# Banking sector commentary: European banks: steadying the ship?

20 March 2023

**A week on from the collapse of Silicon Valley Bank in the US, all eyes are on Europe with the merger of UBS following its takeover of Swiss rival Credit Suisse. Has the deal to rescue Credit Suisse – and the wider actions of European regulators – helped to restore confidence?**

### What has happened?

UBS has agreed to acquire its troubled Swiss rival Credit Suisse in a deal worth CHF 3 billion (USD 3.3 billion). Brokered by the Swiss government, this rescue avoids the disorderly failure of one of the world's 30 systemically important financial institutions and the second-largest lender in Switzerland.

This follows a week of turmoil in the sector beginning with the collapse of Silicon Valley Bank in the US. Other US banks have faced similar struggles, including Signature Bank (now the third-largest bank failure in US history) and First Republic Bank (subject to continuing rescue efforts).[1]

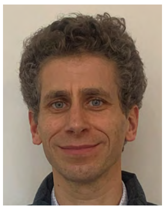
Credit Suisse has underperformed the banking sector for several years, following losses related to the collapse of Archegos Capital Management and Greensill.

While in many ways idiosyncratic events – with each bank suffering from specific issues – these incidents can also be viewed as the ramifications of the fastest and largest rise in interest rates for more than 40 years, following years of easy monetary policy.

In effect, money has a cost again. The world economy has ultimately entered a period of re-adjustment and rebalancing. As so often in the past, this process leads to financial stresses and accidents.

### Our views

## Fixed income:



**Simon Outin**
Director of Financials Research, Global

In our opinion, the acquisition of Credit Suisse by UBS is sufficient to provide visibility for the Credit Suisse group. Credit spreads and credit default swaps on the senior debt issued by the Credit Suisse holding company and operating companies should stabilise in the coming days and weeks, avoiding the disorderly failure of one of the 30 globally systemically important financial institutions.

In many respects, the deal looks favourable for UBS, although may not be without risks:

- **Scope** – Credit Suisse's valuable Swiss bank is included in the deal, and antitrust considerations are not considered relevant given financial stability concerns.

1. First Republic secures $30 billion rescue in aftermath of SVB and Signature Bank collapse | CNN Business

## Fixed income *(continued)*

- **Liquidity** – Includes a liquidity line of up to CHF 100 billion plus the CHF 50 billion provided to Credit Suisse last week.
- **Capital** – CHF 16 billion worth of AT1s written down and badwill of more than CHF 30 billion, ie, the common equity tier 1 (CET1) of Credit Suisse minus the CHF 3 billion price.
- **Tail risk** – Also includes up to CHF 9 billion second-loss insurance from the federal Swiss government.

The consequences for additional tier 1 (AT1) bond holders are significant.

The deal to rescue Credit Suisse involved the write-down of USD 17 billion of AT1 debt to zero. This represents the largest loss in the AT1 market to date.[2]

AT1 bonds were created in the wake of the global financial crisis to absorb losses in a going-concern scenario. The goal was to facilitate the rescue of banks while avoiding using too much public money – in contrast to the banks' hybrids issued before the crisis. Also known as contingent convertibles, AT1s help banks meet their capital requirements, because they can be converted into equity or written down if the issuing bank's capital strength falls below a pre-determined level.

Concerns about the wider prospects for AT1s led to negative price action varying from 5-20 percentage points across the board for European banks on Monday morning.

But it seems the markets have drawn some limited reassurance from the statement by the European banking regulators, and subsequently the Bank of England, reiterating that – despite what happened in the case of Credit Suisse – AT1 debt holders should suffer losses only after equity investors have been fully wiped out.[3]

In addition, we believe banks will do the maximum to pay coupons as due and to reimburse on the first call date with a view to bolster much-needed confidence. Banks can also replace AT1s with pure CET1 capital – a decision, we believe, they are likely to take on a unilateral basis, if the supervisor agrees, as the banks estimate their cost of equity versus cost of funding.

In the case of Credit Suisse, senior creditors (preferred or not) have been fully protected.[4] We think that, after the initial shock reaction on Monday, this will likely be reflected in positive price actions on AT1s, which are critical for financial stability in Europe.

## Equity:

**Dirk Becker**
Senior Portfolio Manager, Global Financials

Credit Suisse has been seen as the weakest link in the global banking sector for several months, after various scandals and poor management decisions.[5] We think the merger can therefore help to stabilise the global financial system:

- In our view, UBS are being paid for running down the risky parts of Credit Suisse, and they get to keep the highly profitable Swiss domestic unit in return. They will have a CHF 54 billion gain on the first consolidation because they are buying the Credit Suisse equity at a huge discount, and they get the AT1 capital on top for "free" – although there will likely be many issues to deal with over the coming years as the Credit Suisse positions are wound down and legal costs have to be paid.
- The decision of the Swiss regulator to wipe out Credit Suisse's AT1 bonds while equity holders receive at least a token compensation initially sent shockwaves through the AT1 market (see above).[6] If, in contrast to what had been said before, those instruments rank, junior to equity in the capital stack, a repricing of those bonds would be required. Banks who issue new instruments will pay a higher risk premium, so this instrument becomes more expensive. (And if it becomes more expensive than equity, there is no reason to issue it any longer.) But in our view, the statement from EU regulators should calm fears in the European banks' AT1 market.[7]
- The takeover of Credit Suisse could be seen as a positive for the wider banking sector and the financial system as a whole. Banks are still expecting a record year in 2023

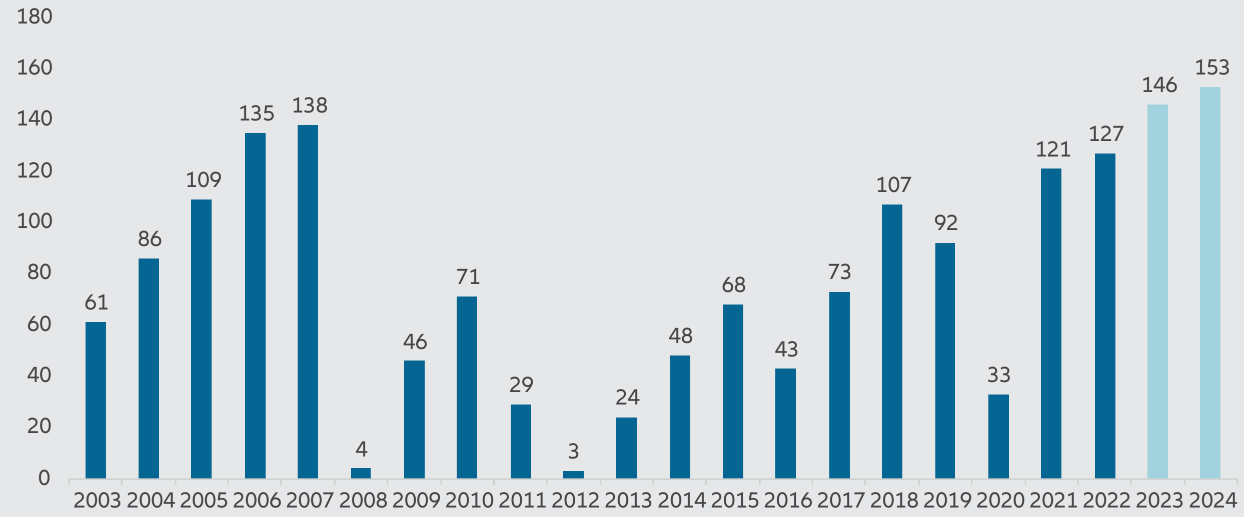
2 Analysis: Credit Suisse rescue presents 'buyer beware' moment for bank bondholders | Reuters
3 AT1 Bond Holders Should Bear Losses Only After Equity, EU Authorities Say - Bloomberg
4 Additional tier 1 bonds: the wiped-out debt at centre of Credit Suisse takeover | Financial Times (ft.com)
5 Credit Suisse: Investors wary of contagion amid banking crisis fears (cnbc.com)
6 $17 billion of Credit Suisse bonds worthless following UBS takeover (cnbc.com)
7 AT1 Bond Holders Should Bear Losses Only After Equity, EU Authorities Say - Bloomberg

## Equity *(continued)*

due to higher interest rates after posting their highest net profit last year since 2007 (see chart below). Q1 results should be helped by fixed-income trading. The economy is still stronger than anticipated, which should keep loan losses under control. The sector is trading on 0.6x price-to-book-value ratio and 6x price-to-earnings ratio for 2023E.

Looking ahead, regulation is potentially the key risk. Regulators tend to take a conservative view on risk and prefer to err on the cautious side. Will the European Central Bank (ECB) prefer the banks to keep equity on the balance sheet – rather than honour their commitments to generous dividends and share buybacks? While it is difficult to call, the Credit Suisse incident may be atypical of a sector that has – so far – seemed relatively robust during this crisis.

**Exhibit 1: European banks net profit (EUR billion)**




Source: Bloomberg, as of 20 March 2023

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