

**Episode 2,354: How Concerned Should We Be About the Banks?**

**Guest: Kevin Duffy**

**WOODS:** Now, here's what I'm going to ask you to do something that so few people who talk about these things seem to be able to do. And that is, I want you to dumb it down three notches. Because not everybody speaks banking, okay?

**DUFFY:** Right.

**WOODS:** All right. So, I may even stop you and ask you to define things to make sure we don't lose everybody. Let me frame the conversation this way.

I did an episode with David Stockman on the whole debt ceiling thing with Kevin McCarthy, and I said to him, it's impossible for me to get worked up about this stuff anymore because I know how it's going to turn out.

We're going to get some hemming and hawing. The Republicans are going to make a big noise, and then nothing's going to happen. They're going to concede, it's going to be a big capitulation, and life is going to go on as before until the next time this happens.

It's every single time. I don't see how anybody even bothers to listen anymore. We all know the outcome. Well, there's a similarity here with all this.

It's almost like, I can't even be bothered to find out about what's the latest alleged banking crisis, because I feel like a lot of people have cried, "Wolf!" over and over again.

Like, I already know. It's: *Oh, my goodness, we're in for a big, big crisis.* And then 99 times out of 100, it passes.

So, what is genuinely different this time?

**DUFFY:** Okay. What's different this time is that there are really two risks on the asset side for a bank. One is credit risk and the other is interest rate risk. So, credit risk is not getting paid back. Interest rate risk is what happens if interest rates go up.

Now, what's happened is we've had a 39-year decline in interest rates. So, banks have not had to worry about this idea of interest rates going back up. If you go back to the global financial crisis, that was a crisis based on credit risk.

What happened last year was that we had the biggest increase in rates and the worst decline in bond prices. Now, keep in mind that interest rates and bond prices go in the opposite direction. So, this was the worst year for bond prices, the bond market, since the early days of the republic.

So, there are a lot of interest rate losses. Where are they? Well, they happen to be residing on the banks' balance sheets. That's the problem. It's a very different problem than what we experienced in 2008.

**WOODS:** Can you take just a minute, maybe use a very simple mathematical example to explain to people why it is that interest rates and bond prices move in opposite directions?

**DUFFY:** Yeah, so I'll try. So, a bond is a loan. So, let's use an example. I loan Tom Woods $100. And let's say the market interest rate is 3%. Let's say this is over a 30-year period.

So, what that means is that I am hoping to get back $3 a year for 30 years, and at the end of 30 years I get $100 back. So, I now have an asset, which is this revenue stream, at 3%. Now what happens if interest rates go up to 6%?

Well, I could make the same loan to somebody just as creditworthy as Tom Woods, but now instead of $3 a year, I'm getting $6 a year. All right. Now, obviously, the value of that loan that I made to Tom Woods has now dropped in value.

What is it worth? Well, in a market of 6% interest rates, those interest payments are worth half of what they were when I first made the loan. Now, the principle that I get at the end ($100) is the same.

But the way the math works out now, that loan, if I were to try to sell that loan to, let's say, a bank or somebody else, they would give me 40% less than when I first made that loan.

**WOODS:** Okay. All right. That think that really helps. All right. So, the banks are in a situation they haven't been in in quite some time.

**DUFFY:** That's right.

**WOODS:** Meanwhile, we have the institution of the Federal Reserve. Is there something the Fed can do to at least push off into the future any problems the banks might now face?

**DUFFY:** Well, I think they're really boxed in. And the problem is they could try to lower interest rates. But the problem is that they got themselves into this mess (or they got the banks into this mess) by lowering interest rates. And the problem was that that ended up increasing price inflation, which raised interest rates, which set off this whole chain of events that then trapped the banks.

So, other than the Fed acting responsibly, I'm not sure that there's a whole lot that can happen. Because the problem is, again, these loans have been made at low interest rates. The only way that the banks can be saved is if interest rates go back down.

The Fed printing money has basically shown that this is going to lead to higher rates. So, there really is not much they can do besides just acting responsibly, which I'm not sure I would want to bet on that.

**WOODS:** So, let's say what you're describing – we'll stipulate that this is in fact what's happening, which seems to me to be right. So, then what should we expect to see happen? What would this look like? This doesn't mean the failure of every single bank, so what exactly does it look like?

**DUFFY:** Right. So, the problem is that I've gone and I've done a study there's been another study done by a professor by the name of Amit Seru at Stanford, a finance professor, and he believes that the losses, if these are marked to market – and this is another problem, that these losses are not being accounted for properly.

They're actually being ignored, the interest rate losses, for the most part. And if they were accounted for properly, the losses – they're claiming would be about $2.2 trillion. I've done the math myself. It seems to be in the ballpark.

And the problem is that the equity of the banks is right now stated to be about $2.3 trillion. So, essentially there's no equity there. And as long as the banks are able to pay depositors a half a percent, basically have free money, then they can keep this going.

But the problem is that the depositors now have options. They're seeing that short term rates have gone way up, rates on T-bills 4% or 5%. Apple is now offering a money market fund at 4.15%.

And so, what you're seeing – and this is, again, very different than what we saw in 2008. In 2008, interest rates went down, deposits went up. The banks were able to actually attract over a half $1 trillion in 2008.

Over the last year and a half, we've actually seen an outflow of deposits of about $900 billion. So, total bank deposits peaked at about $18.1 trillion and they're now at $17.2 trillion. So, you've had a pretty good outflow.

All of these things are going in the wrong direction and all it's going to take is – depositors don't even have to be aware that there are problems. They can be totally, blissfully unaware.

But if they see that their bank is paying them a half a percent and they can get 4% and they start to leave, then this all gets exposed. These losses are exposed. And then what are the banks going to do?

**WOODS:** Well, then that kind of is the question. I know you mean that rhetorically, but I'm trying to imagine what kind of headlines – if this kind of worst-case scenario really does unfold, what kind of headlines are we going to see in the paper?

**DUFFY:** Well, the banks will be forced to sell assets. I mean, that's basically all they can do. And what do they have? Banks that have loans (they're illiquid), and they have securities, government securities, treasuries, munies, mortgage-backed securities.

So, I think what will happen is the banks will start to sell the easiest things that they can sell. And so, that's going to put further pressure on bond prices, driving longer term rates higher.

Which is going to create a whole set of other problems, of course, for anybody like, let's say, the federal government, that is highly indebted.

But when they're having to sell everything, the prices are going to drop, and it's just going to make matters worse. So, this has all been covered up very well. I think the authorities and the defenders of the system have done a remarkable job, but it's not going to take much to start to get this to unravel.

**WOODS:** What should the banks have been doing? How should they have behaved so as not to put them in this situation?

**DUFFY:** They should have been aware of interest rate risk. If you're a bank in Latin America, South America, you are very much aware of interest rate risk. I mean, even the lowest level employee at a bank there is aware of interest rate risk.

The problem is that they were conditioned by 39 years of declining interest rates. I mean, the ten year yield went from 15% in 1981 to almost a half a percent in 2020. And of course, what really got things going was Covid. There was a big flight to "safety" and that drove rates down even further.

But I think it's just basically Banking 101. You have two main risks, credit risk (which everybody was concerned about) but they weren't paying attention to interest rate risk. So, they could have hedged that risk.

They could have basically not made loans. They really just kind of shut down the business and try to do everything they could not to take on that kind of risk. The problem is that with Covid, it was the one-two punch of Covid with super low interest rates and then the stimulus, $6 trillion in stimulus.

And about $4.8 trillion just flooded into the banking system in terms of deposits as a result of that. And a lot of this was money that was printed by the Fed. And so, what do banks do? Money comes their way, they put it at work. They put it at risk.

And it's amazing the conformity of the banking system that so few understood that: Hey, rates are at under 1%. They can actually go up. I mean, it's amazing that everybody was sort of in lock-step doing the same thing.

**WOODS:** Well, there was maybe similar herd mentality in the years leading up to 2008, but not involving the alleged unlikelihood of interest rate risk. But we remember the old slogan that "real estate prices never fall".

And everyone seemed to believe this, and so we're just going to keep this thing going. No matter how absurd it looked, this never happens. And incidentally, I think some people felt like they had reason to believe that.

That in 2001, even though we did have a modest recession, housing starts actually went up, which had not happened in a recession before. So, it just looked like all the signs were green, and so you'd be a chump not to jump into it.

**DUFFY:** Yeah, that's right. And the policy back then was home ownership, that the government was promoting home ownership. Whether they did it with the Community Reinvestment Act, they were really pushing this idea.

And so, I think the banks are very much tied to the government. They very much want to be in tune with the regime and with the regime's narratives. And so, they were promoting all this. And so, anybody who could fog a mirror was getting a mortgage.

And surprise, surprise, it didn't work out. But this idea of front running whatever the government is pushing, I think is a dangerous idea when everybody starts doing it all at the same time. So, this time, the government policy was really zero interest rate policy.

It was somehow that as a response to the global financial crisis in 2008, lowering rates to zero and keeping them pegged to zero for most of 14 years, that that wouldn't have any unintended consequences.

And so, the banks, I think, went along with this. And it looked like free money, basically. How can you lose if you're a bank? You're paying your depositors next to nothing. You basically are able to then loan money to the government at 1% and make a spread in between. And that was the mentality.

The problem is that long trends lead to short memories, and I think they just forgot about interest rate risk. It's mind boggling to think about.

**WOODS:**  I want to talk for a minute about an article you wrote at Mises.org about Silicon Valley Bank, which is a topic from, at this point, 2 or 3 months ago.

And I did do an episode on it. I think you might even have listened to it and sent me one of your emails, as a matter of fact. But I want to talk about this just because this is a case where we're told that an alleged regulatory rollback caused problems.

And it had to do with Dodd-Frank and an institution like SVB not being subjected to annual stress tests. And your point more or less was, but even if they had been subjected to these stress tests, they would have passed them with flying colors. It wouldn't have done any good anyway.

**DUFFY:** Yeah, that's right. These stress tests – and they all came out of the global financial crisis, Dodd-Frank, Basel III regulation. And it was all unfortunately meant to prevent the last war. Nobody really had the imagination that the next problem would change its spots.

So, these tests, they look at a severely adverse scenario. So, that scenario involves a recession. They're really looking at credit risk and stress testing the banks for credit risk. The assumptions were always, throughout all of these stress tests, that actually inflation would go down in a recession and that interest rates would go down in a recession.

And what's interesting about this is I actually found something from Jerome Powell – I think it was a few years ago. And he was actually concerned about the stress tests. That they needed to kind of mix things up, that the banks would kind of conform to basically passing the test and they wouldn't think about other risks.

So, I think the stress test in a way led to even more conformity on the part of the banks. And they never imagined – they never really ran the scenario where it wasn't really the recession that would get the banks, but it would be a rising interest rate environment.

**WOODS:** I heard quite a bit of commentary about SVB and people demanding the government do this or that and what would constitute a bailout and what wouldn't.

And I know Vivek Ramaswami got in trouble with some of his tech and finance people because he was taking kind of a hard line on it. What was the appropriate position to take on that, in your opinion?

**DUFFY:** I mean, let it fail, I guess. First of all, part of the problem with Silicon Valley Bank, when you look at, not just Silicon Valley, but First Republic, both of those banks together. They were really the low hanging fruit, but they were different.

So, Silicon Valley Bank, first of all, they had a fairly risky loan portfolio, but they tried to balance it with a rather large securities or bond portfolio. And the problem with Silicon Valley Bank was that they used this held-to-maturity accounting where they actually did not have to report the losses, the unrealized interest rate losses.

Those losses were so great that they consumed 98% of the tangible equity of the bank. And the other part of the problem was that about 90% of the deposits were uninsured. So, first of all, those uninsured depositors should have taken a haircut and they would have gotten certificates.

Essentially what would happen would be the bank's assets would be liquidated over time. And the insured depositors, they would be made whole by the FDIC, but the uninsured depositors, they'd have to wait, wait for a workout, wait for the assets to be liquidated.

I think that's how it should have been handled.

**WOODS:** Well, now let's go back to the main subject of the conversation today. The average person, I think, would want to know, how, if at all, is this going to affect me and the decisions I make with my money?

In particular, like most people, let's say I've got money in the bank. Should that change? What should I do? Is this just something I'm going to read about in the headlines, or is there a chance it could affect me personally?

**DUFFY:** Yeah, it's a great question. And I think what the government has done (and that the Fed has done) is basically saying: We're going to make everybody whole, and we're going to do this by essentially printing money.

So, it's hard to know exactly how this all plays out. But I think there could be more runs. But I don't know. I think the government has basically said: We're going to backstop all of this. The problem is I'm not sure where "all of this" really ends.

Does it apply to maybe the insurance industry that's also sitting on significant bond losses? And at the end of the day, I think this is going to be good for hard assets, for gold. It probably means that we are going to get another bout of the printing press.

**WOODS:** Oh, good grief. Well, say something about your Coffee Can Portfolio newsletter. And who's the intended audience for that, and what's in there?

**DUFFY:** Okay. Yeah, The Coffee Can Portfolio is really trying to reach a fairly wide audience, the novice. And so, I try to explain things in plain English and layman's terms and use some kind of simple rules. Also, the do-it-yourself investor and I also have some very sophisticated professional investors.

So, really kind of a wide range of knowledge on the part of the investors.

**WOODS:** And how do people get it.

**DUFFY:** They can go to my website, which is TheCoffeeCanPortfolio.com.

**WOODS:** All right. Very simple. Well, I appreciate your comments here today. And I guess we'll just see what happens. Is the consensus, though – I mean, everything you've laid out seems pretty commonsensical, but yet I don't think Paul Krugman is predicting there's going to be a big problem.

So, how's the mainstream coping with this? What's the rosy scenario?

**DUFFY:** I mean, it's really been fascinating. This all happened, what? The first week of March? So, here we are three and a half months later, and it's like nothing happened. You had, eh, okay, a couple of banks, three bank failures, and I think the authorities have done a masterful job of spin, of restoring confidence.

You see the stock market now is at a 14-month high. You see covers of – I had my cover of Barron's, "Buy the Big Banks". I mean, it's just been remarkable the complacency out there. And that's kind of where we are in the cycle.

It's typical. I believe, that the financial markets peaked in early 2021, in February of 2021, the broad market. We had a pretty good correction. And what is typical of a bubble is that you get a rebound rally, and you get a lot of complacency.

And everybody is kind of thinking that: *Okay, that was a lot of fun, but it's over.* That's sort of, I think, where we are. So, all the pieces do seem to fit together.

And I think if we see the stock market start to decline – one of the things we've seen with the bank stocks is that they have not really participated much at all. They've been just kind of flat.

And so, something is not right. You can just tell with the trading of the bank stocks. They just can't get out of bed. So, I just think this is where we are in the cycle. We're in the sort of peak optimism, peak complacency.

And this will kind of wear off and then we'll find out what's beneath the surface. And the surface is a lot of rot and a lot of malinvestment. And surprise, surprise, a lot of this is going to show up on the bank balance sheets.

**WOODS:** All right. Well, thanks again, Kevin. I appreciate your contributions very much.

**DUFFY:** Thanks, Tom. One other thing I should say is that, you asked me about the banks and about the depositors. I'm not as concerned about depositors. I would be concerned if I were an investor. There is no way I would want to touch a bank right now as an investor.

**WOODS:** Yeah, there are a lot of things you can do with your money. It doesn't have to be tied up as a bank investor.

**DUFFY:** Exactly. Yeah. The last thing I'd want to do.

**WOODS:** Yeah, that's probably sound advice for everybody. All right. Thanks again.

**DUFFY:** Okay. You bet.