July 2011

MARKETS AT A GLANCE

Sprott Asset Management LP

The *Real* Banking Crisis

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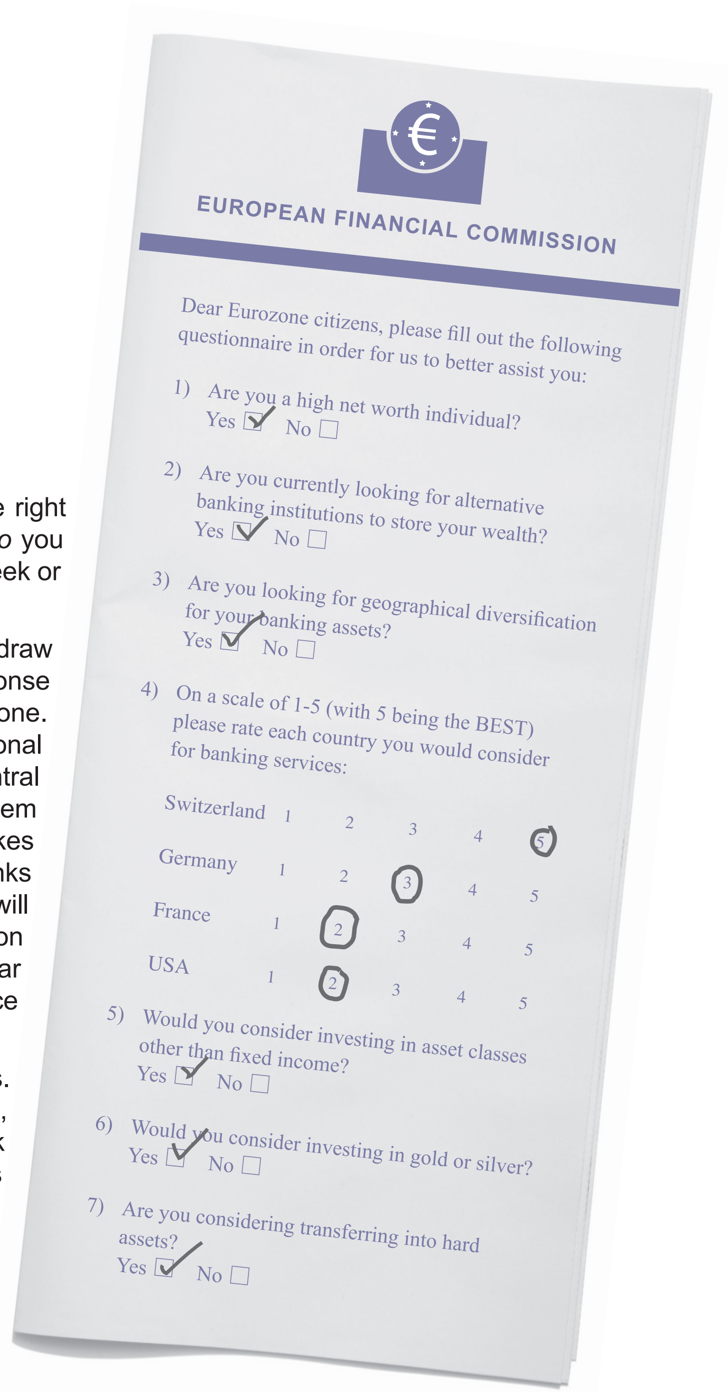

EUROPEAN FINANCIAL COMMISSION

Dear Eurozone citizens, please fill out the following questionnaire in order for us to better assist you:

1) Are you a high net worth individual?
Yes ☑ No ☐

2) Are you currently looking for alternative banking institutions to store your wealth?
Yes ☑ No ☐

3) Are you looking for geographical diversification for your banking assets?
Yes ☑ No ☐

4) On a scale of 1-5 (with 5 being the BEST) please rate each country you would consider for banking services:

Switzerland	1	2	3	4	5
Germany	1	2	3	4	5
France	1	2	3	4	5
USA	1	2	3	4	5

5) Would you consider investing in asset classes other than fixed income?
Yes ☑ No ☐

6) Would you consider investing in gold or silver?
Yes ☑ No ☐

7) Are you considering transferring into hard assets?
Yes ☑ No ☐

Although the adjacent questionnaire is facetious, it does ask the right questions. If you're a wealthy European depositor today, what *do* you do with your money? Do you really continue to keep cash in a Greek or Italian bank account?

European bank depositors all face a tough decision today – to withdraw their deposits, or not withdraw and take their chances. Their response to that decision may determine the financial future of the Eurozone. Since 2008, EU Government bailouts have transformed a traditional banking crisis into a full-blown sovereign crisis. The European Central Bank (ECB) has managed to keep the Eurozone banking system going for now, but the constant threat of depositor bank runs makes its future extremely uncertain. A bank run on deposits forces banks to liquidate assets to raise cash. Governments and central banks will go to extreme lengths to avert such a scenario, because a liquidation reveals what an asset is really worth – and they are likely worth far less than what the banks are claiming they're worth on their balance sheets today.

Bank runs have wreaked havoc in Europe over the past three years. In Iceland, it was a UK-led bank run on its second largest bank, Landsbanki, in early October 2008 that led Landsbanki to block over 300,000 UK depositors from accessing their accounts in its online bank called Icesave. Fear of widespread deposit losses compelled the British government to promptly freeze the assets of Landsbanki in retaliation, inciting an effective lock-down of foreign capital in and out of the country.[1] You certainly didn't want to have an Icelandic chequing account when that happened – especially considering that the Icelandic Krona proceeded to lose 58% of its value by the end of November 2008.[2]

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1 Lyall, Sarah (November 1, 2008) "Iceland, Mired in Debt, Blames Britain for Woes". *New York Times*. Retrieved July 28, 2011 from: http://www.nytimes.com/2008/11/02/world/europe/02iceland.html?pagewanted=all

2 Onaran, Yalman (February 1, 2011) "Iceland Shows Ireland Did 'Wrong Things' Saving Banks". *Bloomberg*. Retrieved July 28, 2011 from: http://www.bloomberg.com/news/2011-02-01/iceland-proves-ireland-did-wrong-things-saving-banks-instead-of-taxpayer.html

In Ireland, it was the withdrawal of almost €4 billion in deposits in less than three weeks that compelled the Irish government to nationalize Anglo Irish Bank in January 2009.[3] Large depositors lost faith in the Irish government's bank account guarantee and began to pull their cash out of Irish banks in droves. As a Trinity College Dublin professor was quoted at the time, "This is a nightmare scenario for the [Irish] government… they can't stop further withdrawals from the bank unless we close the borders and turn into Cuba."[4]

Ireland experienced a *second* bank run in late 2010, when more than €67 billion was withdrawn from Ireland-based institutions in October alone.[5] Ireland's top six domestic banks, two of which are currently in the process of being shut down, have now lost more than €90 billion in corporate deposits since the crisis began in 2008.[6] And the withdrawals continue – in May 2011 it was reported that Irish resident private-sector deposits had declined by 8.7% over the past 12 months.[7] Private sector deposits from non-Irish Eurozone residents declined by 9.7% over the same period, while deposits from *non*-Eurozone residents were reportedly down 28.2%.[8] Ireland's experience makes it fairly clear: when depositors sense danger, *and they are free to move their money elsewhere* – they typically do.

The Irish deposit withdrawals have left Ireland's banks in the hands of the ECB, which graciously bailed the country out back in November 2010, and has now lent Irish banks more than €103 billion as of the end of June 2011.[9] This, in addition to the €55.7 billion the Irish banks have received from their own central bank, is amazingly still not enough to recapitalize the Irish banking system, which at the time of writing still requires an additional €24 billion of capital to remain solvent.[10]

In Greece, bank withdrawals have proven equally as damaging. Greek banks have seen deposit outflows of around 8% thus far in 2011, with an acceleration of outflows in May and June. Moody's recently warned that such flows could cause a "severe cash shortage if they rapidly increased beyond 35% of deposits".[11] Last week's €109 billion bail-out suggests that may have already happened.

Just as with Ireland, the ECB has kept the Greek banks afloat, funding them almost €100 billion in 2010 and an additional €103 billion thus far in 2011.[12,13] The recent bail-out will buy Greece time, but deposit outflows could still derail the ECB's efforts to save the Greek banking system if they continue unchecked.

Although we don't have the data for Spain or Italy, it does not escape us that those countries' governments are likely highly aware of the effect a bank run could potentially have on their fiscal stability. Italy is a much bigger fish than Ireland or Greece. Its €1.8 trillion of borrowing in nominal terms is more than the debt of Greece, Spain, Portugal and Ireland, combined.[14] Italy and Spain are too big to fail and too big to bail-out, so the future of the Eurozone will be seriously compromised if Italian and Spanish depositors take flight with their euros. To that effect, we found it very instructive to read about new provisions that the Eurozone's rescue fund, the EFSF, recently incorporated into the latest Greek bail-out. Included among them is the ability for the EFSF to buy sovereign bonds in the secondary market, give EU states "precautionary credit lines" before they are shut out of credit market, and "**lend governments money to recapitalize their banks**".[15] The sovereign crisis, at its root, is still a banking crisis. The banks hold loads of Eurozone sovereign debt.

3 Lyons, Tom and O'Brien, Stephen (January 18, 2009) "€4bn 'run' triggered Anglo move". *The Times*. Retrieved July 28, 2011 from: http://www.timesonline.co.uk/tol/news/world/ireland/article5537566.ece

4 Ibid.

5 O'Brien, Dan (June 1, 2011) "€12bn decline in bank deposits in April is smallest since September". *The Irish Times*. Retrieved July 28, 2011 from: http://www.irishtimes.com/newspaper/finance/2011/0601/1224298206493.html

6 Humphries, Conor (July 8, 2011) "Irish banks' ECB borrowing inches up in June". *Reuters*. Retrieved July 28, 2011 from: http://uk.reuters.com/article/2011/07/08/uk-ireland-centralbank-borrowings-idUKTRE76728R20110708

7 Finfacts Team (June 30, 2011) "Irish household bank deposits fell by €709m in May; Domestic banks' central bank borrowing was €74bn". *Finfacts*.ie. Retrieved July 28, 2011 from: http://www.finfacts.ie/irishfinancenews/article_1022646.shtml

8 Ibid.

9 Humphries, Conor (July 8, 2011) "Irish banks' ECB borrowing inches up in June". *Reuters*. Retrieved July 28, 2011 from: http://uk.reuters.com/article/2011/07/08/uk-ireland-centralbank-borrowings-idUKTRE76728R20110708

10 Ibid.

11 Brereton-Fukui, Natasha (June 27, 2011) "Moody's warns on deposit outflows for Greek banks". *Wall Street Journal*. Retrieved July 28, 2011 from: http://www.marketwatch.com/story/moodys-warns-on-deposit-outflows-for-greek-banks-2011-06-27

12 Georgiopoulos, George (June 23, 2011) "ECB funding to Greek banks rises 12.3 pct m/m in May". *Reuters*. Retrieved July 28, 2011 from: http://www.reuters.com/article/2011/06/23/greece-ecb-idUSATH00620520110623

13 Koutantou, Angeliki and Melander, Ingrid (July 25, 2011) "ECB funding to Greek banks rises 5.6 pct m/m in June". Reuters. Retrieved July 28, 2011 from: http://www.reuters.com/article/2011/07/25/greece-banks-ecb-idUSATH00628220110725

14 Davis, Andrew (July 12, 2011) "Plunge Brings Europe Debt Crisis to Italy". *Bloomberg*. Retrieved July 28, 2011 from: http://www.bloomberg.com/news/2011-07-11/italian-plunge-brings-debt-crisis-to-europe-s-biggest-borrower.html

15 Baker, Luke and Toyer, Julien (July 21, 2011) "Europe agrees sweeping new action on debt crisis". *Reuters*. Retrieved July 28, 2011 from: http://www.reuters.com/article/2011/07/21/us-eurozone-idUSTRE76I5X620110721

If depositors withdraw capital, those banks must sell some of those sovereign bonds to stay solvent. The EFSF provisions are there to provide the banks with the liquidity they need to survive deposit withdrawals. The question now is what will happen if the EFSF runs out of the funds to do so.

In our view, the depositors that chose to transfer their money out of their local Eurozone banks deserve some recognition, because they 'get it'. The EU banks are still the root of this problem, and depositors are right to question the security of their deposits held with them. We have always postulated that the real problem in our financial system is too much leverage in the banking system. We are continually reminded of this fact every Friday when US bank failures are released. When you compare the failed banks' assets to the cost the FDIC pays to make their depositors whole, it reveals how many times the banks have lost their equity capital. The key to remember here is that banks lend out our money and keep very little in reserve. If we assume they keep 5 cents of capital for every 95 cents they loan out – a 25% 'implied write-down' in Chart A would mean that the bank has effectively lost its capital six times over.

Chart A

Date	Bank	Total Assets	Total Deposits	Cost to the FDIC	Implied Write-down
22-Jul-11	Bank of Choice, Greeley Colorado	$1.07 billion	$924.9 million	$213.6 million	20%
22-Jul-11	Landmark Bank of Florida, Sarasota Florida	$275 million	$246.7 million	$34.4 million	13%
08-Jul-11	Signature Bank, Windsor, Colorado	$66.7 million	$64.5 million	$22.3 million	33%
08-Jul-11	Colorado Capital Bank, Castle Rock, Colorado	$717.5 million	$672.8 million	$283.8 million	40%
08-Jul-11	First Chicago Bank & Trust, Chicago, Illinois	$959.3 million	$887.5 million	$284.3 million	30%

Source: www.fdic.gov

The banking situation in Europe is no different from that above – EU banks are also highly levered, but their situation is further complicated by the fact that what was once the most liquid and secure loan on European banks' balance sheets – sovereign debt – is no longer liquid and secure. This makes EU banks extremely vulnerable to deposit withdrawals as it forces them to approach the ECB for help to maintain liquidity. There is only so much the ECB can do – if a true 'liquidity event' takes place, we can all rest assured that there will be no buyers of distressed assets in the sizes that European banks hold today, sovereign bonds, or not.

We discuss the EU banking crisis this month to remind everyone that we have very recently lived through two instances where the entire financial system almost collapsed. The first took place during the height of the 2008 crash. The second transpired in May 2010 when the ECB stepped in with its $1 trillion bailout package to avert disaster. All financial bailouts up to this point have been instigated with a desire to avert the first domino from falling. They have been instituted to avert contagion – a total financial meltdown that would effectively turn the global banking system into an Icelandic money trap – where no money can get in, or out.

We still don't know if a financial collapse can be averted in Europe because investors and depositors are not all naïve to reality. The financial malfunction is ongoing and will not be prevented through these continual perverse financial machinations. If Eurozone depositors move their capital – more bailouts will be required, thereby increasing the sovereign debt levels and exacerbating the seemingly hopeless situation that much more.

As the questionnaire above suggests, we believe a growing number of European depositors are transferring their money out of EU banks, and many of them are reinvesting their capital into gold and silver for safety. It does not surprise us to see gold hitting all-time highs in euros and dollars. It's worthwhile to acknowledge that those investors in Iceland and Ireland who had the foresight to convert their cash to gold before their countries' respective bank runs have all fared extremely well in both nominal and real terms. We believe that gold and silver are the ultimate alternative for a chequing account in a vulnerable banking jurisdiction, and whether the ECB prints more euros or eventually defaults, both outcomes will continue to support a robust demand for precious metals as an alternative currency.

Sprott at a Glance

With a history going back to 1981, Sprott Inc. offers a collection of investment managers, united by one common goal: delivering superior long-term returns to our investors. Sprott has a team of best-in-class portfolio managers, market strategists, technical experts and analysts that is widely-recognized for its investment expertise, performance results and unique investment approach. Our Investment Team relentlessly pursues a deeper level of knowledge and understanding which allows it to develop unique macroeconomic and company insights. Our team-based approach allows us to uncover the most attractive investment opportunities for our investors. When an emerging investment opportunity is identified, we invest decisively and with conviction. We also co-invest our own capital to align our interests with our investors.

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The company currently operates through four distinct business units: Sprott Asset Management LP, Sprott Private Wealth LP, Sprott Consulting LP and Sprott U.S. Holdings Inc.

Sprott Asset Management LP is the investment manager of the Sprott family of mutual funds, hedge funds and discretionary managed accounts. Sprott Asset Management offers a Best-in-Class Investment Team led by Eric Sprott, world renowned money manager. The firm manages diverse mandates united by the same goal: delivering superior returns to investors. Our team of investment professionals employs an opportunistic, high conviction and team-based approach, focusing on undervalued securities with the greatest return potential.

For more information, please visit ***www.sprott.com***

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