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## Avinash Kumar



*Avinash Kumar has completed his Ph.D. in International Investment Law from the Dept. of Law & Governance, Central University of South Bihar. His research work is on "International Investment Agreement and State's right to regulate Foreign Investment." He qualified UGC-NET and has been selected for the prestigious ICSSR Doctoral Fellowship. He is an alumnus of the Faculty of Law, University of Delhi. Formerly he has been elected as Students Union President of Law Centre-I, University of Delhi. Moreover, he completed his LL.M. from the University of Delhi (2014-16), dissertation on "Cross-border Merger & Acquisition"; LL.B. from the University of Delhi (2011-14), and B.A. (Hons.) from Maharaja Agrasen College, University of Delhi. He has also obtained P.G. Diploma in IPR from the Indian Society of International Law, New Delhi. He has qualified UGC - NET examination and has been awarded ICSSR - Doctoral Fellowship. He has published six-plus articles and presented 9 plus papers in national and international seminars/conferences. He participated in several workshops on research methodology and teaching and learning.*

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# **SILICON VALLEY BANK CRISIS –** **LESSONS TO INDIA FOR** **MAINTAINNING FINANCIAL PEACE**

AUTHORED BY – KEERTI. M

SCHOOL OF EXCELLENCE IN LAW – TNDALU

PHONE NO – 9677593250

E-MAIL ID – manoharankeerti@gmail.com

## **ABSTRACT:**

Several financial crises have occurred in recent decades, including the OPEC oil crises of the 1970s, the United States Savings and Loan crisis of the 1980s, and Japan's extended economic depression. The Asian financial crisis in the late 1990s and the troubles that followed the crash of the dot-com boom in the early part of the 2000's. Each of these events was accompanied by economic shocks to one or more markets or regions, and it took several years of coordinated economic and regulatory policy adjustments for the impacted markets to return to stability.

The worldwide Financial Crisis, which began in 2008, is the most recent in a series of economic crises that have had a detrimental impact on worldwide economies. Unlike prior concerns, the present one has not spared any countries or market sectors and has ravaged usually strong economies. For the past few days the world 16<sup>th</sup> largest bank collapse of silicon valley bank the crisis has been in was not because for the crisis of similar type that has happened before this is something new for the world to learn from in regard to asset liability management and reserve ratio. This paper will discuss about the silicone valley crisis and lessons India should learn to escape such crisis in future and will put an emphasis on comparative analysis of insurance cover in India and USA.

While it is common for financial crisis to occur on a regular basis and for affected economies to recover, it should nevertheless results in economic losses for the countries involved as well as for the people, businesses, and institutions in those countries.

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\* Student LLM 2<sup>nd</sup> year, law of taxation, TNDALU - Chennai

## INTRODUCTION:

“Its fine to celebrate success but it is more important to heed the lessons of failure”

- Bill Gates

Silicon valley Bank was one of the booming and largest banks of the USA. During the pandemic, when several nations' economy were crumbling, many venture capitalists who were investing in various start-ups dropped loan rates to 3% or 2%, and some even to zero. They were dealing in equity rather than interest. In the United States, the situation was the same. Instead of banks, these investors provided significant funding to start-ups. Because banks were unable to obtain consumers for company loans due to higher interest rates than venture capitalists, banks began investing their deposits to gain money. According to media sources, SVB is one of the banks that have established solid relationships with Silicon Valley enterprises, as a result of which a large number of deposits from such companies, start-ups, and investors have begun to flow into SVB. Where in lending and deposits was majorly given and received by service tech sectors and failed to lend to machinery.<sup>1</sup> Where in Indian Banking hugely depends on retail deposits accounting to around 50% and wide number of deposits from social capital which leads to a strong resilience in Indian Banking.

Nevertheless, given our Indian banking system's and economies very limited and minimal exposure to the economic and other ramifications of this US-based bank's bankruptcy, this collapse should have no direct monetary effect on us. Despite this, a few Indian tech start-ups have some exposure in SVB.

However, the SVB crisis has taught us some important lessons. But, before digging into it, it is crucial that we first know and comprehend what transpired in the US that resulted in this catastrophic banking disaster.

## CHRONOLOGICAL TURN OF EVENTS

It all started on a very hopeful and positive note, with a significant number of the US Silicon Valley's big Tech-Start-ups raising huge sums in a funding boom from venture capitalists and

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<sup>1</sup> Lessons from Silicon Valley Bank crisis – Hinh.T.Dinh

Available at <https://www.policycenter.ma/index.php/publications/lessons-silicon-valley-bank-crisis>

significant investors and depositing their surplus/unused cash raises with SVB.

Instead of holding these deposits in cash, SVB invested them in US Treasury Bonds. To be just to SVB, these investments were not terrible or dangerous because they were fully supported by the US government and had minimal default risk.

The ticking time bomb began when the US Federal Reserve (the US Central Bank, similar to the RBI in India) raised the Federal Interest Rate (the US Central Bank lending rate, similar to the Repo Rate in India) in an ongoing string of interest rate hikes to combat inflation in the US.

The interest rate and bond prices have an inverse correlation. The rise in interest rates is offset by a reduction/compression in the principle value of the bond or debenture. As a result of the increase in the US Federal Interest Rate, the price of US Treasury Bonds, which comprised the majority of SVB's investment portfolio, fell.<sup>2</sup>

In SVB's Balance Sheet, the Market Value/Net Realisable Value of these US Treasury Bonds, which comprise the investment portfolio, became less than the carrying value/book value of these investments.

Simultaneously, Silicon Valley start-ups began to sustain cash losses, faced a fundraising freeze, and stopped receiving funds from investors.

Due to the liquidity crisis, these start-ups were compelled to request a refund from SVB.<sup>3</sup>

Due to rising federal interest rates and falling bond values, SVB was compelled to liquidate its investments in US Treasury Bonds at a loss of about \$1.8 billion in order to meet such deposit withdrawal demands from Silicon Valley start-ups. To compensate for this loss, SVB announced a 2.25 billion USD capital increase as well as a stock sale. This caused alarm among Silicon Valley start-ups, hastening the process of withdrawing their deposits from SVB.

With the increase in the federal interest rate, new deposits became more expensive for SVB.

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<sup>2</sup> Ghosh, Jayati (2009), "Global Crisis and the Indian Economy", in 'Global Financial Crisis: Impact on India's Poor', United Nations Development Programme (India).

<sup>3</sup> Why India need not worry about Silicon Valley Bank's collapse, but must learn from it – Radhika Pandey

All of this resulted in a 60% drop in the share price of SVB in the US capital market, and ultimately the bank's failure, with the Federal Deposit Insurance Corp. (US Regulatory Body) taking over regulatory authority.

## **IS SVB THE NEXT LEHMAN<sup>4</sup>**

With \$209 billion in total assets, it was one among the 20 largest banks in the United States, pursuant to the Federal Deposit Insurance Corporation (FDIC). The fundamental reason for failing was asset liability mismatch, as well as slower loan growth than deposit growth.<sup>5</sup> The SVB had \$55 billion in three-month average deposits at the end of December 2019, which climbed by 169 percent to \$147.9 billion at the ending of December 2021 and \$173.1 billion at the ending of December 2022. On the other hand, three-month average lending climbed by 82 percent from \$29.9 billion at the end of December 2019 to \$54.5 billion at the ending of December 2021 and \$74.3 billion at the ending of December 2022.

The bank did not adhere to the fundamentals of balancing liquidity and profitability. Short-term deposits from start-ups and venture capital firms were used by the lender to secure funds for long-term US government assets. They failed to apply the fundamentals of portfolio management, such as not putting all of your eggs in one basket. More than 75% of its investment was in held-to-maturity securities. During the Covid-19 period, when bond yields were low, the bank invested heavily.

With the changes in the banking sector, the United States is definitely in an unstable period. However, SVB's predicament is not the same as what happened with Lehman Brothers in 2008. The issues that the US economy is facing today are vastly different from those that it faced in 2008. SVB is not Lehman Brothers, nor is 2023 2008. SVB is the second largest bank to fail in the United States since 2008, whereas Lehman was the fourth largest at the time of its demise.

The cause of failure of both the banks is distinct.

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<sup>4</sup> Mohan, Rakesh (2009), "Global Financial Crisis: Causes, Impact, Policy Responses and Lessons", Working Paper 407, Stanford University, Stanford, CA, USA

<sup>5</sup> Silicon Valley Bank Crisis – Vinay K

The fundamental cause of the 2008 problem was subprime mortgages; however, the SVB's concerns held-to-maturity securities that were mismanaged by the bank.

Lehman had total assets of \$639 billion and liabilities of \$613 billion.<sup>6</sup>

Given the scale of SVB and Signature Bank, it is not appear that their failure will have a significant impact on the US financial system or financial world. The US authorities have already stated that they will settle the SVB issue in such a way that all deposits in the country are protected, and they will not be restricted by the FDIC limit of \$0.25 million.

## REGULATORY FAILURE

As the Ukraine war took root, the tech sector slowed, venture capital (VC) financing dried up, and inflation rose. In response, the US Federal Reserve hiked interest rates, causing bond values to fall and forcing SVB to incur significant speculative losses in marking them to market. When word of the losses spread, depositors hurried to withdraw their funds, forcing the bank to sell the bonds, incur huge losses, and eventually fail.

All of this begs the question of what role regulators had in the lead-up to the current crisis. Any regulator with its ears close to the ground (which is its duty) would have seen that the SVB was headed for problems. It would also be understood that the problem originated with the Fed's consistent raising of interest rates. When there is a clear inflationary trend, the central bank must intervene and begin raising interest rates, which the Fed did.

In this case, the inflationary bout occurred not as a result of too much money chasing a given basket of goods and creating additional demand, but as a result of a fall in the basket of goods available as a result of global disruption in commodity supply, particularly energy, as a result of the Ukraine war. The Fed could have taken a different path. It might have let inflation run its course and waited for rising prices to decrease demand. If it had done so, bond prices would not have destabilised bondholder portfolios and caused the financial institution crisis that ultimately to the SVB's demise.<sup>7</sup>

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<sup>6</sup> Srivatsava, Vinay. (2023). Silicon Valley Bank Debacle And a lesson for India's Banking Sector

<sup>7</sup> Mayank Mohanka (2023) - Silicon Valley Bank Crisis Explained in 10 Simple Points & Lessons Learnt therefrom Available at - <https://www.taxmann.com/research/fema-banking-insurance/top-story/10501000000022750/silicon-valley-bank-crisis-explained-in-10-simple-points-lessons-learnt-therefrom-experts-opinion>

There is an additional explanation for the absence of any form of depositor panic in India. Over half of the deposits are with public sector banks, which cannot fail by definition. Furthermore, there is an implicit guarantee in how private banks in crisis have been handled, like in the instance of Yes Bank, which was rescued by a group of banks led by the State Bank of India, apparently at the request of the Reserve Bank of India.

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## RESILIENT MECHANISM IN INDIA

The Deposit Insurance and Credit Guarantee Corporation, a wholly owned subsidiary of the Reserve Bank of India, insures bank deposits in the following ways:

In accordance with the stipulations of the DICGC Act of 1961, the DICGC covers all deposits, including savings, fixed, current, and recurring deposits, as well as accrued interest. As defined in Section 2 (g)<sup>8</sup> of the Act, a "deposit" is the sum of all unpaid sums due to a depositor in respect of all his accounts, regardless of name, and includes, among other things, fixed deposits and

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<sup>8</sup> "deposit" means the aggregate of the unpaid balances due to a depositor (other than a foreign Government, the Central Government, a State Government, a corresponding new bank, Regional Rural Bank or a banking company or a co-operative bank) in respect of all his accounts, by whatever name called, with a corresponding new bank or with a Regional Rural Bank or with a banking company or a co-operative bank and includes credit balances in any cash credit account but does not include,

(i) where a banking company or a corresponding new bank at the commencement of this Act or where an eligible cooperative bank at the commencement of the Deposit Insurance Corporation (Amendment) Act, 1968 is working under a scheme of compromise or arrangement or of reconstruction sanctioned by any competent authority providing for the acceptance of fresh deposits, any amount due to the depositor in respect of his deposit before the date of the coming into force of the scheme to the extent it is not credited after the said date under the provisions of that scheme; or

(ia) any amount due on account of any deposit with any insured bank which has been specially exempted in this behalf by the Corporation with the previous approval of the Reserve Bank or,

(ii) any amount due on account of any deposit received outside India;

accumulated interest. Section 16 (1) of the Act also allows for deposit insurance by DICGC for a depositor equal to the amount payable to him in respect of his deposit in the bank, subject to the ceiling prescribed and provisions of the Act.

To provide additional security to bank depositors, the DICGC increased the ceiling of insurance coverage for depositors in insured banks from 1 lakh to 5 lakh per deposit holder with effect from 04.02.2020.

As a result, at the end of March 2022, the number of fully secured accounts constituted 97.9% of the total number of accounts. Total insured deposits was at 81,10,431 crore as of end-March 2022, accounting for 49.0% of assessable deposits (1,65,49,630 crore). This is greater than the International Association for Deposit Insurance (IADI) recommendation of 80% coverage for number of accounts and 20-30% coverage for value.<sup>9</sup>

In such situations, the DICGC is required to make interim payments to depositors up to the deposit insurance cover of 5 lakh within 90 days after the enforcement of such orders. The time-bound payout to depositors of banks placed under AID has prepared the way for increased public trust in the banking industry while also contributing to financial stability.

## **LESSONS FOR INDIA AND INDIAN RESILIENCE**

“Further, our ratio of foreign claims to domestic claims is also least among countries signifying that our banking and financial system is very disciplined and no international balance sheet contagion can start from India. Maturity wise also, International claims on India are the least among major countries,”<sup>10</sup>

- Soumya Kanthi Ghosh

We are living in a global entity now and anything that happens in one part of the globe will have repercussions, going by business model SVB is a 40 year old bank and where lending majorly to

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<sup>9</sup> The Moral Hazard Implications of Deposit Insurance: Theory and Evidence – (2006) Patricia A. McCoy Available at – seminar on current developments in Financial law, Washington D.C

<sup>10</sup> SBI Report – Indian Banks are Epitome of resilience

Available at - <https://www.businessworld.in/article/Indian-Banks-Are-Epitome-Of-Resilience-SBI-Report-/20-03-2023-469680/>

start-ups and their deposits were mostly parked there.<sup>11</sup> In India the system is maintained by DICGC where insurance is 3.1% of per capita income. In India account base are wide majorly by Jan Dhan Account scheme and the lending should be in such a way that the loans are parked proportionately. And, it provides for maintaining CRR and SLR which prevents major risk and for proper management of Assets and Liabilities.<sup>12</sup>

It is critical to understand that the SVB Crisis did not occur as a result of its bad loans or advances becoming non-performing; rather, it occurred as a result of SVB's failure to realistically predict and assess the timing of serviceability/repayment of deposits taken from Silicon Valley start-ups and in lieu of keeping these deposits in liquid or short-term investment instruments, invested these deposits in long-term US Treasury Bonds.

In India, there is a term known as the "Cash Reserve Ratio." (CRR).<sup>13</sup> It is a predetermined minimum fraction of total customer deposits that commercial banks must retain as reserves, either in cash or as deposits with the central bank RBI, to ensure that banks do not run out of cash to meet their depositors' payment obligations. In India, the CRR is an important monetary policy tool for managing the economy's money supply. CRR is now at 4.50%.

Second, SVB was caught off guard and ran out of cash because it failed to anticipate the very basic correlation between rising US federal interest rates and declining US Treasury Bond prices, which comprised its investment portfolio, and thus its mark-to-market loss (book loss) was suddenly changed to actual loss, on necessitate selling of its investments in US Treasury Bonds, below the cost of their acquisition costs, in order to service deposit withdrawal demands by the silicon Valley start-ups.

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<sup>11</sup> Measures taken by the Government to protect the interest of investors/account holders in the bank Available at: <https://pib.gov.in/PressReleasePage.aspx?PRID=1849973>

<sup>12</sup> ALM in banking refers to the management of the cash flows of assets and liabilities in order to increase profitability, manage risk, and ensure safety and soundness.

Simply described, it is the process through which a bank's overall assets and liabilities are simultaneously controlled and managed in an integrated manner.

ALM is concerned with three major risks:

Liquidity Risk Interest Rate Risk

Foreign exchange risk.

It also includes managing, for banks with FX operations. Currency volatility.

<sup>13</sup> Maintenance of Cash Reserve Ratio – circular DOR.No.Ret.BC.35/12.01.001/2020-21 dated 05/02/2021 Available at - <https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12020&Mode=0>

Finally, the SVB crisis can be attributable to an asset-liability mismatch. A healthy bank is usually distinguished by a solid and sturdy advance base. However, in the instance of SVB, its deposits from consumers on the liability side greatly outweighed its loans to customers on the assets side. So, at all times, the interest it was compelled to pay on client deposits outweighed the interest revenue it earned on advances made to customers.

These measures by USA would lead to a relief now:

Allowing all depositors to have full access to their entire deposit base, rather than only the insured value of \$250,000, in stages. More crucially, the cost of this bailout package would not be borne by US taxpayers, but rather by stakeholders in the bankrupt SVB.

Setting up a new lending facility with the US Federal Reserve (US Central Bank) to allow banks to pledge their investments in US Treasury Bonds, Mortgage-Backed Securities (MBSs), and other qualifying assets as collateral, wherein banks will receive loans equivalent to the face value of such Treasury Bonds/MBSs, even if their respective market values have fallen in the wake of rising Fed interest rates, at the prevailing market interest rate plus an additional fee of 0.1% on top of the prevailing market interest rate.

## **CONCLUSION**

Recent economic history has taught us that financial crises that simultaneously affect several economies occur frequently, and that prudent policies and appropriate responses by monetary authorities help in managing the crises. However, the task of containing the adverse effects becomes more challenging when all the economies of the world are affected by the crisis. However, the recent crisis has not affected the world inversely.

This study discussed the effects of the global financial crisis on the Indian economy, as well as the Indian government's response to the crisis.

The RBI's proactive measures have ensured that adequate liquidity is available in the markets. Interest rates and inflation rates have stabilised in the loan and consumer markets. The Indian Rupee has recovered in the foreign currency market against the currencies of its key trading partners.

The government's fiscal stimulus will help cushioning the decline.