Silicon Valley Bank collapse: How safe are Indian banks

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Why is in news? When Silicon Valley Bank (SVB) and Signature Bank of the United States collapsed last week, Indian banks remained unaffected despite the global interconnectedness in the financial sector.

Silicon valley bank collapse

Silicon valley bank is a regional bank based out of California and it was the sixteenth largest bank in the US before the crash.

The bank was a trendsetter as it was one of the early banks to focus on funding start-ups and venture capitalists. This segment formed a big part of its loan portfolio -- in December 2022, 56 per cent of its loans were to VCs and PEs secured by their limited partners.

During the period of near-zero interest rates, SVB invested billions of dollars on US government bonds. What appeared to be a safe investment quickly unravelled as the Federal Reserve aggressively raised interest rates to combat inflation.

Bond prices decline when interest rates rise, hence the rate increase undermined the value of SVB's bond holdings. According to Reuters, the portfolio was yielding an average of 1.79% last week, well below the 10-year Treasury yield of roughly 3.9%

At the same time, the Fed's rate hikes increased borrowing costs, forcing tech businesses to devote more funds to debt repayment. At the same time, they were having difficulty raising new venture capital money. Companies were forced to use SVB deposits to fund operations and growth

Customers of SVB were withdrawing their deposits beyond what it could pay using its cash reserves, and so to help meet its obligations the bank decided to sell $21 billion of its securities portfolio at a loss of $1.8 billion. The drain on equity capital led the lender to try to raise over $2 billion in new capital.

The call to raise equity sent shockwaves to SVB's customers, who were losing confidence in the bank and rushed to withdraw cash. A bank run like this can cause even a healthy bank to go bankrupt in a matter days, especially now in the digital age.

Signature faced a similar problem, as SVB's collapse prompted many of its customers to withdraw their deposits out of a similar concern over liquidity risk. About 90% of its deposits were uninsured.

The resilience of Indian banks

When the global financial crisis, triggered by the Lehman collapse, roiled the banking system across the world in 2008, India remained a safe haven with domestic banks showing strength and resilience on the back of sound and stringent regulatory practices.

The reasons for SVB's failure are unlikely to play out in India as domestic banks have a different kind of balance sheet structure. In India, we don't have a system where deposits are withdrawn in such a bulk quantity

Unlike in the US, where a large portion of bank deposits are from corporates, household savings constitute a major part of bank deposits in India.

Today, a large part of deposits is with public sector banks and the remaining deposits are with very strong private sector lenders like HDFC Bank, ICICI Bank and Axis Bank. So, there is no need for customers to worry about their savings

In India, the approach of the regulator has generally been that the depositors' money should be protected at any cost. The finest example is the rescue of Yes Bank where a lot of liquidity support was provided

The SVB issue, however, created nervousness in the stock markets with bank shares taking a hit and investors losing money in the process.

On September 30, 2008, when the global financial crisis was at its peak, then finance minister P Chidambaram and regulators SEBI and the RBI stepped in to soothe financial markets after the benchmark Sensex plunged 3.5 per cent to its lowest levels in two years and panic gripped ICICI Bank customers, who queued up outside ATMs in certain cities to withdraw deposits. Their assurances helped, and the market closed 2.1 per cent up.

In a rare statement, the RBI said the country's largest private bank was safe and had enough liquidity in its current account with the central bank to meet depositors' requirements. "The RBI has arranged to provide adequate cash to ICICI Bank to meet the demands of its customers at its branches and ATMs," the central bank said on safety of individual banks.

About G-SIBs

Basel-based Financial Stability Board (FSB), an initiative of G20 nations, in consultation with Basel Committee on Banking Supervision (BCBS) and national authorities, identified the list of global systemically important banks (G-SIBs). There are 30 G-SIBs as of now.

They include JP Morgan, Citibank, HSBC, Bank of America, Bank of China, Barclays, BNP Paribas, Deutsche Bank and Goldman Sachs. However, no Indian bank figures in the G-SIB list.

About D-SIBs

Learning from the experience of the global crisis, the Reserve Bank issued a framework for dealing with D-SIBs on July 22, 2014.

The D-SIB framework requires the Reserve Bank to disclose the names of banks designated as D-SIBs starting from 2015 and place these banks in appropriate buckets depending upon their Systemic Importance Scores (SISs).

The banks will be selected for computation of systemic importance based on the analysis of their size (based on Basel III Leverage Ratio Exposure Measure) as a percentage of GDP. Banks having a size beyond 2% of GDP will be selected in the sample.

The RBI has classified State Bank of India, ICICI Bank and HDFC Bank as D-SIBs. The additional Common Equity Tier 1 (CET1) requirement for D-SIBs was phased-in from April 1, 2016, and became fully effective from April 1, 2019.

The additional CET1 requirement will be in addition to the capital conservation buffer. This means these banks will have to earmark additional capital and provisions to safeguard their operations.

As per the RBI's process, D-SIBs would be segregated into different buckets based on their systemic importance scores, and subject to loss absorbency capital surcharge in a graded manner depending on the buckets in which they are placed.

A D-SIB in the lower bucket will attract lower capital charge and a D-SIB in the higher bucket will attract higher capital charge.

Depending on the bucket in which a D-SIB is placed, an additional common equity requirement has to be applied to it.

Based on data collected from banks, as on March 31, 2017, HDFC Bank was also classified as a D-SIB, along with SBI and ICICI Bank. The current update is based on the data collected from banks as on March 31, 2022.

Rationale behind creation of D-SIBs

The financial system has global linkages. During the 2008 crisis, the problems faced by certain large and highly interconnected financial institutions hampered the orderly functioning of the financial system, which in turn, negatively impacted the real economy.

Government intervention was considered necessary to ensure financial stability in many jurisdictions.

The cost of public sector intervention and consequential increase in moral hazard required that future regulatory policies should aim at reducing the probability of failure of SIBs and the impact of the failure of these banks, according to the RBI.

In October 2010, FSB recommended that all member countries needed to have in place a framework to reduce risks attributable to Systemically Important Financial Institutions (SIFIs) in their jurisdictions.

SIBs are perceived as banks that are 'Too Big to Fail (TBTF)'. This perception of TBTF creates an expectation of government support for these banks at the time of distress. Due to this perception, these banks enjoy certain advantages in the funding markets.

However, the perceived expectation of government support amplifies risk-taking, reduces market discipline, creates competitive distortions, and increases the probability of distress in the future.

These considerations require that SIBs should be subjected to additional policy measures to deal with the systemic risks and moral hazard issues posed by them, says the RBI note on D-SIBs.

While Basel-III Norms have prescribed a capital adequacy ratio (CAR) – the bank's ratio of capital to risk — of 8 per cent, in India, the RBI has gone one step ahead and mandated the CAR for scheduled commercial banks to be 9 per cent and for public sector banks 12 per cent.

Selection process of D-SIBS

The RBI's assessment of systemic importance of banks is a two-step process. In the first step, a sample of banks to be assessed for their systemic importance will be decided.

All the banks are not considered as many smaller banks would be of lower systemic importance and burdening these banks with onerous data requirements on a regular basis may not be prudent.

Once the sample of banks is selected, a detailed study to compute their systemic importance is initiated. Based on a range of indicators, a composite score of systemic importance for each bank in the sample will be computed.

The banks having systemic importance above a threshold will be designated as D-SIBs

Importance of D-SIBS as precautions

The failure of a large bank anywhere can have a contagion effect across the world.

The impairment or failure of a bank will more likely damage the domestic economy if its activities constitute a significantly large share of domestic banking activities.

Therefore, there is a greater chance that impairment or failure of a larger bank would cause greater damage to the financial system and domestic real economy.

The impairment or failure of a bank with large size is also more likely to damage confidence in the banking system as a whole.

Size is a more important measure of systemic importance than any other indicators, and therefore, size indicators will be assigned more weight than the other indicators

Impairment or failure of one bank may have the potential to increase the probability of impairment or failure of other banks if there is a high degree of interconnectedness (contractual obligations) with other banks. This chain effect operates on both sides of the balance sheet. There may be interconnections on the funding side as well as on the asset side of the balance sheet.

The larger the number of linkages and size of individual exposures, the greater is the potential for the systemic risk getting magnified, which can lead to nervousness in the financial sector.

The greater the role of a bank as a service provider in underlying market infrastructure like payment systems, the larger the disruption it is likely to cause in terms of availability and range of services and infrastructure liquidity following its failure.

Also, the costs to be borne by the customers of a failed bank to seek the same service at another bank would be much higher if the failed bank had a greater market share in providing that particular service