Private Capital Advisers

Special Edition - March 2023

Banking crisis 2023 style

As you will no doubt be aware two large banks have effectively defaulted over the past week – first the Silicon Valley Bank (SVB) in the United States and then Credit Suisse in Switzerland. So far this has created nervousness in markets, some losses for shareholders in these two entities but not too much else.

SVB and Credit Suisse are NOT the canaries in the coal mine

Silicon Valley Bank failed by investing their depositors' funds in fixed rate bonds that were safe but ignored interest rate risk. As cash rates have increased over the past year SVB needed to pay higher rates to depositors. Both losing money on investing in safe assets and ignoring interest rate risks are highly unusual ways for banks to get into trouble. In all likelihood there are very few banks worldwide that will have repeated this mistake.

Similarly, the Credit Suisse failure is unlikely to be repeated in that it is one of the last remaining large banks that only just survived the GFC but never got their house back in order. For the last decade they have gone from crisis to crisis and their demise has surprised few market experts. Again, few banks share Credit Suisse' problems.

Having said that, we do expect that there will be further, isolated failures of banks overseas simply as a result of the rapid increases in interest rates. When they are lifted as rapidly as has occurred over the past 18 months, things will break. But we do not believe problems are system wide.

Regulators have acted quickly and decisively

It appears that regulators have learned some important lessons from the GFC and have moved quickly to create certainty. The end result is that Governments have effectively guaranteed bank depositors.

Shareholders in the banks concerned have effectively suffered a capital loss and the management of their ongoing operating has been placed in safer hands. This second step is critical as banks such as Credit Suisse are heavily interconnected with the global financial system, and it is important that they continue to function.

Australian Banks are very strongly capitalised and have a very, very small risk of failure

The Australian bank regulator, APRA, has been very diligent in ensuring that Australian banks maintain adequate (some would say excessive) amounts of capital. Regrettably this is not the case elsewhere. Early reports indicate that the US Federal Reserve has been aware of SVB problems for over 12 months and instructed them to raise more capital, but this was ignored by SVB. From an Australian perspective it seems inconceivable that that sort of behaviour can be allowed. Following the experience of SVB, it is even more unlikely to occur in Australia.

The curious case of Credit Suisse Hybrid debt

Most market participants assume, that in the event of a bank failure, Hybrids will be converted to equity which may or may not have some residual value. The Swiss regulators cut out the middle step and deemed that the Credit Suisse Hybrids were worthless. This action has raised questions about whether Australian bank hybrids are riskier than we had assumed.

It seems that the treatment of Credit Suisse hybrid investors was as a result of an unusual clause unique to Switzerland – a clause that does not exist for Australian Bank Hybrids. Early analysis suggests that the Australian Bank Hybrids are exactly as we had previously thought. Our assessment continues to be that they are very low risk investments when viewed from a buy and hold to maturity perspective.

This risk assessment is based primarily on the relatively low risk nature of Australian Banks businesses and the high degree of scrutiny by APRA on the day-to-day activities of the banks. We continue to believe that bank hybrids are attractive investments. For those who are interested in a detailed analysis of the risks associated with these investments, please contact us and we will be pleased to forward it to you.

What should we do now?

The most important thing is to not over-react to the news as it emerges. We know that the higher interest rates we are now experiencing will slow the economy, will put companies under pressure and will create the occasional failure such as we have seen over the past few weeks. However, our analysis suggests that current market valuations are appropriate given those fundamental headwinds that are plain to see.

What we do expect to see in coming months are buying opportunities as the market inevitably over-reacts to whatever news emerges. Despite the uncertainty we remain positive about future market prospects.

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