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Al Gair, MBA, CFP
Vice President &
Investment Advisor

Bonnie Walmsley
Associate

2500 - 666 Burrard Street,
Vancouver, B.C. V6C 3B1

T: 604.665.5526

E: al.gair@rbc.com
E: bonnie.walmsley@rbc.com

www.gairwealthmanagement.com

While now "ancient history", one of the more interesting (and unnerving) financial stories of the past few weeks was the collapse of the banking system in Cyprus. I have to confess that I didn't even realize that this small Mediterranean island, closer to Turkey than Greece, was actually part of the European Economic Union. And the fact that its economy represented a mere 0.2% of the Eurozone made its financial significance even more of a shock.

The reason that Cyprus' financial crisis had such a large impact wasn't the country's tiny economy, however, it was the size of its banking system *relative* to its economy.

It's become clear to most Canadian investors over the past few years that our domestic banking system is a lot healthier than many around the world. We may grumble about service fees and the profits that our banks make each year, but the reality is that our banks are incredibly solid.

The situation in many other parts of the world is quite different – and a good part of the reason is leverage. As mentioned in my piece on Berkshire Hathaway a couple of issues ago, prudent use of leverage can be a road to big profits. But like many things, imprudent use of leverage can be the road to ruin. And banking is all about leverage.

In very, very simple terms banks accept deposits (which become their liabilities) and then lend money out (which become their assets). But it's not one-for-one. It might be 10 or 12 times to one. In a stable, well regulated system like Canada's, that's generally not an issue. Your bank takes in $100 in deposits and issues a $1000 CDIC-insured mortgage to you or me. Pretty safe stuff, typically. In Cyprus, banks took in $100 from Russian oligarchs and regularly bought $1000 worth of Greek bonds!

In fact, banks in Cyprus had so many "assets" on their books that it represented close to 10 times the size of the Cypriot economy. So, if a significant portion of those assets decline in value or become worthless, the country simply doesn't have enough money to bail out the banks.

This, incidentally, was what happened to Ireland and Iceland at the start of the financial crisis. Both Irish and Icelandic banks also had assets on their books in the range of 10 times the size of their country's economies. Much of the Icelandic banks' assets were the-now-infamous collateralized debt obligations (bad debts packaged up to look like good debts) while Ireland's banks enthusiastically rode their domestic real estate bubble (and maybe Spain's as well) to its inevitable conclusion.

So while we all may grumble, overall we should be happy our Canadian banking system is the way it is. And if we really want to be smart, we'll not just give banks our money, we'll buy their shares as well.