Special Coverage:

Swiss bank deal: Good for equity markets but a concern for AT1 bond market

Willem Sels
Global Chief Investment Officer,
HSBC Global Private Banking
and Wealth

Key takeaways

- The agreement by UBS to buy Credit Suisse in a government-brokered deal for CHF 3bn is a positive for global equity market sentiment. Banks around the world have seen their share prices plummet and credit default swap (CDS) levels spike since Silicon Valley Bank (SVB) saw large deposit withdrawals.
- A series of forceful actions by central banks and regulators around the world have reduced the risks of deposit flight and banks have been provided with plenty of liquidity. In the case of Credit Suisse, by combining with UBS, the solidity of the combined bank's business model, capital and huge liquidity assistance provided by the Swiss Central Bank should provide enough confidence to temper European banks' stock price volatility.
- We think credit spreads on bank bonds will widen and volatility will especially increase for all bailinable instruments. Financial conditions around the world have already been hit by the recent turmoil, and surveys are already showing some tightening in bank lending conditions. This could have a negative impact on economic growth. We remain selective in our sector picks, preferring healthcare, energy, consumer discretionary and communications; and continue to focus on quality, across equity and bond markets in all sectors.

What happened?

- The agreement by UBS to buy Credit Suisse in a government-brokered deal for CHF 3bn is a positive for global equity market sentiment. Banks around the world have seen their share prices plummet and credit default swap (CDS) levels spike since Silicon Valley Bank (SVB) saw large deposit withdrawals. A series of forceful actions by central banks and regulators around the world have reduced the risks of deposit flight and banks have been provided with plenty of liquidity. In the case of Credit Suisse, by combining with UBS, the solidity of the combined bank's business model, capital and huge liquidity assistance provided by the Swiss Central Bank should provide enough confidence to temper European banks' stock price volatility.
- The Swiss regulator's (FINMA) announcement reads as: *"In close coordination with FINMA, the Swiss Confederation and the SNB, UBS will take over Credit Suisse in full. The extraordinary government support will trigger a complete write-down of the nominal value of all AT1 shares of Credit Suisse in the amount of around CHF 16 billion, and thus an increase in core capital."*

Investment summary

- We are surprised by the write-down of the AT1, and believe AT1 markets across Europe will react negatively. Very recently, CS management stated the balance sheet was healthy and capital ratios were strong, and well above the level where the mechanical trigger for AT1 would be activated. By using its discretionary powers and disturbing the waterfall (allowing equity holders to receive CHF 3bn but AT1 to be written down), the actions of the FINMA have sharply increased the "regulatory" risks and reduced the visibility for AT1 investors. Although the action by the FINMA does not imply that similar steps would be taken elsewhere, markets would probably welcome more guidance from regulators around the world now on how they could use discretionary triggers in the future.

- We think credit spreads on bank bonds will widen and volatility will especially increase for all bailinable instruments. In our portfolio strategy, we have been focusing on senior and Tier II instruments, but will reassess in coming days and potentially narrow our focus even further on senior instruments.

- If the AT1 market sees extended weakness and less primary activity, this could raise the cost of funding for banks. Financial conditions around the world have already been hit by the recent turmoil, and surveys are already showing some tightening in bank lending conditions. This could have a negative impact on economic growth. As a result, we remain selective in our sector picks, preferring healthcare, energy, consumer discretionary and communications. The first two are defensive sectors, while the other two benefit from the fall in rate expectations we've seen recently as a result of the turmoil. We continue to focus on quality, across equity and bond markets in all sectors.

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