Key takeaways from UBS's takeover of Credit Suisse

Sam Theodore | March 2023

Here are my key takeaways from UBS's takeover of Credit Suisse, which shockingly sees the most junior bondholders totally wiped out and worse off than shareholders.

1 The total write-off of Credit Suisse's AT1s while shareholders retained some small residual value has massively affected the USD 275bn AT1 market (mostly made up of European issuers), to the extent that EU regulators – ECB, EBA, SRB – were forced to issue a joint statement pointing out that common equity instruments are the first to absorb losses, and only after their full use would AT1 be required to be written down. A similar statement on UK creditor hierarchy was issued by the Bank of England.

There will likely be legal challenges to the Swiss approach to AT1, which is to be expected. Aside from the legal aspects, the troubling issue is how AT1 investors have been treated by Swiss regulatory actions. Unlike shareholders and in line with other fixed-income investors, AT1 holders have had minimal input in driving banks' strategies. But unlike shareholders, they are now taking maximum loss.

While AT1s are clearly riskier than other debt instruments, they are and should be viewed as less risky when compared to equity. The fact that the Swiss financial regulators did not reflect this in their decision is puzzling.

On the other hand, this situation is a powerful reminder to AT1 investors that while the characteristics of the product and the features as described in legal documentation are vital, what remains essential is the fundamental creditworthiness of the issuer. From this angle, most large European banks which have been issuing AT1 securities remain as far from a resolution scenario as at any time since the aftermath of the GFC.

2 The regulatory framework for placing banks into resolution as going concerns may be more questionable than previously assumed. The framework was constructed in the aftermath of the GFC, following which assumed distance from resolution was an important valuation element for investors and analysts.

It may be less so in the future, as the orderly resolution process for a large bank in distress may no longer be the base scenario. The key will be the extent and credibility of liquidity being provided by the central bank and the other banks in the system, and if needed back-up guarantees from governments.

3 The demise of Credit Suisse (as with SVB and Signature Bank) showed again that it is funding and liquidity not capital that remain the Achilles' Heel of banks. The banks folded following the flight of non-insured deposits even though they had strong regulatory capitalisation (over 15%) and, in the case of the CS, stable market funding.

It is regulators that determine if a bank still has sufficient capital to continue as a going concern or if it needs to be liquidated or placed into resolution. But it is the market at large, including business, institutional, and other non-retail depositors, that determines if a bank remains properly funded to enable it to survive.

This was one of the lessons of the Global Financial Crisis, which was first and foremost a liquidity and funding crisis driven by a loss of confidence in wholesale funding markets and only then an asset-quality and capital-shortage crisis. This time around, asset quality and especially capital are no longer the main source of concern. And on the funding side, it is non-retail depositors who were the most reactive, not wholesale investors.

Regulatory liquidity and funding ratios are very helpful prudential metrics but in the current environment they do not offer sufficient reassurances. While a sharp capital depletion occurring overnight is an unlikely scenario, this is not the case with liquidity and funding on current evidence, with assumptions about the stability of deposits now being questionable.

4 Banks' fundamentals really matter. Prudential and financial metrics are relevant and cannot be discounted but key to any proper analysis is what a bank does and how it does it: business model, risk culture and tolerance, risk management and competitive positioning.

Time and again, the aggravating factor for a bank's bad performance lies in its investment banking activities: high risk, high volatility, and reliance on a relatively narrow number of traders and dealmakers with a risk-taking culture that can turn out to be harmful. Things that were thought to have been dead and buried after the GFC.

5 Deposits (including non-insured funds and CS's wealth management funds) have been thought of as stable sources of funding. For the affected banks, they have been anything but. Institutional market funding has remained comparatively more stable and predictable.

There is urgent need for banks to be more transparent about non-insured deposits: amount, sources, concentrations, and trend analysis. Supervisors are hopefully looking at indicators related to deposit stability and reliability in their daily work and in colleges. Communicating their analysis through horizontal assessments and including deposit-related scenarios in regulatory stress tests would be very helpful for market participants.

6 Consideration should be given to raising the ceiling for deposit insurance across Europe – EUR 100k, GBP 85k, CHF 100k. In the US, where the ceiling is a much higher USD 250k, there are discussions about raising it further to reassure businesses and institutions in their daily activities. The same argument should apply in Europe. Ignoring this challenge may end up having negative consequences, especially since the real threat of deposit shrinkage has now been identified.

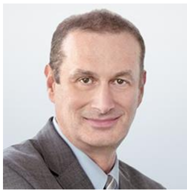
Raising deposit-insurance ceilings would entail a hike in the assessment fees for banks, which would presumably impact profitability (although this would likely be partially recouped through higher customer fees). But deposit safety and stability should be the primary factor behind decisions if it reduces the risk of a bank run.

Within the Banking Union in the euro area, I view the hiking of the insured deposit ceiling as more important than the elusive achievement of the European Deposit Insurance Scheme (EDIS).

7 The issue of global inter-connectedness within the banking and financial system should be revisited. In these days of global instant communication through social and traditional media, the G-SIB universe is no longer sufficiently wide. In a previous age, the sudden demise of a couple of US regional banks would not have instantly impacted the behaviour of Credit Suisse's wealth and asset management clients.

8 The UBS-Credit Suisse merger shows again that major bank M&A occurs mainly when one of the entities is in deep distress. Under normal conditions, such consolidation would not have been advisable and would have never occurred. Among other things, it heightens systemic risk: what will happen in the theoretical case, at some future point, of UBS itself needing support? Who will provide it, other than the public authorities? Or some foreign institutions, which may be a less palatable solution politically?

Analyst



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