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Well, hello and welcome to this week's Dividend Cafe recording from our studio in New York City. And I'm loving being here in the city and loving the topic of this week's Dividend Cafe. We have written in Dividend Cafe already this year about what's going on in the banking world, the saga, if you will. Most people are aware just from the news cycle, if nothing else, that there have been three bank failures this year. Three is not exactly a huge number, but two of them were two of the biggest of all time between Silicon Valley Bank and First Republic. And so it's obviously been newsworthy, and yet it's sort of opened up various other conversations that have also been covered in the Dividend Cafe, about the Fed, about the role of monetary policy and all of this and so forth and so on.

I believe that this setup, these various proceeding events around bank failures, around monetary policy has enabled a little more study and a little more understanding and certainly conversation about some of the nature of banking to begin with, and has prompted me to write about something that I think is very actionable for investors as it pertains to the lay of the land we're in. And so I'm going to start by talking about where we were in thinking about the banking sector 15 years ago. Now, remember in the walk into the financial crisis, Fanny and Freddy were not banks. This was a very different category, financial institution failure. Bear Stearns was an investment bank. It did not even have a commercial bank, and neither did Lehman Brothers. They were classic Wall Street investment banks with a trading arm with a high degree of merchant banking, managing proprietary capital and risk investments.

They had trading desks, they were market makers, they were deal guys and gals on the investment banking side, M&A, advisory, et cetera. But they weren't commercial banks. But the financial crisis was not limited to the drama of non-bank like Fannie Freddy and AIG and investment banks like Lehman, Bear Stearns, eventually Merrill Lynch, et cetera. But Citigroup Bank of America, there was really significant drama with blended groups that had commercial banks and investment banks out of the repeal of Glass Stegel. So Glass Stegel Was a depression era bill separated, merchant separated investment and commercial banking. And by the way, the firm that I came from that I served a great portion of my career in Morgan Stanley was a spinoff from JP Morgan, meaning the nephew of John Pierpont Morgan himself was the Morgan of Morgan Stanley, and it's been a little while. I believe it was Harold Stanley as the other. And that was because JP Morgan had to kick off the investment banking side. Then there was a bill passed in the nineties under President Clinton that was brought forward by former Senator Phil Graham. I'm doing all this from memory right now, so if I get any of it wrong, forgive me, but I know this stuff pretty well, but I can make a mistake, so forgive me, that really, you know, had the massive supermarket bank merger from Travelers Group, which was insurance company, the Smith Barney, and Solomon Brothers, which were large wealth management and broker dealer and bond trading and investment bank type groups that had gone under the city group moniker.

And so City Group became this huge conglomerate, and that was a byproduct of some of the legislation that changed in the nineties. So at the time of the financial crisis, now I can get back to where I was at Div Cafe. You get me going on Wall Street history stuff, I'll just talk all day and bore everybody to pieces. But the reason I'm bringing this stuff up is that the lay of the land for banking out of 2008 was, all right, look, this isn't good. We can't have these firms taking risk and then because of the risk, something goes wrong and they don't have access to Depositor capital. Now, that wasn't really much, what was it? The heart, the deposit base of Bank of America and Citigroup is what kept them afloat. Bank of America actually bought Merrill Lynch and the investment banks that went down high profile, that blew up tens of billions of capital per company.

Merrill Lynch, especially Lehman Brothers with the bankruptcy Bear Stearns, they didn't even have commercial banks. So this whole thing about deposit or money at risk was not really what was going on in oh eight, but it did shine a light on the fact that there were kind of blended business profiles under one firm. And that many firms, even if they weren't doing commercial banking at Goldman Sachs, Morgan Stanley, they were taking on risk and that there was a desire to see a sort of de-risking of the financial system at large, less leverage, more capital. So a lot of things happened out of that. And then the Fed was much more involved regulatory wise, and they passed Dodd-Frank, which really didn't touch a lot of this actually, dod Frank kind of, I think went in different directions ironically from what it was intended to do. But the fundamental premise, and the reason I bring it up is what was a legitimate question is, okay, what do we do about if banks take on too much credit risk?

And even apart from where that does and does not fit into the '08 reality and the '08 narrative, this is a fact of life that from savings and loan where they were overextended with a lot of debt that went bad. If you have a bad amount of real estate debt, obviously in the Depression, a lot of individuals and businesses not being able to pay back money borrowed. And then that led to a lot of bank failures. That's what brought about the need for FDIC insurance to begin with. We've always dealt with this aspect of banks are exposed to credit risk. And the story of 2023 is people saying, what do we do about banks being exposed to interest rate risk? And the reason that this is a story here now, and I, there's a guy, Matt Levine, who writes it, Bloomberg every day. I read him religiously and he writes really, really long pieces, but I just can't, I think it's very good stuff. But there's a theme that has come up, not just what I'm presenting here in different cafe today, but it's been in the press other places, and it's been in a lot of the kind of buy side and sell side research that we read directly. And so this other people are talking about this too. Really what you have with a bank is their capital that is put in and all the deposit money represents their funding access. And then their liabilities represent all of their assets minus what they owe. Excuse me. Their bank deposits are liabilities. And so let's say they had no debt, let's say they don't have bonds that they've issued that they have to pay back, that their only liabilities or deposits the money that they owe to depositors on demand, and then they have their assets on top that you really basically can quite easily have banks fail when they have more assets than liabilities.

That seems impossible, but it isn't because if enough depositors come, the assets which are illiquid might be greater than the liabilities. But the liabilities are now liquid. The liabilities are now instant. The assets are long term, the liabilities are short term banking is set up as a model by which you borrow short and lend long deposits come in, and then you're, you're going to go use money or you're going to borrow from the Fed short term and you're going to use money to land out for mortgages and car payments and business loans and construction financing and other things that have a longer duration. So the real issue is a matching the assets and the liabilities from a liquidity standpoint. And deposits are this heavy liquid funding vehicle that have screwed it all up because people, the deposits aren't really there, right? Fractional reserve banking means that they're lending out more than the amount of what's held in deposit. But the thinking is, and the thinking is right, 99.997% of the time that those deposits are stable, they are reliable. So the point I make in Dividend Cafe this week is that there are three things a bank can do to never let it happen, that they run into a liquidity failure, that they have more assets than liabilities yet run out of an ability to return a deposit of their money. In other words, they're not insolvent, but they are illiquid. One is to not make bad loans. That can be a problem because loans go bad.

They're underwater. Okay? We're not dealing with that right now. We've dealt with it plenty times in history. We're not dealing with that right now for the most part. Not yet. I would like to think we won't. I don't think we will.

Number two is that we can keep depositors from pulling too much money out, but you really can't keep 'em. Now, you could try not marketing to only one part of the country. You could try not marketing to only one particular segment. You could pay a high enough interest rate that depositors are incentivized to stay. But then that of course takes away bank's profit takes away at least bank revenues to some degree, so that's less controllable. But nevertheless, one of the knobs a bank can turn. And then the third is to have abundant amount of capital on hand. So there's always a cushion for additional funding. Well, that's great too, except for of course, the more capital you have on hand, the lower your return on equity will be. The less good of an investment. It is if you have a lower return on equity because you have to keep more capital in the business, and it is therefore hindering your ability to get a good return on that equity.

And so all three of those things come with a trade off. Less deposits is less business, less capital or more capital is less return because you're able to leverage your present resources in a less profitable way and less risky loans or less volume of loans also means lower return, lower coupon, lower interest income, et cetera. And so there's a trade off, and yet a bank with no loans and no defaults me and absolutely no bad loans ever. That means they're taking no credit risk. And basically you probably have no profit if you have no credit risk whatsoever. So you have to turn the knobs up and down a little. Generally, banks satisfy for credit risk by being diversified, by doing good underwriting, by having enough equity you required in the loans they give out that if they do have to do recovery or foreclosure, they eventually over time can recover the asset.

It doesn't help 'em for liquidity, but it does help 'em for solvency. So banks can be in a credit extension business, but they have to control it. They have to be limited in that. They don't want those things getting marked down. The problem on the depositor side or when interest rates go up and it makes the loans they have on the books less valuable because they lent a bunch of good money out at 3%, and now rates are at 5%. The problem is a liquidity mismatch. And I guess I just want to kind of bring this to a better conclusion, move forward a little by saying that what I think is happening before our very eyes started, not in 2023 with First Republic, Silicon Valley Bank and people like me talking about assets and liabilities being mismatched in their duration or there being liquidity illiquidity, even if there was solvency, this really started back around 2008, but it was more of a credit conversation than it was a risk conversation where people said, okay, we can't have these banks taking losses to a level that it impedes their capital and therefore impedes their ability to return money to depositors or to be a systemically significant bank that goes down because they have done too much risky stuff.

And risky stuff can make you a lot of money, but it can also, when things go bad, hurt you. And what happened was there was a really, really large increase in different categories of credit extension, loan origination, loan distribution, but whether it's in various forms of direct lending and private credit securitized lending, certainly the structured credit that's generally asset backed, you had something in the range of about a trillion dollars that is now about four or 5 trillion. So you had a lot of new money issued through a combination of categories that are all under the umbrella of non-bank lending. And non-bank lending was originally a satisfaction of the credit risk conversation. And I will propose to you today that I think it represents a huge satisfaction in the future of liquidity, concerns of not credit risk, but matching assets and liabilities, the type of stuff we've had a problem with this year, you already have a significant amount of some of these non-bank lenders doing more and more of the commercial real estate lending, more and more of cash flow based lending, business lending, small businesses, certainly mid-size.

And now lately, even larger bond companies, not even going to the bond market, but are going straight to private credit for a lot of advantages it represents to their business. And so we view the private credit world as very opportunistic, not just as investors in private credit, but for society, for banks as an alternative to a lot of the lending that needs to get happen. We're a credit dependent society for good or for bad. That's not going to change, I hate to tell you. So really my opinion is that to the extent there are businesses, individuals, money, good borrowers that have projects and ideas and businesses and things that need to be funded, a lot more of it going to non-bank lending solves for some of the liquidity concerns of today and the credit risks of yesterday. And yet the reality is people still fear the losses that could take place in the private credit side because of course there will be, my point is there won't be that jeopardized liquidity right on.

Deposits can be withdrawn at any time. A private credit investor is locking their money up, they're giving it off investment strategy that they know is going to have annual liquidity after three years, and maybe quarterly it could be further out, but there's not the run on the bank that can take place. And so by having private credit options, you satisfy the risk of on demand deposit withdrawals, which by the way are have always been there back from the, it's a wonderful life. Jimmy Stewart run of the bank scene that we always talk about people lining up at Indie Mac in 2008, but now it's one button on an app. And that doesn't happen in private credit markets. There's not instant liquidity. And so you really don't have the same fear of a mismatch of assets and liabilities, and yet you can still lose money. There can be debt that goes bad, there will be debt that goes bad.

And what you're seeing is those losses are absorbed by who can best absorb 'em, which is not grandma with her bank account at a commercial bank. It's investors who are savvier, wealthier, less liquidity constrained and are extending capital at a seven, eight, 9% yield. I'm making up a number to, they're taking more risks to get a better return. And when there are losses, they will absorb losses. That's what investors do when they're risk asset investors. You absorb losses, but you get to absorb gains right? Now, our problem is that we do have a lot of the banking system, not just in credit, but in this concern for liquidity, that really losses can't be absorbed. They're not going to be absorbed by national depositors just like they in one weekend provided unlimited insurance benefit FDIC at Silicon Valley. That was not to bail out anyone in Silicon Valley.

It was to bail out millions of people across the country that bank accounts that were like, what? My bank will be insolvent if everyone raids them on Monday morning. And everyone can disagree with it all they want, and that's totally fine. I can't stand moral hazard, but my only point is it doesn't matter what you think, they will do it. They are not going to ever let millions of people that were just innocent bankers with a payroll and with their retirement account and their social security check and writing checks for their groceries, they're not going to let those people go belly up. And that's my prediction anyways. If I'm wrong, I'm wrong. All right, so here's the thing. In my opinion, more and more money going into the non-bank lending private credit side is better systemically provides great opportunity for those of us willing to take risk in non-bank lending, private credit, structured credit, syndicated loans, different elements of that space that go to investors, professional investors, high net worth, institutional, whatever the case may be.

And you have a better liquidity profile in the banking system. Now, the next logical question is, okay, well then how do banks make any money? Because nobody wants to pay fees and they don't pay much interest out in deposits. And if they do that, that's a loss for them. It's not a gain for them. And now if even more lending goes away, and that's where I got to say, I don't think it is going to be a growth sector ever again, you can have a few exceptions that are kind of like those banks I was talking about, post Glass Eagle that have an investment bank or maybe have credit cards. Maybe they are in, they're still doing some residential mortgages, well underwritten, things like that. There could be those exceptions. But as a general rule of thumb, as an investor, not as a customer, as an investor, does a typical small or community bank offer a lot of growth, offer a lot of return on equity?

Of course not. Of course not. This is the reason why. So one sector's loss is another sector has gained in terms of investment merit, but in both cases it could very well be society's gain and macroeconomic opportunity. Alright, I have to run. I'm going to leave it there. I do hope you've gotten a lot of this. Please do read the whole different cafe. It's quite a long one, but there's quite a bit of unpacking there that you may find more useful than we did here in the video in the podcast. Thanks for listening. Thanks for watching. Thanks for reading the Dividend Cafe. Have a wonderful weekend. Wherever you may be.