Deposit Insurance: How To Protect Your Money The Alternative Way

When you keep your money in a bank, you are basically a general creditor to a business that is typically leveraged by about 10 X to 50 X, even today after the deleveraging post 2008. Fortunately, most countries have some form of deposit insurance. Unfortunately, the guarantees are limited. In the Eurozone, which includes Cyprus for example, the limit of deposit insurance is 100,000 EUR. In Switzerland, it is 100,000 CHF, in the UK it is 85,000 GBP, in Hong Kong it is 500,000 HKD, in the US it is 250,000 USD and in Singapore it is 50,000 SGD. That’s not a lot.
If one buys a security from a bank and or appoints the bank to hold such security in custody, then the risk that the client bears is on the security and not the custodian (in this case the bank.) For example, if I buy a US treasury bond and have it held in custody with Barclays, my risk is on the US treasury, with its duration, default and FX risk, and not on the credit quality of the custodian bank. The bank simply holds the security on my behalf. If the bank is subject to a run, I can transfer custody of my security to another custodian bank. There is no need to camp out in front of an ATM trying to physically shovel cash into a bag to carry precariously to another bank. If the bank should default before I have time to transfer the security, no problem. The security is not part of the assets of the bank and no creditors can lay claim to it. I am safe.

So, as a precaution, I keep a list of money market funds which I may use for this strategy of insulating myself from bank risk. If I see stress in the banking system, I can quickly move cash on deposit into these funds, transforming myself from being a general creditor of a highly levered business to an owner of an asset merely held in custody on my behalf by said highly levered institution. It is important of course, that the fund I choose is insulated from the problem creating the bank stress. Due diligence is necessary to ensure that the asset one buys is not itself highly levered (avoid hedge funds for this purpose) or invests in highly levered or risky assets (avoid equity funds, high yield funds, commodity funds et al). Try to invest in funds that invest in short term debt, preferable secured, if not secured then issued by well capitalized companies, and most important of all, a diversified portfolio, because you won’t think of everything. That’s why a fund, which gives instant diversification, is ideal even though any other security will do. Concentration is undesirable when the banking system gets stressed.

So, the next time the world gets its knickers in a twist about liquidity and the banking system… break glass, fish out list of fixed income and money market funds, subscribe. Get your hard earned money out of the way of the balance sheet of the bank.