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LESSONS LEARNT: ON THE SILICON VALLEY BANK EPISODE

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Banking, NPAs and RBI

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A faltering bank, this time on the U.S. West Coast, sparked a déjà vu moment across global markets last week as fears of a Lehman redux triggered sharp declines in banking stocks worldwide and saw investors make a beeline for safe haven assets such as gold. However, over the course of four days from Friday, regulators in the world's largest economy acted with alacrity to bolster public confidence in the banking system. The Federal Deposit Insurance Corporation (FDIC) first took over the Silicon Valley Bank in California, and on Sunday took control of New York-based Signature Bank and in concert with the Federal Reserve and the Treasury Department announced that depositors in both the banks would be repaid in full. Shareholders of the two banks would, however, not be protected, regulators said. On Monday, U.S. President Joe Biden sought to reassure the nation and global markets that the U.S. was committed to maintaining a resilient banking system, and would move to simultaneously tighten regulations for banks to make it less likely for such failures to occur again. While the coordinated steps have, at least for now, restored a degree of calm in most markets, there are lessons that have been learnt and others that could, perhaps, be gleaned over time.

Silicon Valley Bank's case is fairly unique. With the depositor base comprising start-ups and venture capitalists, mostly from the tech hub of Silicon Valley, the customers were geographically and sectorally concentrated. The bank had also invested extensively in a portfolio of U.S. Treasuries and mortgage bonds, which had as a result of the recent sharp interest rate increases by an inflation-battling central bank accumulated unrealised losses that became too costly to liquidate in a distress situation. Signature, on the other hand, had exposed itself to highly volatile cryptocurrencies by providing services to those investing in digital assets. That, along with a run on deposits, ultimately proved to be its undoing. Blaming the Fed's monetary tightening as the proximate cause for the bank failures is a case of being unable to see the wood for the trees. Interest rates move in cycles and all banking is fundamentally predicated on managing the risks associated with interest rate moves as well as ensuring that the deposits banks accept to fund lending are always reasonably matched with income or holdings that could be used to meet withdrawals. The Reserve Bank of India's guidelines of 2018 advising banks to create an Investment Fluctuation Reserve is just the kind of countercyclical tool that has relatively insulated Indian lenders from interest rate risks. Still, the RBI must remain on guard to ensure neither global contagion nor management missteps threaten any local lender.

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