CI GAM Fixed Income Commentary: Credit Suisse

CI GAM Investment Management Team

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Credit Suisse Bank Run, Acquisition by UBS and FINMA AT1 Decision

March 2023 has been a volatile period for banks, initiated by a historically fast bank run on Silicon Valley Bank (SVB), with contagion risk spreading to other firms, including Signature Bank, First Republic Bank, and other U.S. regional banks. This banking fear and uncertainty spread to European markets and was compounded by a March 9, 2023, announcement by Credit Suisse that it would have to delay its 2022 Annual Report to March 14. Credit Suisse depositors feared for the worst, and began to withdraw their deposits, forcing Credit Suisse to announce on March 15 their use of a CHF 50 billion liquidity facility provided by the Swiss National Bank, Switzerland's central bank. Despite this liquidity backstop, withdrawals continued through the rest of the week.

On March 19, 2023, the Swiss bank regulator (FINMA, or the Swiss Financial Market Supervisory Authority) announced that Credit Suisse would be acquired by UBS Group AG for CHF 3 billion in shares. By creating a bank with more than CHF 5 trillion in assets, FINMA aimed to restore confidence and liquidity within the Swiss banking system. Additionally, the Swiss National Bank has provided a liquidity facility of up to CHF 100 billion to the combined bank to protect from further withdrawals of deposits. There are other liquidity provisions and loss-sharing agreements that were conceded to ensure the success of the merger over the weekend and to stem further withdrawals from Credit Suisse. While over the medium term the combined bank will shake out its ranks, Credit Suisse has advised its clients that it is "business as usual" in the near term.

As part of the deal for UBS to acquire Credit Suisse, FINMA forced the write-down of Additional Tier 1 (AT1) bonds issued by Credit Suisse to $0, citing that the bank reached a point of non-viability given its need for a central bank liquidity facility. This was done despite FINMA indicating earlier in the week that the bank exceeded both liquidity and capital requirements as a global systematically important bank (GSIB) and that its balance sheet was strong.

This decision by FINMA did not follow the conventional credit hierarchy during a rescue, in that shareholders are usually the first type of capital to suffer losses before subordinated bonds. As a result of this, on March 20 the European Central Bank (ECB) issued a statement reaffirming the conventional credit hierarchy, providing reassurances to fixed income investors of AT1 bonds issued by European regulated banks.

CI GAM did not own any equity of Credit Suisse; however, we did own senior bonds and AT1 bonds issued by Credit Suisse. While our Credit Suisse senior bonds continue to trade at levels above pre-acquisition levels, the AT1 decision made by FINMA caught the market and us by surprise. We are disappointed that FINMA did not follow conventional creditor hierarchy, leading to a sub-optimal outcome for our portfolios. CI GAM will continue to monitor the evolving situation regarding any potential challenges to FINMA's decision.

Overall, we remain holders of other AT1 and similar instruments like Limited Recourse Capital Notes (LRCNs), Non-Viable Contingent Capital and Institutional Preferreds issued by Canadian financial institutions. The short-sighted and arbitrary actions of FINMA will be borne for years by European banks in the form of higher borrowing costs on subordinated debt. We believe the Canadian NVCC framework is more attractive as it compels loss absorption via conversion into common shares and, most importantly, there are no principal write-down mechanism in Canadian NVCC. Importantly, both the Canadian and US Regulatory systems respect the creditor hierarchy in a resolution. We will know in a week's time if the combined actions by the Fed, ECB, and the SNB have been sufficient to mitigate a wider banking run but that is our base case.

See below for additional details on Credit Suisse, including how the bank was attempting to restructure into a lower risk bank, differences between the senior bonds and AT1 bonds, and the investment rationale for owning the bonds.

Credit Suisse Backdrop: Prior to Bank Run

Credit Suisse has had well telegraphed issues within its Investment Bank (IB) division, in which they have made attempts to restructure and reduce the size of it. More recently, plans were in place to carve it out into a separate entity, CS First Boston. We believed that the plan to reduce the division was the largest and most credible strategic shift that management had initiated in years, and prior to last week, we believed that they were broadly executing well against these strategic targets. As Credit Suisse would shrink its investment banking business, its earnings would also shrink. Despite this, prior to the bank run, its capital levels and liquidity were good. We believed that if they were successful in executing their restructuring plan over the next few years, Credit Suisse would emerge as a less risky and profitable bank.

CI GAM's Investments within Credit Suisse

CI GAM owned two types of bonds issued by Credit Suisse:

1. Senior bonds issued by Credit Suisse AG, the operating company. These bonds are senior in the overall capital structure and are one of the first types of securities to be repaid in a bankruptcy scenario. They do not have the explicit ability to be written down by the Swiss regulator (FINMA). In exchange for a senior position within the bank's capital structure, these bonds tend to pay lower yields and are considered safer, relative to AT1 bonds.
2. Subordinated AT1 bonds issued by Credit Suisse Group AG, the holding company. These bonds have the ability for the value to be written down if 1) the Common Equity Tier 1 (CET1) ratio falls below 7% or 5.125%, depending on the bond, and 2) if FINMA deems the bank has reached the point of non-viability. In exchange for being subordinated and the potential of impairment, AT1 bonds tend to pay higher yields relative to senior bonds.

As stated above, the two bonds have reacted very differently because of the acquisition. The senior bonds have moved higher in price as of March 20, but are still cheap compared to similar senior bank bonds, while the AT1 bonds were forced to be written off to $0 by FINMA.

CI GAM's investment rationale for Credit Suisse's senior and AT1 bonds include:

- Strong historical bank franchise: Credit Suisse was one of two Swiss national bank champions with a diversified global banking franchise, including a very solid domestic Swiss bank subsidiary, and one of the largest wealth management platforms in the world
- Regulatory backdrop: The conservative Swiss regulatory regime goes beyond the Basel minimum standards for systemically important banks and requires the bank to maintain a very strong capital base. Prior to last week, the bank's CET1 ratio was 14.1% vs. a regulatory minimum of 10.2%.
- Strong capital and liquidity profile: Credit Suisse has always maintained significant liquidity when assessing its regulatory liquidity requirements. It holds a portfolio of High-Quality Liquid Assets (HQL) of CHF118B, of which CHF62B is cash held at the central banks, primarily the U.S. Federal Reserve and the European Central Bank (ECB), and their liquid assets are largely hedged for interest rate risk. Additionally, their Liquidity Coverage Ratio (LCR) was 150% of short-term obligations.
- Incentives for AT1 coupon payment: Swiss AT1 capital notes are structured with a dividend stopper feature, meaning if the coupons are not paid, then a common equity dividend cannot be paid, and the bank has paid an uninterrupted dividend for decades.

Sources: CI Global Asset Management as of March 21, 2023.

CI GLOBAL ASSET MANAGEMENT

For more information, please visit ci.com.

GLOSSARY OF TERMS

Contagion: A contagion is the spread of an economic crisis from one market or region to another and can occur at both a domestic or international level.

Liquidity: The degree to which an asset or security can be quickly bought or sold in the market without affecting the asset's price. Cash is considered to be the most liquid asset, while things like fine art or rare books would be relatively illiquid.

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