

Trees & Forest...In the Banking System

July 2, 2010

If banks can't borrow... banks will go bust... and for banks to borrow... lenders to banks... must have confidence... that banks they lend to... own assets... that these lenders can trust. **If banking, like everything, has its forest and trees, this statement is the forest and everything else is the trees.** The amount of capital a bank has is a "tree". How it pays its people is a "tree". Whether it pays a tax into a rainy day fund to pay for its eventual failure is a "tree." How much capital it invests in a hedge fund it sponsors is a "tree." What warnings it gives to consumers about its products is a "tree." **Its ability to borrow which in turn is based on the quality of its assets is the "forest."**

Because if a bank can't borrow from its two main uninsured lenders – large depositors and other banks and shadow-banks – not only does *it* experience distress but a distressed bank must cut *its* deposits and lending to other banks. **A bank's inability to borrow and subsequent retraction of its lending is what starts a banking panic.** The panic may be a liquidity crisis (banks can't borrow but are fundamentally OK) or a solvency crisis (banks can't borrow because fundamentally they're bankrupt) or a mix. Such a mix occurred in the US in 2007-2008 as large depositors and lenders (banks, shadow-banks, and others) pulled their funds from banks. Such a mix is occurring in Europe today though under a shroud.

From a risk viewpoint, the large depositors and banks and shadow-banks who lend to banks naturally prefer to lend to a bank with lots of, rather than skimpy, capital. More capital means more good money to absorb the losses from bad decisions – such as bad loans – made by the bank they're lending to. **But lots of capital is at best only a first-line-of-defense insurance policy.** Today, in the US, a well capitalized bank has ready-to-use so-called Tier 1 capital equal to about 8 ½% of its assets – \$8.50 of capital for each \$100 of assets such as loans, government securities, etc. If you had homeowner's insurance equal to 8 ½% of the value of your house and its contents, how protected would you be? How would you be if you had a fire in your garage that destroyed 4% of the value of your house leaving you with only 4 ½% more insurance (8 ½% minus the 4% claim for your garage fire?) You'd want to get more insurance just as lenders to banks that have destroyed some of their assets want the banks to replenish their capital. It doesn't take much of a fire to wipe out 8 ½% of the value of your home. Similarly, when most of the 100% of a bank's assets are at risk, 8 ½% **capital is a shock absorber. That's it.**

Good assets are key. A bank with good assets will find lenders. A bank with bad assets will lose them. A financial system with banks with good assets will be stable and prosper. A financial system with banks with bad assets will experience instability and contract. **No amount of financial reform will succeed in its aim of preventing future financial system instability if it does not improve the odds that bad assets will *not* be created.** Bad assets arise for three reasons: 1) there are inherent risks in decision-making that will always produce bad outcomes no matter how much care is taken; 2) a search for growth will drive bankers to go where the growth is, leading to herd-like decisions about the desirability of certain asset classes (e.g. housing) whose problems are rarely foreseen because all decision-makers are part of the herd; and 3) governments give their blessing to policies that win votes at the expense of sound financial policy – the case for Fannie Mae and Freddie Mac in the US and sovereign debt in Europe. Reducing the propensity to create bad assets is no easy challenge. **In the meantime, we can benefit ourselves by having the discipline to stand back – and keep our eye on the financial forest, not just on the financial trees.**

— John Allison

© 2010 UNIO Holdings, LLC.

UNIO® and the UNIO® Logo are registered trademarks of UNIO Holdings, LLC.

The information contained in this communication is proprietary to UNIO Holdings, LLC. Reproduction or retransmission of this information, in whole or in part, is prohibited without the prior written consent of UNIO Holdings, LLC. This information does not constitute investment advice.