Catalyst
Equity Research

Special Report

September 20, 2016
Robin Cornwell (416-910-7985)

Bank Bail-Ins – Depositors' Worst Nightmare
How You Could Lose Your Money in The Bank

It's Your Money… or is it?
Do You Trust Your Banker – Well You Better!
A Depositor One Day… A Bank Shareholder The Next

Your Bank Deposits May Become Your Worst Nightmare

I am sure that the arcane world of bank regulation is not uppermost on most people's minds these days. However, recent changes may have important implications for taxpayers, bank creditors and bank customers, that is to say most people in the western world. By this, we refer to the newest "bail-in" regime for banks in financial trouble as legislated in the USA, EU, UK and Canada. In fact, all G20 countries are expected to put similar legislation in place.

Did you know that these bank bail-in rules could endanger the majority of all bank deposits? While some might say money confiscation by the government or banks could never happen, all we need to do is look at the numerous laws and infrastructure already in place within the jurisdictions previously mentioned. For example, under new rules recently made into law in these countries, banks that are going bankrupt – or appear to be going bankrupt – are no longer to receive emergency funds from governments or their agencies. Instead, the principle has been established that the next source of money for profligate banks will be from within the bank itself.

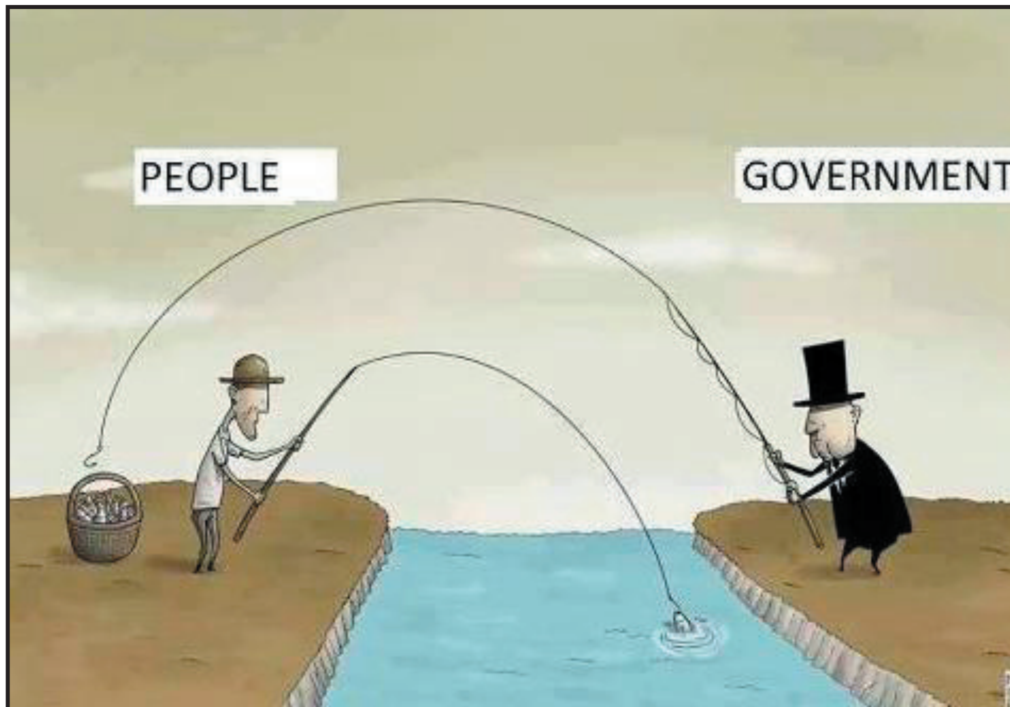
This, of course, would begin first at the common shareholder or equity capital level as one would expect. However, that is generally less than 8% of any given bank's funding and not terribly liquid at that. Then, of course, the next layer of equity that would be consumed is that of the preferred equity of the bank. Finally, the outstanding bank debentures would be converted to common equity. In total, these instruments generally represent 10% to 15% of the total funding for any one individual bank.

Bank Bail-Outs Are Over - Bail-Ins Are in
Large Personal & Corporate Bank Deposits Are Exposed – Low Return High Risk
Account Balances Over Insured Thresholds & Longer Maturities Are Most at Risk

So, now the real problems begin. Bank deposits that are to be targeted as temporary loans from governments or central banks have been abandoned in order to protect the taxpayer. Yes, that's right - the balance of the money to stabilize the banking sector during the next crisis will come out of your "bank accounts". Insured deposit accounts are likely to be spared. However, uninsured accounts will be at risk. We estimate that uninsured personal, corporate and government deposits comprise the majority of total bank deposits.

Now let's add insult to injury. Since the banks pay close to zero percent on many deposit accounts in the first place, the banks have the right to confiscate uninsured depositors' funds should the financial gurus crash the economy again. Deposits, whether they are personal, corporate, or government, do not really belong to you, the depositor. Technically and legally, once a deposit has been made, the funds become a liability of the bank. In other words, the bank just issues you what amounts to an IOU. As far as the bank is concerned, your deposit is just another unsecured liability.

Don't Turn Your Back on Your Money
New Laws Mean New Ways to Steal it



Courtesy: Maxkeiser.com

You might consider it theft, and yes you would be right! In reality, a bail-in is a totally law abiding theft of assets. Under these new rules, there is no principle of law that could authorize such a seizure of private property. And in fact, there are many principles of law that demonstrate that this is lawlessness at work here. As with much of the financial jargon, "bail-in" is simply another gibberish euphemism like "quantitative easing." It is now the case that in the event of bank failure, your deposits could be confiscated in the USA, EU, UK, and Cyprus. Recall the Cypriot banking crisis a few years back. Ultimately, 47.5% of bank deposits over €100,000 were confiscated overnight as they were converted into bank equity for a loss of roughly €4 billion!

To date, the credit rating agencies largely ignored, as did much of the media coverage, the real risk that bail-ins pose to people's life savings and companies' capital, and the likely negative impact of this on consumer sentiment and employment!

Bank Bail-Ins – Why Now? The story really began with the financial crisis of 2007–09 when international banks considered "too big to fail" were bailed out by governments in order to avert a financial contagion that would have had disastrous consequences for a global economy reeling from the Great Recession. Taxpayers ended up footing the bill in the trillions of dollars for imprudent risks assumed by the big banks, inadequate oversight of systemic risk by regulators and the failure of rating agencies to properly evaluate mortgage-based securitizations. Don't be fooled if you don't hear "too big to fail" anymore, as most countries have now renamed these institutions as "SIFIs" (systemically important financial institutions). SIFIs have been legislated to hold higher capital as a backstop due to their importance to the financial system. However, the added higher capital is minor at +1% to +3% at best.

Let's be crystal clear – Bank Bail-In Rules Are Here: The EU and the UK have had bail-in legislation in place as of January 1, 2016. The USA has it provided for under Title II of the Dodd-Frank Act. Australia and New Zealand have plans for like legislation in various forms of draft. Canada's bail-in legislation has been enacted by its Parliament. Although the bank liabilities subject to bail-in conversion are stated to exclude all deposits, the governing bail-in regulations have yet to be published.

Liquidity 101 – Risk / Reward! This now leads one to question whether or not current bank deposit rates adequately reflect the risk of a potential bail-in. Even if the answer was yes, there is the added concern over liquidity. Liquidity is defined as "the availability of liquid assets to a market, individual or company". In other words, how quickly can you get your hands on your money when you need it? Recall Greece when bank withdrawals were restricted and line-ups were horrendous just to withdraw a mere €60 per day or €420 per week. If the risk is so high, then perhaps depositors should be willing to pay more for liquidity. The Bank of International Settlements ("BIS") seems to agree. It implied in a recent report entitled "The Future Will Soon Be Today" that depositors should be happy to pay a premium for liquidity; and, in fact, "liquidity may well have been underpriced in the last banking crisis...".

If the central banking systems of the major world economies are no longer the backstop for liquidity during a banking crisis, then bank depositors should wake up and not be so complacent! Especially in light of the fact that they are the future liquidity backstop of troubled banks.

Just think about the trend to "negative interest rates." Bondholders are willing to pay certain governments to hold their money rather than receive payments for lending them money. Is it then that these bondholders are willing to pay for the assurance that they will get their money when they need it? The European Central Bank ("ECB") was the first major monetary institution to venture below zero and charge to hold funds at the ECB overnight. In addition to the ECB, negative interest rate policies now exist in Japan, Sweden, Switzerland, Denmark and Germany. Trillions of dollars of government bonds worldwide now offer yields below zero. That means investors knowingly will not get all their money back if they hold this debt to maturity.

Conclusion

Government policy decisions in some of the world's largest economies have made depositors the new backstop (i.e. central bank) of failing banks through the new bail-in legislation. Following on logically, then, we should expect that:

- Once a major G20 banking institution needs a bail-in, then confiscation of bank deposits will be commonplace.
- Liquidity will become more important to depositors given the risk profile of bank deposits now mandated by legislators.
- The price of liquidity will be whatever it takes to get money when you need it. Otherwise, the risk is losing a part, if not all, of your money.

There are few good alternatives:

- Keeping cash under the mattress. Doesn't sound so stupid after all, does it?
- Accept negative interest rates in government bonds provided that the investment has exceptionally high liquidity and your confidence in the issuer is unimpeachable.
- Hold allocated and insured gold. Negative interest rates make a strong case to hold gold, as it has kept pace with inflation since 1972 with a 44-year average annual compound rate of appreciation of 8.3% risk free. Gold has been used as currency (i.e. money) for over 3,000 years and is used as money by the central banks. Gold is highly liquid. According to the London Bullion Market Association (LBMA) statistics, the net daily turnover of gold is $23 billion.

So, if you are receiving little economic return on your bank deposits and are now burdened with uncertain risks including liquidity, should you feel truly safe and comfortable about those deposits?......Unfortunately, the answer is NO!

Definition of Risk Rankings

Low: Low financial and operational risk, high predictability of financial results with stronger than average balance sheet and strong free cash flows. Company may pay substantial dividends or have an active share repurchase program.

Medium: Moderate financial and operational risk, moderate predictability of financial results, positive free cash flows and may or may not pay a dividend.

High: High financial and/or operational risk, low predictability of financial results. Limited financial history, negative free cash flows, adequate working capital and no dividends.

Definition of Research Ratings

The Catalyst research recommendation structure consists of the following categories:

Buy: The stock's total return, including dividends paid, is expected to exceed a minimum of 15% on a risk-adjusted basis, over the next 12 months.

Hold: The stock's total return, including dividends paid, is expected to be between 0% and 15%, on a risk-adjusted basis, over the next 12 months.

Sell: The stock's total return, including dividends paid, is expected to be negative over the next 12 months.

Speculative: The stock's total return is expected to exceed 30% over the next 12 months; however, there is material event risk associated with the investment that could result in significant loss.

Note: Analysts have discretion within 500 basis points of the upper and lower limit of each rating to maintain the recommendation.

Analyst Certification

All of the views expressed in this report accurately reflect the personal views of the responsible analyst(s) about any and all of the subject securities or issuers. No part of the compensation of the responsible analyst(s) named herein is, or will be, directly or indirectly, related to the specific recommendations or views expressed by the responsible analyst(s) in this report.

The information contained in this report has been compiled by Catalyst Equity Research Inc. ("Catalyst") from sources believed to be reliable, but no representation or warranty, expressed or implied, is made by Catalyst, its affiliates or any other person as to its accuracy, completeness or correctness. All opinions and estimates contained in this report represent Catalyst's judgment as of the date of this report and are subject to change without notice and are provided in good faith but without legal responsibility. This report is not an offer to sell or a solicitation to buy any securities. Catalyst and its affiliates may have a relationship or may receive compensation for services with some or all of the issuers mentioned. Catalyst or its affiliates or officers, directors, representatives, associates may have a position in the securities mentioned herein, and may make purchases or sales of these securities from time to time in the open market or otherwise. The securities discussed may not be eligible for sale in all jurisdictions. To the full extent permitted by law neither Catalyst nor any of its affiliates, nor any other person, accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or the information contained herein. No matter contained in this document may be reproduced or copied by any means without the prior consent of Catalyst. This report is not for distribution in the United States of America.