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RBA Tip-Toes Amid Banking Woes

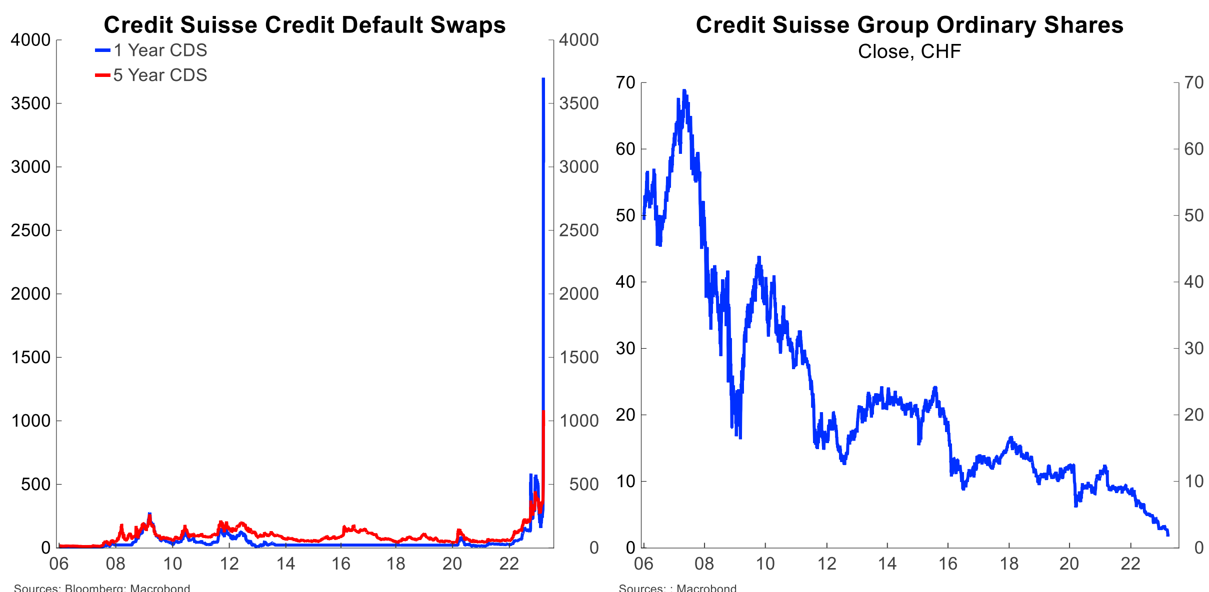
Since concerns at Silicon Valley Bank (SVB) bubbled to the surface not even two weeks ago, it seems that not a day has gone by where new information on the health of the US and global banking system hasn't hit front page news.

Over the weekend, the featured finance news was that Credit Suisse, the Swiss global banking firm founded in 1856 was being bought by Swiss rival UBS, in a government-brokered deal to shore up the global bank and restore confidence in the European banking system.

Credit Suisse has faced troubles for some time as it has been implicated in a range of banking controversies and customers have gradually been losing faith in the institution. This resulted in customers leaving the bank and taking their deposits with them. The group had faced deposit outflows for some time, which accelerated in late 2022 and over the past few weeks following contagion from the broader issues faced by US regional banks.

This further weakened the position of Credit Suisse and led to a situation where regulators had to take swift action to save the group. The Swiss Government considered a range of options, including a takeover by another bank, state liquidity assistance, temporary public ownership, and a resolution (i.e. bankruptcy). After talks over last week, a government-brokered takeover of the institution by its rival UBS was agreed.

UBS will purchase the Credit Suisse Group for 3 billion Swiss francs (CHF), in an all-share takeover of the group. This represents a significant haircut to the closing market capitalisation on Friday of almost CHF 7.5 billion, resulting in large losses for equity holders.



Further, to assist the recapitalisation of the troubled lender, all the group's Additional Tier 1 (AT1) capital instruments will be bailed-in and wiped out. This will result in the write-down of around

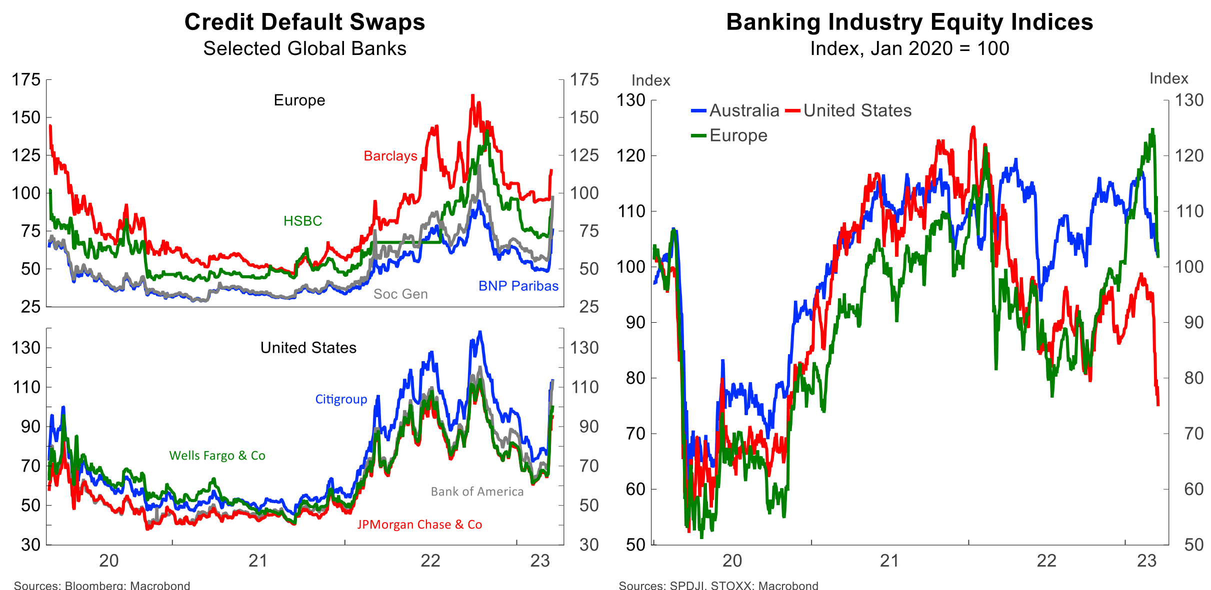
CHF 16 billion of AT1 securities.

Under the Basel III regulatory capital framework, banks are required to maintain capital ratios above mandated minimums and they can do this using a combination of different capital instruments. This includes:

- Common Equity Tier 1 (CET1) – e.g. ordinary shares and retained earnings
    - Automatically loss-absorbing and considered the highest form of capital.
- Additional Tier 1 (AT1)
    - Hybrid securities that have both bond- and equity-like characteristics. In ordinary times, these instruments typically pay interest. However, during a stressed scenario, they can be converted into CET1 or written down completely to $0. This is done to help recapitalise the bank while it remains a 'going concern'.
- Tier 2
    - Typically made up of hybrid securities that are more 'bond-like' than AT1 securities and sit higher in the capital structure. These instruments absorb losses when the bank is deemed a 'gone concern' to help facilitate a resolution.

The Swiss Government and Swiss National Bank (SNB) are also providing significant support to UBS as part of the deal. Specifically, the SNB will provide CHF 100 billion in liquidity assistance to UBS.

Further, the Swiss Government will provide UBS with an indemnity of up to CHF 9 billion for losses above an initial CHF 5 billion threshold (worn by UBS) in a specific part of the portfolio. UBS would also wear any additional losses above the indemnity amount (i.e. above CHF 14 billion).



While stemming the immediate risk of a failure of Credit Suisse, it is uncertain what impact these measures will have on confidence across the global banking sector and on contagion concerns. Confidence is a key bedrock of the global banking system, and other banks have been affected by these issues. Immediate effects have been felt through deposit outflows across other US regional banks, spikes in Credit Default Swaps (CDS), which investors use to insure against the cost of a bank defaulting on its bonds, and significant falls across global banking shares.

In other developments today, the Bank of England, Bank of Canada, Bank of Japan, the European

Central Bank, the Federal Reserve, and the SNB announced co-ordinated action to expand pre-existing currency swap line arrangements. This is likely an effort to prevent dollar funding strains from appearing.

Currency swap arrangements are already standing and have been for some time. In October 2013, following the GFC and concerns about debt sustainability in Europe, the currency swap lines were made into permanent standing arrangements.

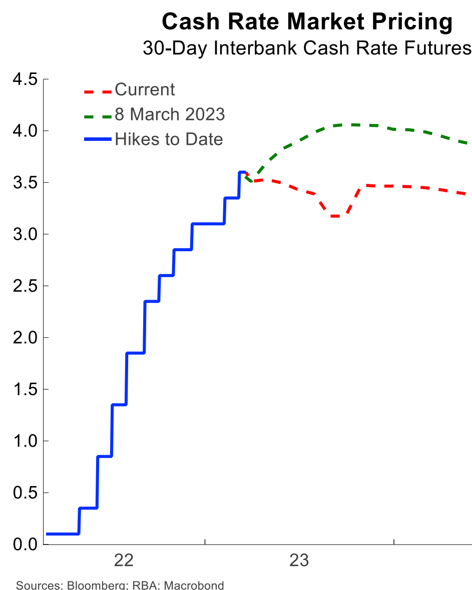
The main change in today's announcement is that central banks will increase the frequency of 7-day maturity operations from weekly to daily. Daily operations will begin on March 20 and extend through to the end of April.

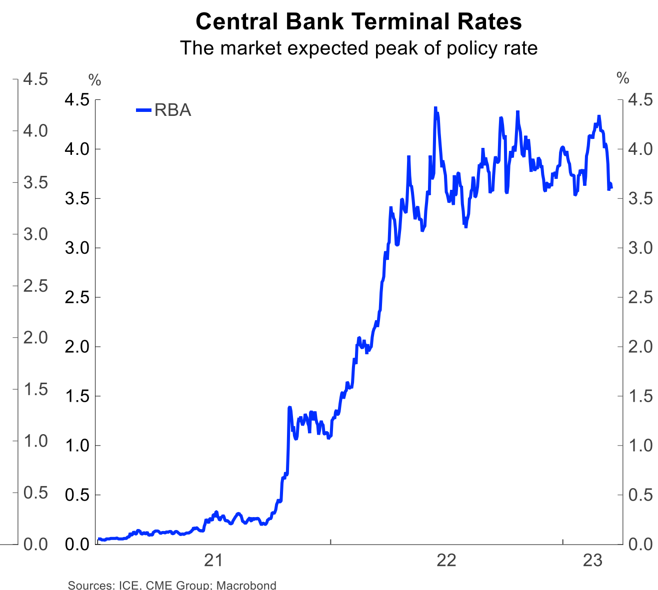
Implications for Australia and the Reserve Bank (RBA)

How quickly things can change...

Around two weeks ago, prior to the issues at Silicon Valley Bank and other US regional banks coming to the fore, financial markets were pricing more hikes from the RBA. In fact, on 8 March, interest rate markets were pricing around a 45% probability of a 25-basis-point hike at the April meeting and a terminal cash rate of around 4.05%.

Currently, the picture looks very different. Financial markets now expect that the rate hiking cycle from the RBA is over and that interest rates are on the way down from here. To be more specific, interest-rate markets are now pricing in around almost a 30% chance of a cut at the April meeting and are expecting almost 50 basis points of cuts to the end of 2023.





Even prior to the banking issues, the RBA firmly opened the door to a pause at its April meeting. This included a dovish shift in the monetary policy statement following the March meeting and comments from the RBA Governor in a speech titled “Inflation and Recent Economic Data”.

Specifically, the statement made a few key changes, with the hawkish sentence (emphasis added) “further increases in interest rates will be needed over the months ahead” from the February statement being changed to the more dovish “further tightening of monetary policy will be needed” in March. Additionally, the March statement added a conditional point about any future hikes: “In assessing when and how much further interest rates need to increase…”

These changes suggested that the RBA was ready and willing to pause if the data supported it.

Further to this, in the Q&A to his speech following the Board meeting, the Governor explicitly noted that the RBA was ready to pause if necessary and outlined the four key data releases they would be watching ahead of the April meeting, stating (emphasis added):

- "Before our next Board meeting, we'll have important data on employment, we'll have another monthly inflation indicator, we'll have more detail on retail spending, and the business survey. So, they're four really important pieces of data that we'll look at in our next Board meeting. If collectively they suggest that the right thing is to pause, then we'll do that; but if they suggest that we need to keep going, then we will do that. So, we've got a completely open mind about what happens at the next Board meeting."

Since then, the February employment survey and the monthly business survey have both suggested that while conditions across the economy remained robust in early 2023, an underlying trend of weaking economic and labour market conditions is evident and is expected to continue to play out through 2023.

We had flagged the possibility of an April pause in recent communications, and we have now updated our base case to a pause in April, followed by one further hike in May, to a peak in the cash rate of 3.85%.

A pause is the most likely approach in the near term given the broader context of issues in the US and European banking systems, and that the economic data to date, while remaining robust, wasn't so far above expectations as to overly worry the RBA in the near term.

Domestic data

In a quiet week for domestic data, the key release will be the Minutes from the RBA's March Board meeting, due Tuesday. These are likely to provide further insights on the deliberations of the Board during its meeting. An important thing to watch for will be the options that the RBA Board considered before it made its final decision to hike by a further 25 basis points. At the December meeting, all options were on the table, with a pause, 25-basis-point hike, and 50-basis-point hike being discussed. However, in February, talk of a pause was dropped and only a 25- or 50-basis-point hike was considered, given the upgrade in global growth and the stronger-than-expected December quarter underlying inflation report.

However, for the March meeting, it is likely that the discussion centred around a pause or a 25-basis-point hike. Indeed, talk of a 50-basis-point hike was likely the option that was off the table following the weaker-than-expected December quarter GDP data.

As concerns surrounding SVB and other US regional banks hit front page news in the days following the meeting, the Minutes are unlikely to provide any insights into those developments.

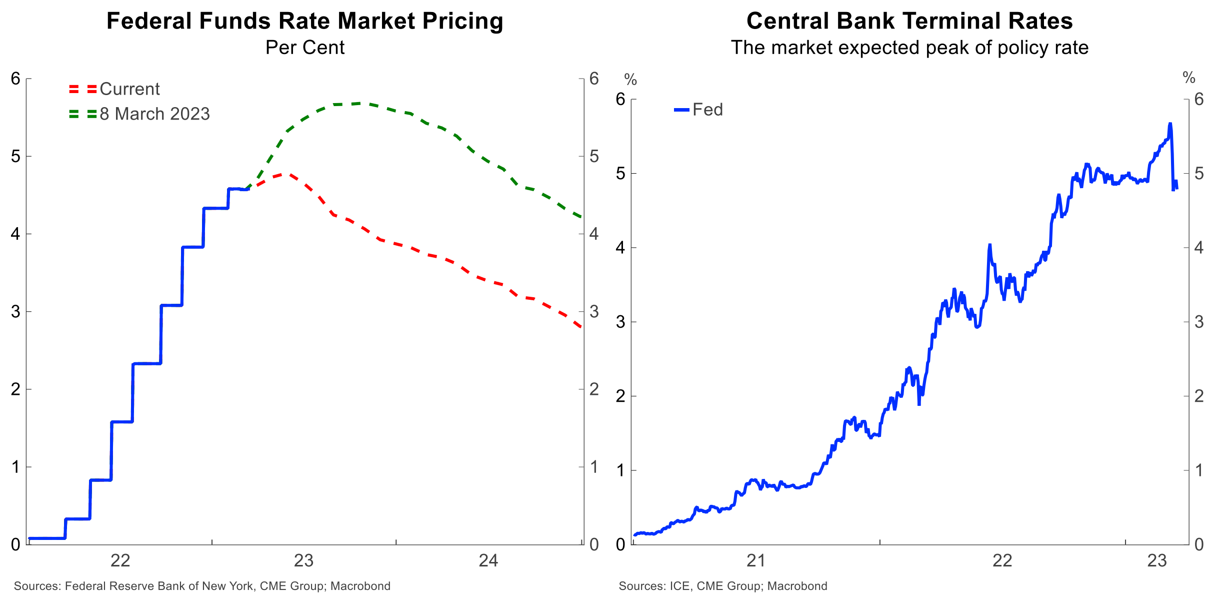
International data

After having to address financial stability risks over the past few weeks, a few key central banks will turn their attention back to monetary policy this week. Central banks are increasingly finding themselves between a rock and a hard place as they juggle getting on top of inflation concerns, trying to engineer relatively soft landings, and considering the broader financial stability implications of aggressive monetary policy tightening.

Central banks meeting this week include the US Federal Reserve, the Bank of England, and the SNB. The key meeting will be that of the US Federal Reserve, who will deliver their decision early

Wednesday morning (AEDT).

Market expectations for hikes by the Fed have pulled back materially following the banking concerns. Indeed, markets are now pricing in only a 60% chance of a 25-basis-point hike. This compares with over 40 basis points of hikes being priced prior to the collapse of SVB. In other words, prior to the collapse of SVB, markets thought a 25-basis-point hike was locked in and that there was a good chance of a larger 50-basis-point move.



Looking beyond March, interest-rate markets are now pricing a quick shift from hikes to cuts as financial stability concerns rise and a general tightening of financial conditions through reduced lending by impacted banks does some of the heavy lifting for the Fed. Markets are pricing the fed funds rate to fall to around 3.75% by the end of 2023, a full 100 basis points below the current upper bound.

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Group Forecasts

		2023			2024		
End Period:	**Close (17 Mar)**	**Q2 (f)**	**Q3 (f)**	**Q4 (f)**	**Q1 (f)**	**Q2 (f)**	**Q3 (f)**
Aust. Interest Rates:							
RBA Cash Rate, %	3.60	3.85	3.85	3.85	3.60	3.35	3.10
90 Day BBSW, %	3.69	3.95	3.95	3.97	3.72	3.47	3.22
3 Year Swap, %	3.39	3.65	3.60	3.50	3.40	3.20	3.00
10 Year Bond, %	3.39	3.60	3.40	3.20	3.00	2.80	2.70
US Interest Rates:							
Fed Funds Rate, %	4.625	4.875	4.875	4.875	4.375	3.875	3.375
US 10 Year Bond, %	3.43	3.70	3.50	3.30	3.10	2.90	2.80
USD Exchange Rates:							
AUD-USD	0.6697	0.69	0.72	0.74	0.75	0.76	0.76
USD-JPY	131.85	131	130	129	128	127	126
EUR-USD	1.0670	1.09	1.10	1.11	1.12	1.13	1.14
GBP-USD	1.2173	1.22	1.23	1.24	1.25	1.26	1.27
NZD-USD	0.6269	0.64	0.66	0.67	0.68	0.68	0.68
AUD Exchange Rates:							
AUD-USD	0.6697	0.69	0.72	0.74	0.75	0.76	0.76
AUD-EUR	0.6276	0.63	0.65	0.67	0.67	0.68	0.67
AUD-JPY	88.300	90.4	93.6	95.5	96.0	96.5	95.8
AUD-GBP	0.5502	0.57	0.59	0.60	0.60	0.60	0.60
AUD-NZD	1.0695	1.08	1.09	1.10	1.11	1.13	1.13

	2021	**2022**	**2023 (f)**	**2024 (f)**
GDP, %	4.6	2.7	1.0	1.5
CPI (Headline), %	3.5	7.8	4.0	3.0
CPI (Trimmed mean), %	2.6	6.9	3.6	3.1
Unemployment Rate, %	4.7	3.5	4.6	5.1
Wages Growth, %	2.4	3.3	4.0	3.2

AUD cross exchange rates have been rounded.

Financial forecasts are quarter end.

GDP, CPI, employment and wage growth forecasts are year end.

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