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# News

## Why We Don’t Own Banks

Banks are complicated, commoditised, over-leveraged, under-regulated and cheap for a reason


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**Why we don’t own banks**

We are often get asked “Why don’t you own banks?” As we write this, a number of banks from across the globe, some small, some very large have faced collapse and been rescued. We are not about to argue that this banking crisis is about to topple the economy. We have no special insight on that. Our negativity on the sector is longer term in nature and whilst we could give a dozen reasons for not holding banks, the five below top our charts.

**#1 No one properly understands bank liabilities**

A fundamental rule for investors focused on preserving capital is to avoid businesses that are too hard to explain (or understand). Of course, the sort of financial institution run by Mr Banks in Mary Poppins isn’t hard to explain. It takes in money from depositors (paying a low interest rate) and lends it out at a higher rate. Today’s banks are far from that simple model. Despite the ever- expanding annual reports, footnotes that have footnotes, and pages of indecipherable derivative position disclosure, it’s our view that outside investors simply can’t ever properly understand the exposures. Evidence suggests that those running the banks are equally in the dark.

Add to this the relentless “financial innovation” that gave us the now familiar acronyms from the last financial crisis – synthetic CDO’s etc. As one bank CEO stated at the time “It is interesting that the investment industry has invented new ways to lose money when the old ways seemed to work just fine"[1]

### #2 The ultimate commodity

Money has been described as the ultimate commodity. That's why banks spend a fortune trying to differentiate themselves. Do you feel more compelled to bank with the institution represented by a horse galloping across a beach, the one that has aligned its values with those of Premier League football, or the one that is no longer allowed to make spurious claims about its green credentials[2]? In fact 72% of Britons feel "all banks are basically the same"[3] In a new world where there is the potential to get some interest on your deposits, we're not convinced that the banks get to hold on to net interest margin gains.

### #3 Ridiculous leverage

Banks don't work without lots of leverage. To boost a return on assets of around 0.5% to a return on equity of 10% requires leverage of 20x. Leverage has reduced significantly since the last financial crisis, however Martin Wolf describes this neatly in the Financial Times as having "gone from the insane to the merely ridiculous."[4] Leverage amplifies mistakes. In good times, it means that an improvement in margins flows generously into higher profits. All should be fine unless someone pulls the economic rug (or makes a bad hedging decision). At this point bad news is amplified, and all too often, equity holders get wiped out.

### #4 Vulnerable to collapse

Back to Mary Poppins and Mr Banks, whose son Michael's tussle with senior banker Mr Dawes causes panic amongst other depositors and leads to a run on the bank. Something not dissimilar appears to have happened in the case of Silicon Valley Bank. The announcement of a manageable loss from a sale of securities to meet withdrawals caused the domino effect of panic, best summed up in an article in the Financial Times:

*""The prisoner's dilemma was basically: I'm fine if they don't draw their money, and they're fine if I don't draw mine," said one of the CFOs, whose company had banked around $200mn with SVB.*

*But then some started to move. "I got a text from another friend — he was definitely moving his money to JPMorgan. It was happening," the finance chief said. "The social contract that we might have collectively had was too fragile. I called our CEO and we wired 97 per cent of our deposits to HSBC by midday on Thursday."*[5]

Perhaps this favours the big banks, although anyone who believes they are immune from such runs did not work through the 2008 crisis.

### #5 Public enemy

Tightening regulation on banks doesn't lose votes for any politician. The US regulator had reduced some of the regulation for smaller banks in 2019, a move that may now be reversed. Arguments for lighter regulation of banks will have been delt a blow even if the current crisis passes. In addition, banks are a useful tool for any government desperate to stimulate growth. In the UK, the Government's command of the commercial banking system during the pandemic is now extending into other policy areas such as energy transition. The objective of government policy is not to generate higher profits from banks, and we don't expect that to be the outcome.

### But they aren't they cheap?

UK bank share prices are trading well below book value – so they must surely be cheap? For us, cheap is never enough in itself. This 1995 Rover Metro 100, currently available on eBay at a starting bid of 99p is also cheap. I don't suggest you buy it.

[1] https://www.forbes.com/2008/02/29/buffett-shareholders-letter-face-markets-cx_pm_autofacescan04.html?sh=10bf8bd64b26
[2] https://www.theguardian.com/business/2022/oct/19/watchdog-bans-hsbc-ads-green-cop26-climate-crisis
[3] https://yougov.co.uk/topics/consumer/articles-reports/2021/08/02/perceptions-banking-four-major-hubs
[4] https://www.ft.com/content/9dd43a1a-9d49-11e7-8cd4-932067fbf946
[5] https://www.ft.com/content/b556badb-8e98-42fa-b88e-6e7e0ca758b8



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