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The SVB collapse: what it means for Indian equity markets and the banking sector

By Himadri Buch & Ami Shah Mar 15, 2023, 04:30 AM IST

Media interviews a Silicon Valley Bank customer outside of the bank office on March 13, 2023

Synopsis

Experts believe the SVB downfall will not have a major impact on Indian markets. They feel, while there will be short-term volatility, the overall pain will be limited. However, banking crises are becoming more of a feature than a bug in the greater financial system. Should one blame the irrational exuberance of bank CEOs or the apathy of banking regulators?

On February 23, the Byrne Hobart newsletter informed its readers that the Silicon Valley Bank (SVB) was insolvent and levered at 185:1. The bank was planning to raise cash, and that raised alarms. Customers rushed to withdraw their deposits amounting to USD175 billion, which lead to a ripple effect on financial markets across the world.

The US Federal Reserve, which has been on a war footing to tame inflation, will now have to relook at its strategy of hiking interest rates at such a fast pace.

The contagion effect

Over the last five days (since March 7) JP Morgan is down 8%, Citigroup plunged 14% and Wells Fargo has fallen 17%. The S&P 500 is down 5%. Banking stocks, which account for 25% of the Nifty 50, are also down 4%; the Nifty Bank Index has slid 5%, whereas SBI, which has the highest weight in the index, has plummeted 6%.

Indian markets are dependent on foreign money and there is a strong correlation between the US yield curves. Even equity markets follow the US markets, especially during times of distress. While the US regulator is doing its best to avoid a contagion effect, investors in India feel this will lead to some serious volatility.

"Collapse of SVB will definitely compound the negative sentiment prevailing in the Indian equity market. Indian markets have been overvalued due to infusion of domestic liquidity," says Sandeep Bagla, CEO, Trust MF.

"It certainly was not justified for the bank to have such an asset-liability mismatch. It was the basic violation of Banking 101. They had a lot of short-term funds which were deployed in long-duration securities, mainly because they were chasing yields at a time when yields were close to zero."

— Devina Mehra, CMD, First Global

Indian companies that have deposits in SVB or similar banks would have to suffer temporarily as the money might get stuck, he adds. "Luckily our banking system is well regulated, and it is likely to have a limited effect on the Indian banking system. However, as SVB was primarily a major banker for startups in the US, the startup ecosystem in India is also likely to be impacted adversely," says Jyoti Prakash Gadia, managing director at Resurgent India, an investment banking firm.

According to a Jefferies report, the SVB bank runs an NBFC in India known as SVB India Finance, which was sold to Temasek and United Overseas Bank in 2015. It is engaged in venture debt lending and has stable liquidity. Jefferies feels this is unlikely to be a systemic risk in India.

Experts, ET Prime spoke to, are confident that the crisis will not have any big effect on Indian markets. While there will be short-term volatility which will affect prices in India, the overall pain will be limited.

"There should not be a direct impact on markets as the issue has now been contained with the US regulators ensuring that all depositors for SVB, as well as other banks, are covered in full wherever there is erosion in the bond and securities portfolio because of interest rate changes. This doesn't cover credit-related issues but that doesn't appear to be the problem, at least as of now," says Devina Mehra, chairperson and managing director, First Global.

She further adds that the event may have an indirect impact on markets if it changes the Fed's stance on rate hikes and tightening. The market has moved very rapidly on that with two-year yields down 75 basis points (0.75%) in a matter of three days, which is higher than even what happened during Black Monday in 1987. Now, several Wall Street firms are assuming that the Fed will not increase rates this week at all. The terminal rate -- the rate at which the Fed will stop hiking -- has fallen by 0.6%-0.7%.

"My personal view is -- this is a little overdone as the Fed cannot signal it has completely taken its eye off the inflation ball. Especially, as labour markets have been extremely tight," Mehra adds.

So, what really happened at SVB?

The devil is in the details

The Byre Hobart newsletter said that since assets were not marked-to-market, SVB could hold them as long as it has deposits. The bank did have deposits initially – from startups or other matured tech companies in the US market. These companies had raised a lot of money in the post-pandemic boom either through venture capital or IPOs. Between 2021 and 2022 beginning, US banks had either invested in debt securities or kept some part of the money in cash. According to Netinterest.co, the securities portfolio ballooned to USD6.26 trillion, up from USD3.98 trillion at the end of 2019 and cash balances went up to USD3.38 trillion from USD1.67 trillion in 2019. This was all good till startups were raising money. But in the latter half of 2022, funding activities and IPOs dried up. At the same time, startups started to burn cash. Some even wanted to move funds to the money market mutual funds. To obtain liquidity, SBV had to sell some of its held-to-maturity portfolio and book losses.

While nobody expected a bank run on the Silicon Valley Bank, this is what precisely happened. Around USD42 billion in deposits flowed out of SVB in two days -- 25% of the total deposits simply evaporated.

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Banking in the US market is less regulated than India or even Europe. This leads to CEOs taking risks on interest rates or credit quality only to chase high yields. When things turn, it leads to a catastrophe, which is just not limited to the financial markets.

"Regulating banks like utilities could help prevent the kind of reckless behaviour and risk taking that led to the 2008 crisis and the current SVB bailout. Taxpayers' money is used in the bailout, and they don't have any share in the profits. They should look at the best interest of the society than maximise profits for shareholders," says Anish Teli, managing partner, QED Capital.

Now Peter Theil, the billionaire-investor accused of influencing others to withdraw their deposits from the bank, allegedly sent first emails or messages to pull out money from SVB. That was more than enough for someone to go to Twitter and talk about it. There was a fire on the mountain -- run, run run!

Impact on banking sector

The current collapse is the second biggest in the US banking history. On Friday, financial regulators decided to shut down the bank and took control of deposits. Interestingly, one more bank, Signature Bank, went down.

So, why is it that sophisticated banks go down even now when they have access to forecasting and information and can plan their asset-liabilities more carefully?

Experts believe, in this case the Fed is also to be blamed. While interest rates increased fast, banks have not been able to adjust to the change where funding costs or deposit rates are also high. There is an inverted yield curve and bankers are now blaming the Fed for the same.

The trouble with interest rate is that when they start to go up, they hit bank assets the most. For SVB, unrealised losses through long-term debt, which was held to maturity, went up to touch USD16 billion in September 2022 as compared to profits a year ago. The short-term book, which was available for sale (AFS), was much smaller and not hit so badly. According to Netinterest.co, SVB was technically insolvent at the end of September 2022. "Its USD15.9 billion of HTM mark-to-market losses completely subsumed the USD11.8 billion of tangible common equity that supported the bank's balance sheet," Marc Rubinstein writes in Netinterest.co. Rubinstein is a former hedge fund manager, and the author of a weekly finance newsletter Net Interest.

The bank moving much of its assets to HTM also meant that hedging was not an option anymore, writes Michael Green in his newsletter. Green is the chief strategist and portfolio manager at Simplify Asset Management. But at the same time nobody really expected interest rates to move up, or for that matter mortgage rates to go to 5%. For over a decade, no bank executive has dealt with such kind of situation where interest rates were on a rise for so long.

The CEO of SVB, Greg Becker, an avid cyclist, was like any other CEO. He believed the deposit money is here to stay. This is despite the industry having faced a dot-com boom in 2000 where many clients asked for their money rather quickly when deposits fell from USD4.5 billion to USD3.4 billion within a few months in early 2001. This time, deposits fell from USD198 billion at the end of March 2022 to USD165 billion by February 2023-end. Out of the total USD173 billion deposits, USD152 billion are uninsured.

"It certainly was not justified for the bank to have such an asset-liability mismatch. It was the basic violation of Banking 101. They had a lot of short-term funds which were deployed in long-duration securities, mainly because they were chasing yields at a time when yields were close to zero. Also, there was a concentration risk with most of the deposits coming from VC-funded startups and crypto companies. Also, there was not a recognition of the fact that even though company accounts were separate, many of them were effectively controlled by a handful of VC firms. The book was a lot more concentrated than it appeared," Mehra says.

Banking crises are becoming more of a feature than a bug in the greater financial system. It is either due to the irrational exuberance of CEOs or the insensitivity of the banking regulator. It has happened in the past. It will happen in the future. It hurts financial markets – sometimes even for the long term.