Our Views

SVB saga reminds that there are no free lunches.

Just when we thought that the debate on 'hard landing' of the US economy was getting settled, things have started looking much harder than expected over the weekend. Someone very quickly pointed out "this had to happen – a steep rise in the interest rates with squeezing liquidity had to impact the credit markets and an accident was imminent." In the hindsight, it sounds so logical. Banks, being at the dead centre of all economic engineering, have always been vulnerable. The current situation with Silicon Valley Bank (SVB), popularly known as 'Start-ups bank', is a repeat of the same movie where credit market turns illiquid.

When liquidity is in abundance, one can afford to risk an assets-liability mismatch and invest in higher yielding long dated assets. However, when the liquidity dries out the same long dated assets, whether credit book or treasury bonds, start hurting. The scenario in 2008 was the same, albeit that time it was mortgage security which became illiquid, this time it is treasury or other long duration bonds which are not very liquid. Thankfully, this time it is not as much of a credit quality issue, at least thus far. Ultimately, it is a liquidity event which is causing the stress. Of course, it is accentuated by mark to market losses on the bonds portfolio due to rising interest rates.

So, what triggered the perceived 'hard landing' to a harder landing. I think it is the statement by the Fed Chair in his testimony to Congress last week that "the ultimate level of interest rates is likely to be higher than previously anticipated" and "restoring price stability will probably require that we maintain a restrictive stance for some time." This statement was quite in contrast to his earlier statement wherein he mentioned "We can now say for the first time, the disinflationary process has started." I would say that the market saw the tough side of Fed this time and accordingly reacted adversely. This tightened the credit markets further which had been under pressure post the increase in the interest rates by approximately 450bps since March 2022. Overall, the liquidity dried up and with reduced funding to startups, they started withdrawing their deposits.

In such a situation, the most important part is to contain the contagion. In India, when Global Trust Bank (GTB) went through a similar liquidity crisis in 2004, the Reserve Bank of India had moved swiftly over the weekend to announce the merger of GTB with Oriental Bank of Commerce (OBC). This had helped arrest the spiral effect of GTB's fall. The Indian regulators and the policy makers have handled many other such situations like Yes Bank and Satyam with significant maturity to prevent a larger or widespread issue. We must hope that the US policy makers avoid any collateral damage by handling the SVB situation as they had handled AIG, Freddie Mac and Fannie Mae; and not the way Lehman Brothers was handled.

The events over the weekend will require Fed to go back to the drawing board to re-assess the liquidity risk in the market. Given the steep rise in interest rates, most banks will be carrying losses in the HTM portfolio which is otherwise not marked to market. In such a time, further tightening of liquidity will have a dual pressure on the system.

On the question of how will the SVB saga impact India? In a globalised world, a positive or a negative financial event in any known corner of the globe has a ripple effect. There is nothing like 'decoupled' anymore, and India is no exception. Any larger contagion effect will impact our markets as well. The extent of impact, minor or severe, could be assessed from 3 different perspectives. First, in terms of a direct implication from banking with SVB, there aren't likely too many Indian startups having a direct banking relationship with SVB, a handful of them have some deposits. Second, in terms of impact on funding through venture funds/ private capital (PE/ VCs), given that SVB was a banker to many PE/ VCs, there could be likely slowdown in such funding activities. Finally, the larger impact could be more indirect including a cascading effect on other banks and corporates, a negative sentiment and turn in the markets, or a further tightening of the Indian liquidity situation.

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Interestingly, most such situations of financial failures develop unexpectedly fast. Just a few weeks back, SVB had received the best bank award and most of the leading brokers had a BUY on it with a target price higher than the then prevalent market price. One may even recollect that until the controlling shareholder of Satyam wrote the famous line “It was like riding a tiger not knowing how to get off without being eaten” on January 8, 2009, the company had received several awards for Corporate Governance. There is a need to figure out an early warning mechanism as once things go out of control, the collateral damage is serious.

In such times, we often take a leaf out of our scriptures and draw learnings. As lord Krishna says in the Gita, every extremity culminates into a fall, calibrated or otherwise! But then, the law gets re-established, and a new order is set. Just that the fall is indeed painful for everyone!

Sunil Sanghai
Founder & CEO
NovaaOne Capital Pvt. Ltd

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