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CONQUER THE CRASH

Excerpted from

Bob Prechter

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Risks in Banking
Excerpted from Bob Prechter's Conquer the Crash

Between 1929 and 1933, 9000 banks in the United States closed their doors. President Roosevelt shut down *all* banks for a short time after his inauguration. In December 2001, the government of Argentina froze virtually all bank deposits, barring customers from withdrawing the money they thought they had. Sometimes such restrictions happen naturally, when banks fail; sometimes they are imposed. Sometimes the restrictions are temporary; sometimes they remain for a long time.

Why do banks fail? For nearly 200 years, the courts have sanctioned an interpretation of the term "deposits" to mean *not* funds that you deliver for safekeeping but a *loan* to your bank. Your bank balance, then, is an IOU from the bank to you, even though there is no loan contract and no required interest payment. Thus, legally speaking, you have a claim on your money deposited in a bank, but practically speaking, you have a claim only on the loans that the bank makes with your money. If a large portion of those loans is tied up or becomes worthless, your money claim is compromised. A bank failure simply means that the bank has reneged on its promise to pay you back. The bottom line is that your money is only as safe as the bank's loans. In boom times, banks become imprudent and lend to almost anyone. In busts, they can't get much of that money back due to widespread defaults. If the bank's portfolio collapses in value, say, like those of the Savings & Loan institutions in the U.S. in the late 1980s and early 1990s, the bank is broke, and its depositors' savings are gone.

Because U.S. banks are no longer required to hold any of their deposits in reserve (see Chapter 10), many banks keep on hand just the bare minimum amount of cash needed for everyday transactions. Others keep a bit more. According to the latest Fed figures, the net loan-to-deposit ratio at U.S. commercial banks is 90 percent. This figure omits loans considered "securities" such as corporate, municipal and mortgage-backed bonds, which from my point of view are just as dangerous as everyday bank loans. The true loan-to-deposit ratio, then, is 125 percent and rising. Banks are not just lent to the hilt; they're past it. Some bank loans, at least in the current benign environment, could be liquidated quickly, but in a fearful market, liquidity even on these so-called "securities" will dry up. If just a few more depositors than normal were to withdraw money, banks would have to sell some of these assets, depressing prices and depleting the value of the securities remaining in their portfolios. If enough depositors were to attempt simultaneous withdrawals, banks would have to refuse. Banks with the lowest liquidity ratios will be particularly susceptible to runs in a depression. They may not be technically broke, but you still couldn't get your money, at least until the banks' loans were paid off.

You would think that banks would learn to behave differently with centuries of history to guide them, but for the most part, they don't. The pressure to show good earnings to stockholders and to offer competitive interest rates to depositors induces them to make risky loans. The Federal Reserve's monopoly powers have allowed U.S. banks to lend aggressively, so far without repercussion. For bankers to educate depositors about safety would be to disturb their main source of profits. The U.S. government's Federal Deposit Insurance Corporation guarantees to refund depositors' losses up to $100,000, which *seems* to make safety a moot point. Actually, this guarantee just makes things far worse, for two reasons. First, it removes a major motivation for banks to be conservative with your money. Depositors feel safe, so who cares what's going on behind closed doors? Second, did you know that most of the FDIC's money comes from other banks? This funding scheme makes prudent banks pay to save the imprudent ones, imparting weak banks' frailty to the strong ones. When the FDIC rescues weak banks by charging healthier ones higher "premiums," overall bank deposits are depleted, causing the net loan-to-deposit ratio to rise. This result, in turn, means that in times of bank stress, *it will take a progressively smaller percentage of depositors to cause unmanageable bank runs*. If banks collapse in great enough quantity, the FDIC will be unable to rescue them all, and the more it charges surviving banks in "premiums," the more banks it will endanger. Thus, this form of insurance compromises the entire system. Ultimately, the federal government guarantees the FDIC's deposit insurance, which sounds like a sure thing. But if tax receipts fall, the government will be hard pressed to save a large number of banks with its own diminishing supply of capital. The FDIC calls its sticker "a symbol of confidence," and that's exactly what it is.

Some states in the U.S., in a fit of deadly "compassion," have made it illegal for a bank to seize the home of someone who has declared bankruptcy. In such situations, the bank and its depositors are on the hook indefinitely for a borrower's unthrift. Other states have made it illegal for a bank attempting to recover the value of a loan to seize any of a defaulting mortgage holder's assets other than the mortgaged property. In such situations, the bank assumes the price risk in the real estate market. These states' banks are vulnerable to severe losses in their mortgage portfolios and are at far greater risk of failure.

Many major national and international banks around the world have huge portfolios of "emerging market" debt, mortgage debt, consumer debt and weak corporate debt. I cannot understand how a bank trusted with the custody of your money could ever even *think* of buying bonds issued by Russia or Argentina or any other unstable or spendthrift government. As *At the Crest of the Tidal Wave* put it in 1995, "Today's emerging markets will soon be *sub*merging markets." That metamorphosis began two years later. The fact that banks and other investment companies can repeatedly ride such "investments" all the way down to *write-offs* is outrageous.

Many banks today also have a shockingly large exposure to leveraged derivatives such as futures, options and even more exotic instruments. The underlying value of assets represented by such financial derivatives at quite a few big banks is greater than the total value of all their deposits. The estimated representative value of all derivatives in the world today is $90 trillion, over half of which is held by U.S. banks. Many banks use derivatives to hedge against investment exposure, but that strategy works only if the speculator on the other side of the trade can pay off if he's wrong.

Relying upon, or worse, speculating in, leveraged derivatives poses one of the greatest risks to banks that have succumbed to the lure. Leverage almost *always* causes massive losses eventually because of the psychological stress that owning them induces. You have already read of the tremendous debacles at Barings Bank, Long-Term [sic] Capital Management, Enron and other institutions due to speculating in leveraged derivatives. It is traditional to discount the representative value of derivatives because traders will presumably get out of losing positions well before they cost as much as what they represent. Well, maybe. It is at least as common a human reaction for speculators to double their bets when the market goes against a big position. At least, that's what bankers *might* do with *your* money.

Today's bank analysts assure us, as a headline from *The Atlanta Journal-Constitution* put it on December 29, 2001, that "Banks [Are] Well-Capitalized." Banks today are indeed generally considered well capitalized compared to their situation in the 1980s. Unfortunately, that condition is mostly thanks to the great asset mania of the 1990s, which, as explained in Book One, is probably over. Much of the record amount of credit that banks have extended, such as that lent for productive enterprise or directly to strong governments, is relatively safe. Much of what has been lent to weak governments, real estate developers, government-sponsored enterprises, stock market speculators, venture capitalists, consumers (via credit cards and consumer-debt "investment" packages), and so on, is not. One expert advises, "The larger, more diversified banks at this point are the safer place to be." That assertion will surely be severely tested in the coming depression.

There are five major conditions in place at many banks that pose a danger: (1) low liquidity levels, (2) dangerous exposure to leveraged derivatives, (3) the optimistic safety ratings of banks' debt investments, (4) the inflated values of the property that borrowers have put up as collateral on loans and (5) the substantial size of the mortgages that their clients hold compared both to those property values and to the clients' potential inability to pay under adverse circumstances. All of these conditions compound the risk to the banking system of deflation and depression.

Financial companies are enjoying big advances in the current stock market rally. Depositors today trust their banks more than they trust government or business in general. For example, a recent poll asked web surfers which among a list of seven types of institutions they would most trust to operate a secure identity service. Banks got nearly 50 percent of the vote. General bank trustworthiness is yet another faith that will be shattered in a depression.

Well before a worldwide depression dominates our daily lives, you will need to deposit your capital into safe institutions. I suggest using two or more to spread the risk even further. They must be far better than the ones that today are too optimistically deemed "liquid" and "safe" by both rating services and banking officials.

Safe Banking in the United States
Excerpted from Bob Prechter's Conquer the Crash

If you must bank in the U.S., or if you prefer it, choose the best bank(s) available. I believe that even in a deflationary crash, many of the safest U.S. banks have a good shot at survival and even prosperity. The reason is that relatively safe banks, if they have the sense to inform the public of their safety advantage, are likely to become *even safer* during difficult times. Why? Because depositors in a developing financial crisis will move funds out of the weakest banks into the strongest ones, making the weak ones weaker and the strong ones stronger. One of the great ironies of banking is that the more liquid a bank, the less likely it is that depositors will conduct a run on it in the first place.

The Street.com Ratings, Inc., formerly Weiss Ratings, Inc., provides one of the most reliable bank-rating services in America. (See Chapter 18 of the last section of this book for contact information.) CEO Martin Weiss has graciously consented to provide a practical guide for this book. Table 19-1 lists what his researchers consider the two strongest banks in each state in the union. ... For our purposes, I see little point in listing the weakest banks, but if you want to know which ones they are, you can find them listed in the brand-new *Ultimate Safe Money Guide*, by Martin Weiss (John Wiley & Sons, 2002). Weiss' book is a good complement to this one for many reasons. Aside from banks and insurance companies (see Chapter 24), his firm also rates mutual funds, brokerage firms, HMOs and corporations with common stock.

THE TWO HIGHEST-RATED BANKS IN EACH STATE *Prepared: August 21, 2009*					
Full State	Bank Name	City	State	TheStreet.com Financial Strength Rating *	Total Assets ($Mil)
ALABAMA	FIRST NATIONAL BK OF TALLADEGA	TALLADEGA	AL	A	355.4
ALABAMA	CITIZENS BANK OF WINFIELD	WINFIELD	AL	A	197.9
ALASKA	MOUNT MCKINLEY BANK	FAIRBANKS	AK	A	271.4
ALASKA	FIRST NATIONAL BANK ALASKA	ANCHORAGE	AK	B+	2,400.8
ARIZONA	NORDSTROM FSB	SCOTTSDALE	AZ	A-	174.3
ARIZONA	FOOTHILLS BANK	YUMA	AZ	B+	140.5
ARKANSAS	FIRST NATIONAL BANK IZARD CNTY	CALICO ROCK	AR	A+	137.0
ARKANSAS	FIRST NATIONAL BANK & TRUST CO	MOUNTAIN HOME	AR	A	386.9
CALIFORNIA	FARMERS & MERCHANTS BK CTRL CA	LODI	CA	A	1,731.6
CALIFORNIA	FIRST SECURITY BUSINESS BANK	ORANGE	CA	A	361.9
COLORADO	DOLORES STATE BANK	DOLORES	CO	A	105.7
COLORADO	FIRST NATIONAL BK ESTES PARK	ESTES PARK	CO	A	89.4
CONNECTICUT	CITIZENS NATIONAL BANK	PUTNAM	CT	A	291.6
CONNECTICUT	LIBERTY BANK	MIDDLETOWN	CT	A-	2,896.7
DELAWARE	APPLIED BANK	WILMINGTON	DE	A+	230.1
DELAWARE	FIRST BANK OF DELAWARE	WILMINGTON	DE	A-	113.4
DISTRICT OF COLOMBIA	NATIONAL CAPITAL BANK OF WA	WASHINGTON	DC	A+	273.4
DISTRICT OF	CITY FIRST BANK	WASHINGTON	DC	C-	130.2

COLOMBIA	OF DC NA				
FLORIDA	DRUMMOND COMMUNITY BANK	CHIEFLAND	FL	A+	185.0
FLORIDA	PEOPLES BANK OF GRACEVILLE	GRACEVILLE	FL	A	68.5
GEORGIA	WEST CENTRAL GEORGIA BANK	THOMASTON	GA	A	94.5
GEORGIA	PELHAM BANKING COMPANY	PELHAM	GA	A	61.4
HAWAII	BANK OF HAWAII	HONOLULU	HI	B	11,427.2
HAWAII	TERRITORIAL SAVINGS BANK	HONOLULU	HI	B	1,221.7
IDAHO	BANK OF COMMERCE	AMMON	ID	A	759.4
IDAHO	FARMERS NB OF BUHL	BUHL	ID	A	395.9
ILLINOIS	FIRST NATIONAL BANK OF DWIGHT	DWIGHT	IL	A+	107.4
ILLINOIS	GERMANTOWN TRUST & SAVINGS BK	BREESE	IL	A	311.2
INDIANA	FIRST FINANCIAL BANK NA	TERRE HAUTE	IN	A-	2,215.0
INDIANA	MERCHANTS BANK OF INDIANA	LYNN	IN	A-	242.5
IOWA	CITIZENS FIRST NATIONAL BANK	STORM LAKE	IA	A	190.6
IOWA	IOWA TRUST AND SAVINGS BANK	CENTERVILLE	IA	A	144.4
KANSAS	FARMERS & DROVERS BANK	COUNCIL GROVE	KS	A+	124.9
KANSAS	BANK OF TESCOTT	TESCOTT	KS	A	211.2
KENTUCKY	KENTUCKY-FARMERS BANK	ASHLAND	KY	A+	137.0
KENTUCKY	EDMONTON STATE BANK	EDMONTON	KY	A	397.4
LOUISIANA	M C BANK & TRUST	MORGAN CITY	LA	A	271.2

	COMPANY				
LOUISIANA	GULF COAST BANK	ABBEVILLE	LA	A	253.9
MAINE	FRANKLIN SAVINGS BANK	FARMINGTON	ME	A	309.0
MAINE	CAMDEN NATIONAL BANK	CAMDEN	ME	B-	2,273.9
MARYLAND	ROSEDALE FEDERAL SAVINGS & LOAN ASSN	BALTIMORE	MD	A+	614.5
MARYLAND	MIDDLETOWN VALLEY BANK	MIDDLETOWN	MD	A+	132.4
MASSACHUSETTS	BROOKLINE BANK	BROOKLINE	MA	A-	2,573.4
MASSACHUSETTS	EVERETT CO-OPERATIVE BANK	EVERETT	MA	A-	252.7
MICHIGAN	UPPER PENINSULA STATE BANK	ESCANABA	MI	A	166.9
MICHIGAN	CENTURY BANK & TRUST	COLDWATER	MI	A-	244.8
MINNESOTA	FIRST NATIONAL BANK OF BEMIDJI	BEMIDJI	MN	A	470.8
MINNESOTA	VERMILLION STATE BANK	VERMILLION	MN	A	416.3
MISSISSIPPI	FARMERS & MERCHANTS BANK	BALDWYN	MS	A+	191.2
MISSISSIPPI	BNA BANK	NEW ALBANY	MS	A	392.1
MISSOURI	NEW ERA BANK	FREDERICKTOWN	MO	A+	265.5
MISSOURI	FIRST NATIONAL BANK	CAMDENTON	MO	A+	263.5
MONTANA	YELLOWSTONE BANK	LAUREL	MT	A	437.2
MONTANA	FIRST STATE BANK OF MALTA	MALTA	MT	A	110.5
NEBRASKA	WORLDS FOREMOST BANK	SIDNEY	NE	A	843.7
NEBRASKA	FIRST NATIONAL	GORDON	NE	A	140.5

	BANK OF GORDON				
NEVADA	CREDIT ONE BANK NA	LAS VEGAS	NV	A	103.4
NEVADA	HERITAGE BANK OF NEVADA	RENO	NV	A-	362.5
NEW HAMPSHIRE	LEDYARD NATIONAL BANK	HANOVER	NH	B	376.4
NEW HAMPSHIRE	LAKE SUNAPEE BANK FSB	NEWPORT	NH	B-	863.0
NEW JERSEY	SUMITOMO TRUST & BANKING CO	HOBOKEN	NJ	A	623.8
NEW JERSEY	FIRST INVESTORS FEDERAL SAVINGS BANK	EDISON	NJ	A	51.3
NEW MEXICO	WESTERN COMMERCE BANK	CARLSBAD	NM	A	320.2
NEW MEXICO	CITIZENS BANK OF CLOVIS	CLOVIS	NM	A	230.4
NEW YORK	MASPETH FEDERAL SAVINGS & LOAN ASSN	MASPETH	NY	A	1,466.8
NEW YORK	BROOKLYN FEDERAL SAVINGS BANK	BROOKLYN	NY	A	514.9
NORTH CAROLINA	SURREY BANK & TRUST	MOUNT AIRY	NC	A-	207.2
NORTH CAROLINA	INDUSTRIAL FEDERAL SAVINGS BANK	LEXINGTON	NC	A-	164.1
NORTH DAKOTA	BANK OF TIOGA	TIOGA	ND	A	78.1
NORTH DAKOTA	SARGENT COUNTY BANK	FORMAN	ND	A	77.4
OHIO	ST HENRY BANK	SAINT HENRY	OH	A+	182.9
OHIO	WORLD FINANCIAL NETWORK NA	COLUMBUS	OH	A	1,552.5
OKLAHOMA	OKLAHOMA BANK & TRUST COMPANY	CLINTON	OK	A+	131.5

OKLAHOMA	FIRST NATIONAL BANK & TRUST	CHICKASHA	OK	A	348.8
OREGON	FIRST FEDERAL SAVINGS & LOAN ASSN	MCMINNVILLE	OR	A-	339.8
OREGON	PIONEER TRUST BANK NA	SALEM	OR	A-	267.5
PENNSYLVANIA	FIRST NATIONAL BANK & TRUST	NEWTOWN	PA	A	658.5
PENNSYLVANIA	WAYNE BANK	HONESDALE	PA	A	511.5
RHODE ISLAND	WASHINGTON TRUST COMPANY	WESTERLY	RI	B	2,945.3
RHODE ISLAND	TALBOTS CLASSICS NATIONAL BANK	LINCOLN	RI	B	9.8
SOUTH CAROLINA	FIRST PIEDMONT FEDERAL SAVINGS & LOAN	GAFFNEY	SC	A	282.0
SOUTH CAROLINA	BANK OF CLARENDON	MANNING	SC	A	182.7
SOUTH DAKOTA	FIRST FIDELITY BANK	BURKE	SD	A+	245.1
SOUTH DAKOTA	FIRST PREMIER BANK	SIOUX FALLS	SD	A	901.4
TENNESSEE	ELIZABETHTON FEDERAL SAVINGS BANK	ELIZABETHTON	TN	A+	332.9
TENNESSEE	CITIZENS BANK	CARTHAGE	TN	A	495.8
TEXAS	CITIZENS 1ST BANK	TYLER	TX	A+	684.8
TEXAS	COMMUNITY NATIONAL BANK & TR	CORSICANA	TX	A+	317.3
UTAH	HERITAGE BANK	SAINT GEORGE	UT	A+	92.9
UTAH	OPTUMHEALTH BANK INC.	SALT LAKE CITY	UT	A	1,054.2
VERMONT	MERCHANTS BANK	SOUTH BURLINGTON	VT	B	1,353.4
VERMONT	UNION BANK	MORRISVILLE	VT	B	421.0
VIRGINIA	VIRGINIA BANK & TRUST COMPANY	DANVILLE	VA	A+	152.0

VIRGINIA	BURKE & HERBERT BK & TRUST CO	ALEXANDRIA	VA	A	1,807.9
WASHINGTON	VALLEY BANK	PUYALLUP	WA	A-	219.8
WASHINGTON	SOUTH SOUND BANK	OLYMPIA	WA	A-	167.8
WEST VIRGINIA	PENDLETON COMMUNITY BANK	FRANKLIN	WV	A	206.0
WEST VIRGINIA	LOGAN BANK & TRUST COMPANY	LOGAN	WV	A-	235.0
WISCONSIN	NATIONAL EXCHANGE BANK & TR	FOND DU LAC	WI	A+	1,156.4
WISCONSIN	WAUKESHA STATE BANK	WAUKESHA	WI	A+	754.3
WYOMING	FIRST STATE BANK OF NEWCASTLE	NEWCASTLE	WY	A+	127.1
WYOMING	HILLTOP NATIONAL BANK	CASPER	WY	B+	462.4
Table 19-1					
Source: TheStreet.com Ratings, Inc.			Ratings Based on Q1 2009 Data Prepared: August 21, 2009 *		
DISCLAIMER: *Reprinted by permission. This list represent only one rating group's opinion as of the prepared date above. The author reprints this list as a service only. If you choose to do business with any of these firms, you alone stand to realize the gains of that decision; so too do you alone stand to realize any related losses. The author takes no responsibility for the safety of these firms and encourages you to research these firms on your own before committing funds. For updates on this list, visit http://www.elliottwave.com/conquerthecrash/.*					

There are other independent and reliable bank rating sources. Among them, Veribanc, Inc. has been in the ratings business the longest. The service covers banks, S&Ls and credit unions. The company's classifications rank financial institutions not just on their present standing but also on their future outlook, which is what you should care about. Using a clear, simple rating system, it assesses capital strength, asset quality, management ability, earnings sufficiency, liquidity and sensitivity to market risk.

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If, despite all your precautions, you come to suspect that any of your chosen banks face the risk of closure, move your money to a safer bank immediately. If you cannot identify a safer bank, then do not hesitate to withdraw all of your money in cash. If you are not first in line, you may forfeit the opportunity.

Safe Banking Worldwide
Excerpted from Bob Prechter's Conquer the Crash

A free market in banking would provide every imaginable service, from 100% safekeeping for a fee to 100% lending with a large return. To preserve their reputations, bankers would have an incentive to be extremely careful with your money. Monopoly money and regulated banking have produced quite another result. Nevertheless, there still exist a few banks in the world that mainly provide a wealth preservation service as opposed to interest income and daily transactional conveniences. If you want the utmost safety for capital storage, if a bit less convenience, you must use these banks. The safest banking institutions in the world reside in countries that (1) do not have, and are unlikely to impose, exchange controls or wealth transfer restrictions and (2) have a low overall debt-to-deposits ratio. Not surprisingly, the top candidates are the same as those with the safest debt: Switzerland and Singapore.

Nevertheless, do not fall into the trap of choosing any Swiss bank just because it's Swiss. Today's largest Swiss banks, with their fat portfolios of derivatives, are at immense risk of failure if a depression occurs. Furthermore, they have branches worldwide and are thus vulnerable to the whims of numerous governments. The best course of action is to locate smaller, safer local Swiss banks. Austria's low debt per capita makes it a good backup alternative. If you want to find a safe bank, these jurisdictions are the place to begin.

Using stringent bank-rating requirements, SafeWealth Group has identified banks in these countries that earn its highest rating for survivability in a global depression. This "Class 1" rating requires an aggressively discounted liquidity ratio of at least 75 percent, an otherwise nearly unheard-of 35 percent net liquid equity ratio (i.e., the percentage of a bank's capital that is free and accessible at all times), a low derivatives/capital ratio, no derivatives held on a speculative basis, a low amount of deposits held at other banks and that the bank operate in a single nation so that the rules it must follow are clearly defined.

A 75 percent aggressively discounted liquidity ratio means that deposits are held in such liquid investments that even if the bank were suddenly faced with demands from depositors to withdraw 75 percent of the total money in the bank, given a few days or weeks, it could do so. There are even a very few banks in the world with liquidity ratios at or above 100 percent. In other words, they could pay off *all* their depositors, *in full*, on very short notice. Many banks couldn't pay off 10 percent of their depositors quickly, and the world's weakest banks would be hard-pressed to service *any* above-normal level of simultaneous withdrawals. And that is in *today's* benign financial environment, never mind a depression environment.

If you are serious about safety and can meet a recommended bank's account minimum, you should set up a relationship with a Class 1 bank. SafeWealth Group can help you cut through red tape to establish relationships with such banks and other institutions. The reason you need to go through a representative is that these private Swiss banks do not readily accept accounts from any individual, corporation or trust representative that walks through the door, a policy that reflects their overall principle of conservatism. They will accept a new account only if its ownership and purpose are completely above board and will not endanger the bank's reputation. Presuming that you meet these standards, SafeWealth Group can secure the proper introductions for you in most cases and guide you through the process. (See Chapter 18 or the final section of this book for contact information and typical minimums.) If you are a Swiss or Singaporean resident and have ready access to such institutions, by all means stay put as long as local politics remain stable.

Act While You Can
Excerpted from Bob Prechter's Conquer the Crash

When it comes to safety, it is always best to act early. Due largely to aggressive governmental policing of illegal activities such as the drug trade, money laundering, tax evasion and terrorist financing, average honest people do not enjoy the free, ready access to financial institutions that they did a few years ago. Some banks are now obliged to meet with prospective clients in person to satisfy suitability rules. There can be little doubt that if a crisis climate comes to pass, you could face many more obstacles if not outright denial of service. If you are truly intent on preserving your wealth, you should resist the temptation to procrastinate under the presumption that you can rely on the status quo. Opportunities close down all the time. For example, the two safest banks in London no longer accept non-British clients. In the U.S., the bank deemed the safest in the nation two years ago no longer takes out-of-state accounts. A few of my prudent subscribers got in after I recommended it, but now the procrastinators have to look elsewhere. This is a lesson. Don't delay, or the institutions now available to protect your savings may close their doors to you. Another word of warning: Bank ratings can change. The smart approach is to keep in touch with the services that rate banks seriously to make sure your bank(s) continue to qualify for a high safety rating.

Once you move the bulk of your investment funds into the safest cash equivalents, and after you have chosen a safe bank or two for savings and transactions, then and only then should you consider speculating in the stock market with a small portion of your capital. That is the subject of the next chapter.

Lending vs. Banking
Excerpted from Bob Prechter's September 2008 Elliott Wave Theorist

Every now and then EWT revisits the question of credit and the U.S. banking system. It is a difficult subject, and every time you can understand a little more of it, the clearer my long-standing argument for deflation becomes.

Let's start with a question. Suppose you owned title to $50,000 held at a safekeeping institution. Then a neighbor asks to borrow $40,000 from you on the promise of paying you back $42,000 a year later. You agree, so you go to the safekeeping institution, withdraw $40,000 and give it to your neighbor in exchange for an IOU for $42,000, payable in a year. If someone were to ask you, "How much money do you have in the bank?" you would say, "$10,000." Now let's change the scenario to the modern banking system. This time, you deposit $50,000 into a bank. Your neighbor calls the bank and asks it for a loan of $40,000, and the bank lends your money to the neighbor. Now if someone were to ask you how much money you have in the bank, you would say, "$50,000."

How is this possible? The bank is simply a middleman, brokering the loan between you and your neighbor, and taking a fee to do it, yet somehow you think you still have $50,000. Someone might point out that yes, $40,000 is gone from the bank, but the deposits are pooled, so the first person in the door can always get his money. You, for example, could go to the bank tomorrow and withdraw $50,000. That's true, but everyone in the pool thinks he has the money shown in his bank book, and that is obviously false. At latest count, U.S. banks report $6.942t. in deposits and $6.945t. in loans. In other words, the average bank in the U.S. has lent out 100 percent of its deposits. The money is not there. It is lent out. (Some banks have more loans than deposits, others less, because while deposits can move—so far, at least—banks can get stuck with illiquid loans. It used to be that when a large depositor left a loaned-up bank, the bank would sell off loan agreements to raise the cash to pay him. But today there is almost no market for mortgages. See the problem?) If your bank has a billion dollars on deposit but all of it is lent out, then it has no money. But if one were to poll all the depositors, their combined statements would indicate that, as a group, they think there is a billion dollars in the bank. So 100 percent of their belief is a fantasy. That is also the amount of potential deflation, if all the borrowers were immediately to default.

Confusion comes about due to a magical word: deposit. This word makes it sound as if you have placed your money in the bank for safekeeping. But what you have actually done—as courts have confirmed—is to lend your money to the bank so it can, in turn, lend your money to your neighbors and split the interest with you. It is a speculative business, not a safekeeping institution. In reality, a bank book should not list “money on deposit” but “money lent to our bank, to be paid on demand unless we run short.”

Loan upon loan escalating through the banking system has created the bulk of the inflation in the system. But this inflation holds up only as long as all the loans backing the money listed in all the bank books are still good. If all the borrowers were to find that they could not pay back the banks, then the purchasing power that everyone thought he had would evaporate into the nothingness it truly was.

This outcome seems hard to grasp, so let’s go back to the original scenario. Your neighbor calls you up after a year and says, “Sorry, chum, but I invested the money and lost it. I can’t pay you back.” O.K., how much money do you have in the bank? Answer: You still have $10,000. But you already knew your balance, so it’s no big surprise. In the modern banking world, if 90 percent of borrowers were to default, the bank with $1b. on deposit would have to admit to having only $100m. worth of loans on hand. Most depositors would be shocked to discover that for every dollar they thought they had “in the bank,” they in fact have only ten cents’ worth of IOUs and not a penny of actual money. Contrast this outcome with the case of the direct loan. In that situation, you, the lender, knew the score every step of the way: You took a risk with his neighbor and it didn’t pay off. Those are the breaks. In the modern banking system, almost no one knows the score. Even those who do understand the situation, from having seen “It’s a Wonderful Life” a dozen times, rarely worry, because Congress, by creating the Fed as a lender and the FDIC as a supposed insurer, support the illusion that no losses are possible. This is a system with massive “systemic risk,” which means in effect that huge illusions can melt away in a flash if the “system” fails. The modern banking system has no option but to fail. Its very design, in fostering the illusion of riskless lending, insures that ultimately a huge portion of the creditors someday will wake up broke.
In the direct-lending scenario, moreover, you consciously decided to take the risk. You could have chosen to keep your money safe. Indeed, because the risks are crystal clear and honestly represented, many would have done just that. But that option does not exist as an institutional service today, because with fiat money, holding is losing, at least for all but the rare, brief periods of deflation. So, almost nobody does it. People “keep their money in a bank” and think it’s the same thing as “a bank keeping their money.” But it isn’t. To put it another way: The time-worn phrase “Money in the bank” really means “money not in the bank.”

If a depositor were to ask a banker, “Where is my money?” the proper answer would be, “It’s gone.” If he were to press on and ask, “What, then, do I own?” the banker should say, “Shares in a bunch of IOUs.” Deflation, then, simply makes manifest something that is already true—the money is gone—but the obligation to pay it disappears only in the case when borrowers can’t pay up. That’s a rare thing, which is why deflation is a rare thing.

Why Banks Will Not Lend, Even with a Gun to Their Presidents’ Heads
Excerpted from Bob Prechter’s October 2008 Elliott Wave Theorist

Congress and the administration have passed a bailout bill, and one of its provisions is that the Treasury will offer to buy stock in troubled banks, thereby liquefying them, but only if these banks promise to lend out the money they receive. This “plan” is not likely to work.

To whom exactly are banks going to lend? The credit profligacy of the mid-2000s was so extensive that further plumbing of the depths seems impossible. At the peak of the lending boom, the average customer of auto dealerships was putting down only ten percent of the value of a new car. The leverage was nine times. Mortgage lenders found customers for homes who not only lacked the money for a down payment but had no money even to cover the closing costs. The leverage there was infinite. Have you seen those furniture ads on TV? “No money down and no interest payments for two years.” You can’t find a lower common denominator than a customer who cannot even put down pocket change toward his furniture purchase for—forget now—two whole years! How do you measure that leverage? Perhaps the Treasury Secretary will stroll down Broadway poking the homeless to see who wants a loan.

It is further unclear whether people need new homes and cars. Twenty-five percent of the property sold at the peak in 2005-2007 were second dwellings purchased as investments, so there is a glut of housing. And it is difficult to find a home today without four cars in the driveway, and most parking lots are full of new ones. For the next ten years, most people could drive the cars they already own and be just fine.

One option might be for the Treasury to demand that banks make more credit-card debt available. But bankers know that many credit-card borrowers are over their heads now. More credit-card debt would mean that much more debt that would not be repaid. In other words, forced lending to broke people would insure that the credit offered would disappear. Then the Treasury would have to buy more bank stock under the same scheme, to the same net-zero effect. This does not sound like a reflation plan that will work.

End

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