



Interest Rate v/s Collateral Valuation - Emerging Debate and Implications

Dear Reader,

Events that have unfolded and are unfolding in the market place remind me of folklore. Though the story is long, the end line that I still remember is “No matter how much money one gives, it is the gold in solid form that is important” Here, as you could see Gold is only a metaphor for the underlying collateral assets and its valuation which is a near-certainty as long as you protect it from your neighbour or unwanted night-time visitors. In that context, if I may, let me draw your attention to Shakespeare's play “Merchant of Venice”. At the end of the play, it is impossible for anyone to remember what the interest charged for the loan was, but everyone remembers the concept of collateral which was in the form of human flesh.

So, what is the point I am trying to convey here? As in the folklore from my village in a remote part of Karnataka and as in Shakespeare's play, it is the collateral that is most important in a transaction and not the interest rate or the value of exchange.

Crisis which has engulfed the finance world is forcing unlearning its most important tenet - Interest as a medium of value creation.

Presently, eroding portfolio value and the volatility it poses to the cash flows which are defined through a series of interest calculations, is losing its importance in the finance world. The world over, the debate is shifting from Market Risk management to Liquidity Risk management. As detailed in classical financial theories, liquidity ratios provide insight into a firm's abilities to meet its short-term financial obligations. In layman terms, current assets need to be higher than the current liabilities. If one looks into today's unfolding phenomenon, it is these ratios which are pointing against the viability of many firms in the long run. Many of these firms have sound business models, great customers and in the long run will probably create more value; hence the feeling of their long-term growth story being intact. Therefore, they will further invest to protect their turf in expectations of better days, further eroding liquidity and quality of assets. In fact, unless it is addressed quickly by unwinding the leverage and recognising the losses on the book, these firms may not be able to change the impending events.

This has led to a very peculiar outcome of valuing the collateral on a daily basis. Since many of the assets which are

offered as collateral do not have any reference pricing points and moving market indices is not of much help, assessing the value of the collateral has become irrelevant. The only trust many lenders have is that these collaterals are of importance to the firm. This hypothesis too does not give much comfort to the lenders. In light of this, many lenders are increasingly looking into their fund commitments to the firm's projects and reversing the decisions where they don't have contractual obligations to fund. Absence of new fund commitments can kill many businesses and further deepen the slowdown or recession - whichever terminology you want to use.

World over, economists are afraid of these outcomes. Unfortunately, not much credit is left with the economists, as a community. But I too belong to the same community and I believe that our fear is real and governments world over need to take measured approach to help firms to unwind the asset leverage to ease the liquidity situation. Since most lenders are asking for collateral and valuing those in real-time basis to press the margin call - for assets created by these firms, it is not helping a lot in easing liquidity. As in Shakespeare's play, lenders are not looking at possible interest earnings, but the pound of flesh - which will eventually kill the firm.

Please send your feedback to

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