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OPINION

Advice & Comment

Why I never invest in bank shares

Silicon Valley Bank and Credit Suisse collapses prove my point

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Having spent the first decade of my career working in a bank and then becoming a top-rated bank analyst*, I find that people often express surprise that I never invest in bank shares.

But I think it is precisely because I understand banks that I never invest in their shares. Recent events surrounding the collapse of Silicon Valley Bank (SVB) and of Credit Suisse reinforce this stance. Why?

First, I never invest in anything that requires leverage to make an adequate return. Banks have a very small amount of equity to support their balance sheet. Here are the actual numbers for NatWest group for 2022. To make it easier to understand I have reduced them to percentages.

NatWest Group

	£mn	%
Loans	373,479	52
Cash	144,832	20
Bonds	30,895	4
Other	170,847	24
Total assets	**720,053**	**100**
Equity	36,496	5
Loan Capital	58,585	8
Deposits	470,759	65
Other	154,213	22
Total liabilities	**720,053**	**100**

Source: Bloomberg

NatWest has £5 of shareholder's equity to fund £100 of assets — it has gearing or leverage of 20 times. If 10 per cent of the £52 of loans in every £100 of assets prove to be bad then the whole of the shareholders' equity is more than wiped out.

Frankly, long before that happens, depositors are likely to spot the problem and panic and cause a run on the bank, as we saw with SVB. Nor are these circumstances unimaginable. Author Nassim Nicholas Taleb in his book The Black Swan points out that in the 1982 Latin American debt crisis the large US banks lost all of their cumulative past earnings.

In contrast, the average company in the S&P 500 index (this includes banks which distort the numbers) has $26bn of assets and $8.5bn of equity — they are on average geared two times. Falls in asset value are not their main risk, but their assets would have to fall by more than one-third in value to lose the value of their equity.

Next, despite this massive leverage and the risk which accompanies it, returns from the banking sector are inadequate. The average return on equity (ROE) in the S&P banks sector over the past five years is just 10.9 per cent. This compares with the ROE on the S&P consumer staples sector over the same period of 17.9 per cent. These poor fundamental returns unsurprisingly translate into poor share price performance. The total return on the S&P banks sector over the past five years was -15.1 per cent a year, whereas consumer staples returned +12.1 per cent annually. So much for the theory that you need to take more risk to get higher returns.

What are the essential functions of a bank? To take deposits, make loans and effect payments. All of these essential roles are now being supplanted by so-called fintechs

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Finally, surely there must be some good banks to invest in which are better than the average? That brings me to another problem: systemic risk. Even if the bank you are invested in is well run it can still be damaged or destroyed by a general panic in the sector.

There is an anecdote which illustrates this. In the early 1980s doubts first set in about the future of Hong Kong, with the looming handover of control to China, and a crisis soon developed in the property sector which provided the collateral for much bank lending.

In the midst of this, there was a local bank which had an awning open over its front window to keep the sun out. It was by a bus stop and as a heavy rain shower developed, the bus queue moved to take shelter under the awning. In the febrile atmosphere passers-by thought this was the beginning of a bank run and, as a result, one soon developed.

That's banking for you. Banks can be brought down by the actions of their peers. Look at what happened to some US regional banks in the wake of the SVB disaster. Lord Mervyn King, the former Bank of England governor, encapsulated this when he observed that it made no sense to start a run on a bank, but once one has started you should join in.

That encompasses my longstanding reasons for avoiding bank shares but another has emerged in recent years — fintech. What are the essential functions of a bank? To take deposits, make loans and effect payments. All of these essential roles are now being supplanted by so-called fintechs. Bank loans are being replaced by peer-to-peer lending platforms and credit funds. You don't need a bank for payments or deposits. You can get your salary paid straight into your Mastercard or Visa account and they are far better at payment processing. for which you can also use your Apple or Android phone.

Technology is supplanting traditional banking. Have you noticed that your local bank branch has become a PizzaExpress, in which role, by the way, it makes more money? Not only that, but the banks are often handicapped by legacy systems which do not trouble new entrants and, at least until recently, fintech start-ups enjoyed a seemingly endless supply of funding with little or no requirement to show a profit.

As Paul Volcker, the infamous former chair of the Federal Reserve Bank, said the only innovation of any consequence by the banking sector in the 20 years running up to the Global Financial Crisis was the ATM, and we don't even need those any more.

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