'Your' Money in Banks has just been Reclassified to 'Their' Money

by Russell Napier via steve - Zerohedge *Tuesday, Dec 2 2014, 11:33pm*
international / prose / post

> *A little known and even less publicised agreement was reached at the recent G20 in Brisbane; it seems a distraction campaign by the mass media was also utilised -- Putin bashing -- to great effect. How many people are aware that their bank deposits are now integral to a bank's own assets? That means banks would be allowed to use 'their' (your) assets to bail themselves out if viability is threatened by hazardous banking investments. Banks now have a free hand to gamble with funds recklessly, as they would simply draw on 'your' funds to bail themselves out -- what a total travesty, a sordid and scurrilous trick has just been perpetrated on the global community!*

On Sunday in Brisbane the G20 will announce that bank deposits are just part of commercial banks' capital structure, and also that they are far from the most senior portion of that structure. With deposits then subjected to a decline in nominal value following a bank failure, it is self-evident that a bank deposit is no longer money in the way a banknote is. If a banknote cannot be subjected to a decline in nominal value, we need to ask whether banknotes can act as a superior store of value than bank deposits? If that is the case, will some investors prefer banknotes to bank deposits as a form of savings? Such a change in preference is known as a "bank run."

Each country will introduce its own legislation to effect the ' bail-in' agreed by the G20 this coming weekend. The consultation document from the UK's Treasury lists the following bank creditors who will rank ABOVE depositors in a 'failing' financial institution:

- Liabilities representing protected deposits (in the UK the government guarantee protects 100% of deposits up to the value of GBP85,000) any liability, so far as it is secured
- Liabilities that the bank has by virtue of holding client assets
- Liabilities arising with an original maturity of less than 7 days owed by the banks to a credit institution or investment firm
- Liabilities arising from participation in designated settlement systems
- Liabilities owed to central counterparties recognized by the European Securities and Markets Authorities... on OTC derivatives, central counterparties and trade depositaries
- Liabilities owed to an employee or former employee in relation to salary or other remuneration, except variable remuneration
- Liabilities owed to an employee or former employee in relation to rights under a pension scheme, except rights to discretionary benefits

- Liabilities owed to creditors arising from the provision to the bank of goods or service (other than financial services) that are critical to the daily functioning of its operations

The above list makes it clear that deposits larger than GBP85,000 will rank ahead of the bond holders of banks, but they will rank above little else. Importantly, both borrowings of the banks of less than 7 days maturity from other financial institutions and sums owed by banks in their role as counterparties to OTC derivatives will rank above large deposits.

Large deposits at banks are no longer money, as this legislation will formally push them down through the capital structure to a position of material capital risk in any "failing" institution. In our last financial crisis, deposits were de facto guaranteed by the state, but from November 16th holders of large-scale deposits will be, both de facto and de jure, just another creditor squabbling over their share of the assets of a failed bank.

Interestingly, HM Treasury uses the word ‘failing’ rather than "failed" in its consultation document and investors could find their large deposits frozen for a prolonged period in any "failing" institution while the courts unpick the capital structure and decide exactly where any losses should fall.

If we have another Lehman Brothers collapse, large-scale depositors could find themselves in the courts for years before final adjudication on the scale of their losses could be established. During this period would this illiquid asset, formerly called a deposit and now subject to an unknown capital loss, be considered money? Clearly it would not, as its illiquidity and likely decline in nominal value would make it unacceptable as a medium of exchange.

From November 16th 2014 the large-scale deposit at a commercial bank is, at best, a lesser form of money, and to many it will cease to be money at all as its nominal value can fall and it could cease to be accepted as a medium of exchange.

Fortunately, the developed world’s commercial banks are flush with central bank reserves and these are instantly convertible into the banknotes which they may need to meet demand from depositors. While the huge level of reserves on the balance sheet is a buffer, the funding of fractional reserve banks is still very negatively impacted by a shift from deposits to bank notes. With deflationary forces gathering momentum, this further impediment to the extension of commercial bank credit would be another factor preventing central bank monetary largesse translating into growth and inflation.

As the world’s smartest lawyer Charlie Munger is fond of saying, "Show me the incentive and I will show you the outcome." Some simple mathematics reveals that the November 16th announcement will create a very major incentive for investors to change deposits into banknotes.

Consider that the standard pallet measures 1 metre by 1.2 metres and will take 84 piles of Euro 500 banknotes. The UK’s Health and Safety Executive recommends that the height of a pallet should not exceed the widest side of its base. A 1.2 metre high pile of banknotes contains 11,000 notes and thus each pallet can safely hold 84 piles of 11,000 banknotes. A pallet of safely stacked 924,000 Euro 500 banknotes is therefore worth Euro462m.

There is a small warehouse for rent near Newry, at the foot of the Mourne Mountains in Northern Ireland. Given its dimensions (16.5m x 9.0m x 5.6m) one could stack 468 pallets of 500 Euro notes representing Euro 216bn. At the current bank deposit rate of minus 50bp per annum, the cost of carry to have Euro 216bn on deposit with a commercial bank would be Euro 1,081m. The annual cost of the warehousing space is around Euro 7,000!

Now clearly this warehouse will need significant private security, but in Northern Ireland there is an over supply of such security due to a structural change in market conditions, and prices are reasonable. Anyway, just how much security could you afford if you charged clients 20bp to hold their Euro 216bn, and generated an annual fee of Euro432 million, with an annual saving to your clients of about Euro 648 million?

This represents both a yield improvement and a significant improvement in capital risk compared to bank deposits, as bank notes cannot be "bailed in." There is therefore an annual profit of around Euro432 million for the manager with a warehouse and friends in low places. Anyone for the "Mourne Or Newry Enhanced Yield Banknote Actively Guarded Security", or MONEY BAGS for short?

As ever, there is a first-mover advantage. There are only about 600 million 500 Euro notes available, though sizeable arbitrage profits still exist on warehouses full of 200 Euro notes. As the function of such warehouses is focused on the role of money as a store of value, a role no longer fulfilled by the large-scale deposit, one should expect a premium to develop, and potentially a secondary market in note-filled, well-protected warehouses. For warehouses full of German Euro notes --- those are the ones with a serial number beginning in X --- a particularly high premium may arise due to risks of a future Euro break-up.

Irish legend tells of an X at the end of the rainbow marking the position of a pot of gold. In our post-Brisbane world, investors may be content to find just a bundle of paper marked with an X.

Oh, Mary, this London's a wonderful sight
With people here working by day and by night.
They don't sow potatoes nor barley nor wheat,
But there's gangs of them diggin' for gold in the street

At least when I asked them, that's what I was told,
So I just took a hand at this diggin' for gold,
But for all that I've found there, I might as well be
In the place where the dark Mourne sweeps down to
the sea.’

Percy French 1854-1920

Follow link to read entire article:

http://www.zerohedge.com/news/2014-11-12/russell-napier-declares-november-16-2014-day-money-dies

---