Banks in crisis

It is the banks all over again. In an all-too familiar and discomforting deja vu, the global markets were jolted by a failure in three US institutions and then the big one - Credit Suisse, an iconic European behemoth, went kaput.

Is this another Global Financial Crisis (GFC)?

What does it mean for India?

On the former, this is not another GFC though the same need not bring a lot of cheer to equity investors. It is not a GFC of the 2008 variety because the system is not anywhere close to being frozen as it was then. If this is of some comfort, the system is better regulated now and there are learnings that are coming in handy. In the US, the banks that fell were smaller regional actors. The big US banks are better placed from a systemic perspective. Broadly, there is no serious problem of asset impairment there. They are a shadow of what they used to be, but they are capable of chugging along. Credit Suisse has been tottering for a while. Some would argue that the institution which has survived two world wars and many a banking crisis was doomed for failure due to many missteps. The takeaways from the above are not about whether we have an emergency at hand - we don't have one in all probability.

The GFC was about impairment in assets. The assets melted down and given that the banks are all about gearing, the capital got eroded. This time around, the primary problem seems to be about liabilities. The spectre of bank runs, which has agitated policymakers from the day banking started, is staring at us. And it emanates from the loss of confidence or trust. The dictum that bank runs can become self-fulfilling prophecies is at work. That said, the banks failures are only external manifestations or symptoms of the corner the world has steered itself into. This is not about banks alone though they emerged as the conduit through which excessive risk taking was funnelled fuelling an asset inflation of mammoth proportion.

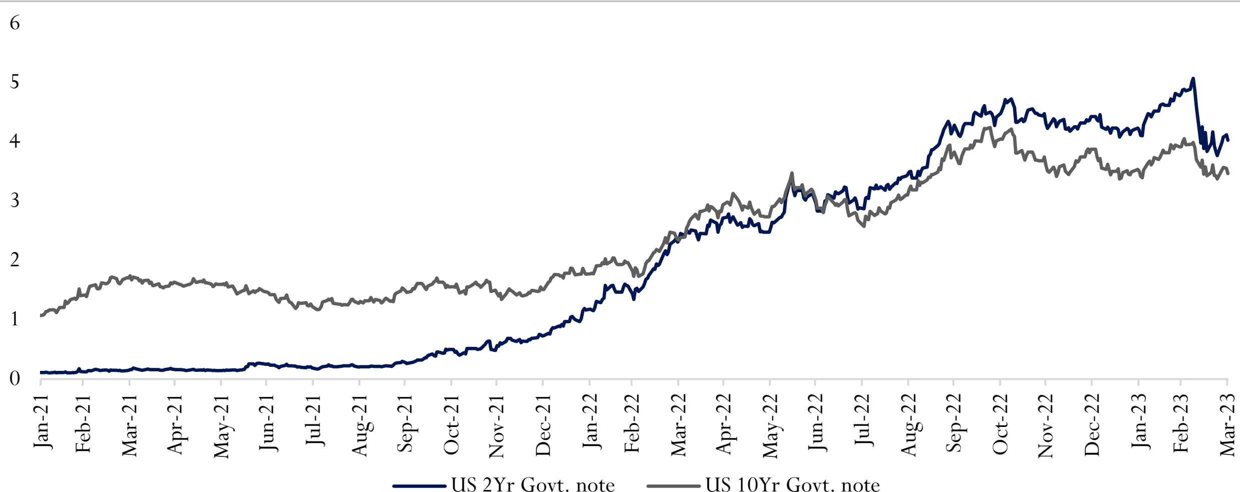
In a broader sense, it is increasingly about the spot at which the world economy finds itself in - which is between several rocks and many hard places. Some observations:

1. The institutions that hold the world economy together are not able to command the respect of the markets. The Fed is hardly able to do the balancing act which it was willy-nilly pre-committed to perform.

2. The Fed is indicating that the interest rates would remain higher for longer. However, the inverted yield curve in the US tells us the opposite suggestive of a recession.

3. If the market expects interest rates to moderate, the conventional wisdom will dictate that the rate sensitives should benefit. But the shares of tech companies that never borrow are trying to start a party. In other words, it is the asset prices that are tending to be more sensitive to interest rates than the real economy. That those assets will become even more over-valued if the economy slows down is something that the markets do not seem to care about.

Of course, the last word is not yet out on anything. The extent of confusion and if we may use the word dysfunctionality, is all too apparent. The world at large is not looking good.

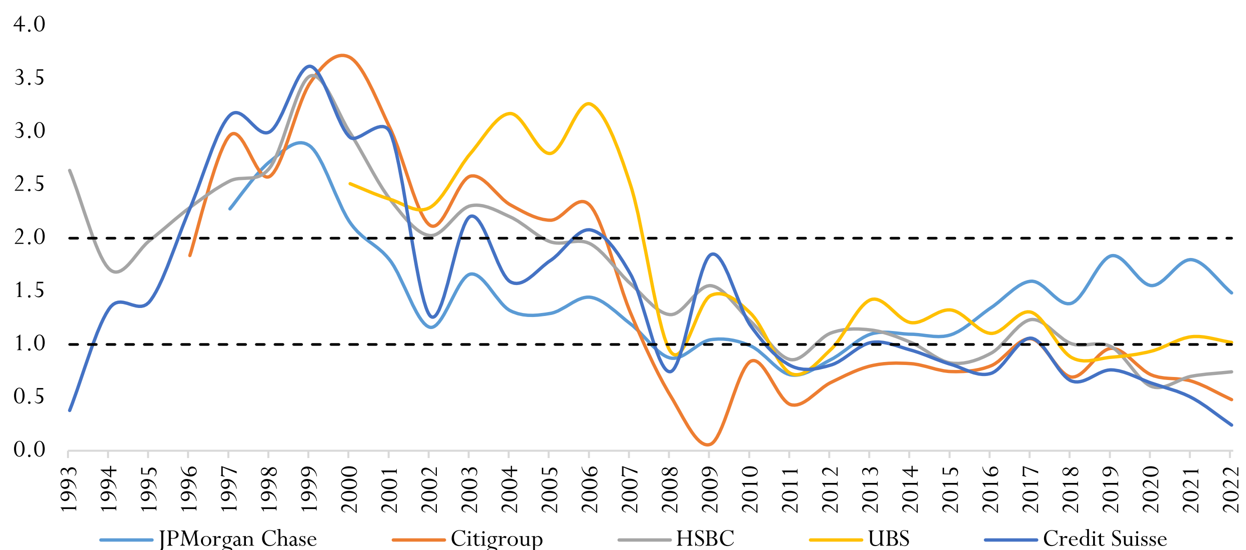


Source: Bloomberg, Spark Fund Research

The yield curve inverted last year and almost every time this happened, a recession followed. A recession is not good for earnings and the market reaction in 2022 was indicative of that. So far, so good. However, it appears that the notion that the Fed must loosen a lot after tightening is entrenched in the muscle memory of traders/institutions, so much so that their hands are pressing the Buy button at every turn. They want to be latching on to any excuse to justify higher asset prices without regard to the fact that the disease of imbalances is far from being cured. They also seem to forget that the Fed Put is dead. The banking crisis is a manifestation of this underlying heady mix of liquidity which is still way too high and the all-out aggression in using that liquidity to fuel the asset bubble.

In fact, the current problems in the global banks may have had their genesis in the burial that was given to Glass-Steagall Act, a law that was born in the embers of the original crisis in the 1930s. The law separated core banking from other activities like investment banking/insurance. The dilution in the provisions of the same in the beginning 1980s led to the creation of financial super giants. The valuation of the global banks tells us the story. The global banks over-heated in the late 1990s and before the GFC. The valuations plummeted after in 2008 and to be fair, are yet to get anywhere near the previous highs. The current crisis is cementing their status as businesses with no excitement or as some people have made the case for, as public utilities. However, they are not the only class of shares to bubble up and the problems in the new economy space have not been given the attention that is due in the current episode. Not yet.

Price to Book ratio of select global banks (x)



Source: Bloomberg, Spark Fund Research

Silicon Valley Bank (SVB) epitomised such problems. The bank had left a key flank totally exposed. Its liabilities were not granular, and the bank lent to the same ecosystem that gave it deposits and took on higher risk to make a decent turn on its assets. It turned out that its customers on the liability side were dependent on lower interest rates to keep the deposits in the bank. They needed never-ending doses of capital infusion and operating profits were not their source of funds they deposited into the banks. When funding fuelled by low rates dried up, the weaker amongst them started to pull out money from SVB. Of course, the rest was a meltdown in confidence. SVB was as much a victim of the lopsided dependency in Silicon Valley to monetise streams of potential future profits at low discounting levels as it was about poor management.

In short, it turns out that the whole world wants lower rates and higher asset prices for living happily hereafter. When the Fed Put died and the rates started to inch up, the bubble was pricked. The problem for banks is a problem in the asset markets fuelled by easy money and there is no easy way out now. It was clear for a while, but it takes something big for the system to accept the inevitable. The Fed can neither be expected to save the bulls nor are they inclined. Global markets may be facing a long winter and not a meltdown.

Now on to what matters more for us - which is the impact on the Indian financial system & banks.

Indian asset bubble an offshoot of the Mother bubble - It lacks a life of its own

First things first. Unlike in the distant past, India is not an island economy. It is too deeply intertwined with the rest of the global financial system. It cannot choose what shock should impact it and what should not. If global growth is looking shaky, Indian growth will slow down too.

Secondly, India had its own mini bubble in assets on the back of the giant global one. We have called this out many times now. If you break down the re-rating of valuations over the last decade, lower global rates (not necessarily much lower cost of capital for India or very low rates here) played a big part and not earnings growth or quality. If you look at the Unicorn ecosystem, less said the better. The consistent fall in the value of these assets into a seemingly bottomless pit is entirely consistent with the retreat of the easy money regime. It is logical and this is how bubbles that get pricked deflate. It does not surprise us one bit.

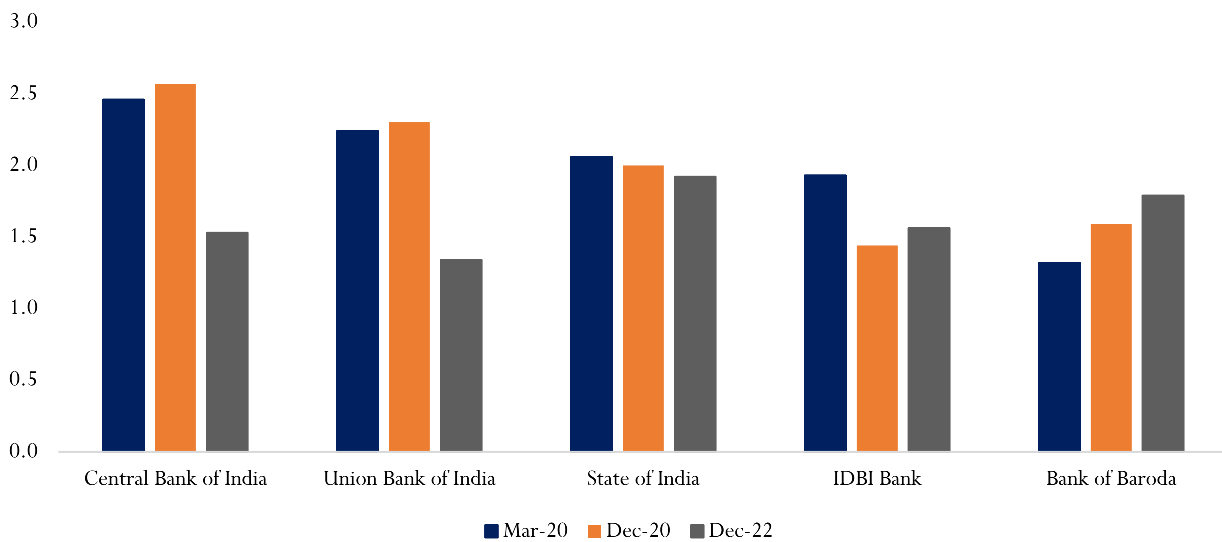
The above does not however mean that India has a problem with its financial system. Far from it. Consider the following:

1. Indian banks have been improving their asset-liability profile over the years.

2. Indian banks came out of a nasty and extended NPA cycle just after Covid. That one lasted more than ten years in essence. While ups and downs in asset quality form an integral part of a bank's journey, there is no balance sheet stress for banks, the kind of which should cause concern.

3. A down-cycle is possible only after some excesses happen - usually in leverage. We are not there yet.

Modified duration of AFS portfolio (Bonds held by banks) of select PSU banks (years)



Source: Company reports, Spark Fund Research

The PSU banks, which are perceived as a more vulnerable, have actually reduced their duration from before Covid. The data is clear. The Indian banking system is not borrowing short and investing or lending long. The system is not likely to be spooked because of interest rate fluctuations. There is no doubt some impact as volatility in rates goes up. But this is well within the risk boundaries that banks operate in.

Above all, what we want to highlight is the role of the Indian regulator. RBI has once again proved that it is far more conservative in its approach towards banking regulation than most of its Western counterparts.

1. RBI does not allow the kind of risk taking that allowed a bank (like SVB did) to bet the house on rates.

2. While India has no Glass-Steagall Act or equivalent, RBI has always put out various obstacles in the way of commercial banks entering other areas.

3. The leverage in the Indian banks has reduced post-Covid. The capital buffers are now at a very healthy level and with no impending asset quality stress, the Indian banks are on a sound footing.

Tier - 1 Capital Ratio (%)	FY17	FY18	FY19	FY20	FY21	FY22	FY23YTD
HDFC Bank	12.8	13.3	15.8	17.2	17.6	17.9	17.7
ICICI Bank	14.4	15.9	15.1	14.7	18.1	18.4	18.3
State Bank of India	10.4	10.4	10.7	11.0	11.4	11.4	10.8
Bank of Baroda	9.9	10.5	11.6	10.7	12.7	13.3	12.6
Canara Bank	9.8	10.3	9.0	10.1	10.1	11.9	13.7
Punjab National Bank	8.9	7.1	7.5	11.9	11.5	11.7	12.2

Source: Ace Equity, Spark Fund Research

4. Indian banks are seeing growth ahead (may be slower growth but growth nevertheless) and not a potential stagnation/contraction. Indian banks are funded mostly by domestic savings, and we have no inversion in yield curve. We have positive real rates through this whole saga and that is important for risk pricing.

5. RBI has been pro-active in recognizing problems most of the time. RBI managed the Yes Bank fiasco in a deft manner. RBI has also tackled the issue of shadow banks rather well. The merger of HDFC with HDFC Bank is perhaps a case in point.

6. The reluctance of RBI to open up the capital account fully is consistent with a very measured approach to leaving the banks to face a fickle global market.

In short, the actions of RBI have acted as shock absorbers more than once. In effect, it is not far-fetched to conclude that a good part of the returns in bank stocks that investors have enjoyed is owed to the conservative regulatory approach of the RBI (and not due to the fanning of asset bubbles).

Why are Indian banks selling off then?

Banks are the top sector of choice for foreign investors. Banks are also the most liquid part of the market. There is no reason to believe that the foreigners will not resort to indiscriminate selling when global banks are appearing vulnerable. They are bound to sell first and think later.

Besides the above, the banks had a good run in 2022 relative to the market. While we cannot make a case for valuations to re-rate for stocks anywhere, most Indian banks are not trading expensive in the first place. Once the focus comes back to fundamentals, the banks that are under-valued should give reasonable returns. As we have highlighted earlier, the days of easy returns are behind us. Returns will need to come on back of earnings performance and not deriving from posturing and optics.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

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