date. There are safer and often more remunerative places to invest spare, short-term, funds. National Savings offer small investors access to products, not least, premium bonds that are 100% government (taxpayer) guaranteed.

For more sophisticated and experienced investors Gilts, US Treasuries and some European Sovereign bond markets offer reasonable returns with, again, 100% capital security.

Happily, as we have recently written elsewhere, we do not read the perturbations with SVB and Credit Suisse as harbingers of a systemic banking crisis. Banks will continue to have a central role in the functions of a healthy economy, but perhaps, we shouldn’t be surprised that bank equity still yields more than bank deposits.

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