[Bank versus Brokerage]

“You have heard of bank bailouts, because banks fail regularly. But you have never heard of a brokerage bailout, because brokerages don’t fail.”

The next question becomes: Where do I put my assets?

You have 3 choices:
1. Commercial Bank (ie- Citibank)
2. Investment Bank (ie- Goldman Sachs)
3. Brokerage (ie- Schwab)

All of these institutions are a combination of a brokerage firm and a bank. The question is what percentage? Because the banking operation is inherently risky (which is why it is regulated by the US government) and can lead to a bankruptcy of the overall entity. The larger the banking operation, the more at risk the overall firm is.

Why are banks risky?

Commercial banks will hold your cash and then lend it out to others. The bank gets all of the upside of these loans and you bear all of the risk. If the economy tanks and the loans go bad en masse, then the bank fails and (barring a federal intervention) all of your assets go to pay off the creditors of the bank itself. Holding your money in a commercial bank (above the FDIC insured $250,000 per account holder) is a terrible idea.

Investment banks are similar to commercial banks in that they will use your money to generate profits on their own account. The only difference is that investment banks are not restricted to loans. They can make any kind of bet or investment with your assets. The bank receives all of the upside, while you bear all of the risk. Again, a terrible idea to hold your money at an investment bank.

Almost all commercial and investment banks do have a brokerage arm. If you hold securities there, the firm cannot lend out these assets unless you sign a margin agreement. A margin agreement allows you to receive a margin loan. In that agreement, you also give the brokerage permission to loan at your securities. However, if you never sign a margin agreement, the brokerage is not allowed to loan out your securities. Most investment and commercial banks with a brokerage account also provide a relationship manager who is highly incented to get you to sign a margin agreement.

Some people feel that the largest few commercial and investment banks in the US, if they failed, would cause a catastrophic failure to the US economy, and therefore the US government will not allow them to fail. These institutions are "too big to fail". If the investments made by these institutions go bad, the thinking is that the US government will step in a pay back all depositors 100%, as happened to the largest banks in the 2008 crisis. Therefore some feel that with this implied US government guarantee, it is safe to hold assets at the biggest institutions (JPMorganChase, Goldman Sachs, Morgan Stanley, etc).

There is some logic to this. But it is faulty logic.

Banks do provide services (wire transfer, bill pay, ATMs) that make it convenient to hold working capital (the amount of money needed to operate the business, or your personal life for 90 days) at a bank. But beyond that amount, you want to keep your additional assets at an institution that is inherently stable and does not require the US government to bail them out.

And that is a company that is primarily a brokerage firm. (ie- Schwab, Fidelity, Brex).

These firms do not try to get each of their depositors to sign a margin agreement. (And please DO NOT ever sign a margin agreement.) And therefore the vast majority of securities held there are not loanable. If you don't sign a margin agreement, whatever assets you place at a brokerage firm remain in your name, are only invested in the way that you direct, and you remain the sole beneficiary.

That being said, a brokerage firm is still a business and can go bankrupt if its expenses exceed its revenues for a long period of time (though this is much less likely than at a bank that is almost sure to go bankrupt in a sharp economic downturn). In that case, your assets do get tied up in bankruptcy court, with one exception: US Treasuries. US Treasuries are never held in custody. They are always held for the beneficial owner. If the brokerage firm were to go bankrupt, your US Treasury certificates would be sent directly to you, and not held by the bankruptcy court.

So, start by placing your liquid assets (above your working capital needs which are fine to leave at bank) in a brokerage firm. Then invest all of the cash into US Treasuries while you decide on your investment strategy.