The Trouble With Banks.

There is something wrong with the fractional reserve banking system. It should have become clear post 2008 but it hasn’t.

Banks at their simplest form take deposits, (borrow money) usually short term, and lend money, usually medium to long term. They also augment their short term borrowings with the issue of longer term debt instruments. So banks borrow on the one hand and lend on the other, making a margin, being the difference between the rate at which they borrow and the rate at which they lend.

For the borrower, banks provide services by seeking the capital and aggregating it. Along the way they also provide corporate finance advice. There are costs associated with seeking capital and aggregating it, and there are costs associated with administering the business as well. What borrowers seek from a bank is the ability to provide the requisite capital at attractive terms and pricing. Banks do represent some risk to a borrower, if they unexpectedly withdraw funding or are otherwise unable to support the borrower further. With the complex array of structures through which a bank aggregates and directs capital, for example with securitizations, the risks that a bank poses to borrowers can be complex.

For the depositor or lender, the bank provides safe keeping of and interest on their money. Often the bank will provide a bewildering array of other products and services as well but these are ancillary to the primary business of borrowing cheaply from the public. The risks to the depositor or lender are simple enough. Credit risk. In the case of securitizations, the risk is transferred away from the bank, to the particular pool of borrowers. For the depositor, the risk is in the bank defaulting. As long as banks act as nothing more than intermediaries of capital, the analysis of bank’s credit default probabilities is straightforward. Banks use depositors money to lend and make a spread. The financial strength and performance of a bank are the result of its credit underwriting standards and balance sheet management. As banks have evolved and drifted into other activities, the volatility of the asset base becomes less correlated or related to its liability base. Fee income is fine as it is compensation for a stable business activity; there are no negative fees. The risk increases with trading profits which can be positive or negative and introduce uncertainty of cash flow and mark-to-market variation to the assets of a bank. The asymmetric pay-offs to traders in a bank are well documented and represent a serious agency issue to shareholders and depositors. Basically, the trading desk gambles with the capital provided by shareholders and depositors. The risk reward to the depositor is particularly poor as their upside is capped.

In a low interest rate environment, the disadvantage to the depositor is amplified. Not only is the compensation for holding cash, (lending it to the bank) low, but banks are likely to engage in more risky activities to maintain returns on equity and assets as well as to generate generous bonus pools for management.

The current environment is interesting. Interest rates are low, unilaterally depressed by most developed world central banks. It is unclear what the ultimate lenders would be happy to charge in a competitive environment to ultimate borrowers in the absence of the intermediary bank. It is safe to assume that the interest rate would be significantly higher than it is today.

Banks are unwilling to lend to private borrowers due to increased capital requirements under Basel 3 and tighter credit underwriting standards post the 2008 financial crisis. Private enterprise therefore faces a shortage of capital at current low rates of interest. Lenders or depositors face near zero interest rates, and are unable to disintermediate the banks to earn a higher return on their cash. The banks end up hoarding cash out of fear of the next liquidity crisis, (or perhaps they know something we don’t about the quality of their own balance sheets), or they invest in assets which consume little or no capital, such as sovereign bonds.

The European Central Bank’s LTROs are still not well understood even by some industry pundits. The LTRO provides liquidity and not capital. Since banks are capital already constrained, LTRO funds can only be deployed in assets that carry a zero risk rating under Basel 3 capital rules. This limits banks to investing in sovereign bonds, and rationality dictates that they invest in their own sovereign’s bonds.

Basel 3 capital rules must be one of the most effective means of crowding out private investment. Regulators beholden to governments are happy to encourage the refinancing of government debt which might otherwise struggle to find free market investors.

The result is a banking system that sweats depositors by paying them nothing for their capital, and starves the private sector of access to credit. It is hardly the picture o
f efficient free market capital allocation. The banking system has become the de facto lender of last resort to government, which is hardly the most efficient allocator of resources or producer of output.

The long term impact on economic growth must be felt.