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Devina Mehra: Why investing in a bank often takes nerves of steel

Devina Mehra | 18 June 2025

Risk blindness and failure of imagination are the biggest issues in banking risk management. **(Bloomberg)**

SUMMARY

Banking is an inherently risky business which has more that can go against it than an external investor can make out from information available in the public domain. Nasty surprises in this sector invariably outweigh pleasant ones.

To those who ask me why my *takiya kalam* is “I am a nervous investor in banks and lenders," here’s the answer. My refrain has nothing to do with poor quality bank management or anything of that kind. It’s just that the structure of banking differs inherently from that of most other businesses.

One, it is in the nature of this business for negative surprises to outnumber positive surprises. The most recent being losses in the currency derivatives of a private sector bank that came to light a couple of months ago, with the result that its share price has halved from its highs even as the Nifty bank index has been doing very well.

Even on the lending side, when bank borrowers do very well, unlike equity investors, lenders do not get any extra income. However, when something goes wrong with a borrower, its lender has to take a hit.

So, where can the positive surprises come from? Credit growth? Unfortunately, higher-than-expected growth may not be a good thing at all for banks because problems in a lending book show up only some years later.

The financial crisis of 2008-09, for instance, was triggered by a hit on the home mortgage business of US banks where reckless lending resulted in way higher-than-expected defaults.

On the other hand, if a bank management remains conservative through a credit boom, it gets penalized for not growing as fast as the competition. As the then CEO of Citigroup Chuck Prince said in the context of the 2008 crisis: “When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you’ve got to get up and dance."

Two, while many banking crises start with too much poor lending, this is not always the case. Silicon Valley Bank (SVB), which was tottering at the edge of collapse in early 2024 till it was bailed out by the US Fed, had actually lent out too little. Assets on a bank's balance sheet are not just credit or loans. They also include investments like bonds. In SVB's case, it had channelled most of its deposits into such investments.

There was also a considerable asset-liability mismatch (ALM). What this complicated-sounding term means is that while the bank had deposits that were short-term in nature, its assets were long-duration securities. All banks do this to an extent, but in the case of SVB, it was pronounced. The result: it suddenly had losses when interest rates went up and that too in illiquid assets.

Three, why do problems on the asset side, whether in lending or investing, go out of hand for banks? This is because a bank is inherently a leveraged institution—it has a balance sheet typically 8 to 10 times that of its equity capital. Simplifying a bit, for every ₹10 of equity put in or retained by equity holders, the bank lends out or buys investments of ₹80-100. Even if ₹5 of the bank's lending goes bad, this is 40-50% of its capital.

For similar reasons, a leveraged trading or investment bet can deal a fatal blow to a bank's balance sheet. After all, a single trader took down the 200-plus year-old Barings Bank in 1995.

As an outside investor, you never know where problems are hiding in either the credit or trading book of a bank. There is no way to take a really informed bet when investing in a bank. It is mostly a blind wager that the management is doing what it is supposed to.

The really interesting part? Banking is the ultimate confidence game.

I remember my mother explaining a bank run to me when I was in school (for context, she's a postgraduate in economics): while a bank promises to give you the money you have deposited on demand, in reality no bank can pay back its depositors all at once. The money given by depositors is tied up elsewhere and is not really available with the bank to be returned on the spot.

Even the most solid bank in the world will collapse if all or most of its depositors line up at its door asking for their money back. That is why banking regulators move so swiftly anytime there is even a hint of a loss of confidence in a bank. And, as we have seen multiple times in India, when there are rumours of a bank being in trouble, a shotgun marriage in the form of merger is often arranged with a stronger bank. This protects the weak bank's depositors but usually not its shareholders.

Further, lessons from history in finance are easily forgotten and institutional memory is notoriously short.

As a friend who was working for a major international bank that largely side-stepped the global financial crisis of 2008-09 told me, mostly what saved the bank was the memory of one of the senior management team members who vividly recalled the Asian crisis of a decade ago, when he was barricaded all night in the bank's branch in an Asian capital while people screamed for the heads of bankers outside. That reminded him—and hence the bank—of how bad things could get. Else, risk blindness and failure of imagination are the biggest issues in banking risk management.

Ironically, I am writing this at a time when I am probably the most positive I have been—at least in the last three years—on Indian banking stocks as an investment. But this piece is about the framework of banking as a business.

Disclosure: I was a banker once upon a time.

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