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Neuberger Berman Fixed Income

Update on European Banking Sector— Monday, March 20, 2023

We have seen some significant market movements post the events over the last week and will be addressing these in turn. Firstly, the UBS takeover of Credit Suisse (CS), and secondly, our view on the broad implications on the European Banking Sector.

Summary of UBS takeover of Credit Suisse

- *On March 19, 2023, Swiss regulators approved the merger of UBS and Credit Suisse in an effort to ensure the stability of the bank's customers. The government brokered transaction will consist of UBS acquiring Credit Suisse for approximately CHF 3 billion in an all-stock transaction with the Swiss National Bank (SNB) providing UBS liquidity in support of the transaction. The Swiss government will also provide guarantees for potential losses of certain assets that UBS will acquire.*
- *In terms of creditors, the government support will also trigger a complete write-down of the CHF 16 billion outstanding CS Additional Tier 1 bonds (AT1) resulting in an increase in core capital. The outstanding holding and operating company senior unsecured bonds of CS will be assumed by UBS upon closing of the transaction expected to occur in the second quarter of 2023. UBS will be the surviving entity upon the closing of the transaction.*
- *Our view is that UBS's business profile will strengthen over the medium-term with the inclusion of CS's core franchises in Swiss Universal Banking, Global Wealth, and Asset Management.*
- *Integration risk will be in focus near-term, and there is some uncertainty on the final cost to wind down part of CS's non-core assets, mainly in the Investment Bank.*
- *However, the deal was structured favourably for UBS, with UBS receiving CHF 25bn of downside protection to help with these costs.*
- *Both UBS and CS will also benefit from unrestricted access to the SNB facilities for liquidity posting eligible collateral, if required.*
- *CS operating bank entities continue to operate as a going concern today offering customers bank services as per normal.*

AT1 Bonds and the broader European Banking Sector Thoughts

- *The immediate reaction for the European banking sector is that bank senior unsecured credit spreads are wider today and could impact funding costs over time.*
- *However, we note that the issues with CS were quite specific to the issuer as they were already executing a restructuring plan. However, the market grew relatively impatient with the bank's three-year turnaround plan to return to stronger profitability.*
- *We do not expect any losses for other banks from this situation at CS and UBS.*
    - *We note that CS AT1 bonds were structured differently than AT1 bonds issued by European or UK issuers. For example, the Credit Suisse Group AG (CSG) AT1 were all issued out of the holding company and structured as permanent write-down instruments.*
    - *These bonds could suffer from a full principal write-down to nil if the Swiss supervisor, FINMA, declares a "viability notice" had occurred or if the issuer's common equity Tier 1 ratio falls below 7.0%.*
    - *The viability notice is broadly defined to include deficiency on capital, inability to pay debts as they come due, and receiving commitment of extraordinary support from the public sector without which, by the regulators determination, the bank would become insolvent.*

  - *As CS received extraordinary support from the public sector in the form of liquidity support from the SNB on March 19 as part of the agreed merger with UBS, a viability notice was triggered and FINMA declared CHF 16 billion of CS AT1s would be written down to nil.*
- *However, as noted above, AT1 bonds issued by UK and Europe (non-Swiss) institutions are different.*
  - *These UK and (non-Swiss) European AT1 bonds are typically structured as equity conversion instruments, meaning the loss absorption mechanism results in the AT1 principal converted into common equity.*
  - *Europe (non-Swiss) and UK legislation also both follow EU's Bank Resolution and Recovery Directive, which states AT1 instruments can only be written off to zero if common equity shareholders of the bank have effectively been wiped out first, following the "no creditor worse off" principle.*
  - *This essentially would prevent the equity of a failed bank to receive positive value, while the AT1 would receive nil value as in the case of CS.*
  - *The typical feature that allows regulators to impose losses on AT1 bonds is if the bank's common equity Tier 1 ratio were to fall below a specified threshold—typically set at either 5.125% or 7.0% common equity ratio—or the bank is declared to have failed or is expected to fail by the supervisor.*

In summary, while the situation remains fluid, we will continue to monitor as events unfold across the wider banking sector.