AHAM CAPITAL ASSET MANAGEMENT

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FUNDAMENTAL FLASH

UBS-Credit Suisse Deal

Prepared by AHAM Asset Management

Overview

On Sunday, March 19, 2023, the Swiss Financial Market Supervisory Authority (FINMA) orchestrated a rescue merger of Credit Suisse. Under the deal, UBS would acquire Credit Suisse for US$3.2bn to prevent the latter's collapse.

In our Fundamental Flash, we unpack the key takeaways from the deal and implication to markets.

What happened to Credit Suisse?

Credit Suisse has been experiencing a crisis of confidence, which has resulted in a considerable outflow of deposits. This was intensified by the upheavals in the US banking market over the past 2 weeks.

There was a risk of the bank becoming illiquid, even if it remained solvent, and the Swiss regulators deemed it necessary to act in order to prevent serious damage to the Swiss and international financial markets.

Thus, FINMA, the Swiss Confederation and the Swiss National Bank (SNB), approved the transaction for UBS Group to take over Credit Suisse Group in full, where UBS would acquire Credit Suisse for US$3.2bn in an all-share merger.

In addition, SNB will offer up to CHF 100bn liquidity line to UBS for this transaction.

Flashpoints

- Swiss regulators have orchestrated a rescue merger of Credit Suisse to prevent the collapse of the Swiss bank.
- Under the deal, UBS would acquire Credit Suisse for US$3.2bn to prevent the latter's collapse
- However, in an unprecedented case, the transaction would trigger a complete write-down of the nominal value of all AT1 bonds.
- The recent banking turmoil would likely result in tighter financial conditions for households and businesses which could in turn impact the US economy.
- While the US could see a slowdown in economic growth as banks grow more cautious of lending, we could see the limelight shift to Asia.

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Timeline of Events – Credit Suisse

9 Mar

Credit Suisse ("CS") delayed the release of 2022 annual report.

14 Mar

- CS published the 2022 annual report and noted on "material weakness" spotted in financial reporting processes.
- CS CEO said bank's liquidity basis is "very very strong" in an interview with Bloomberg.

15 Mar

Saudi National Bank said it was not able to provide any more cash to CS, citing regulatory and statutory constraints. CS share price down 24%.

16 Mar

- Swiss National Bank ("SNB") offered CS up to CHF 50 billion short term liquidity facility.
- SNB and FINMA mentioned CS meets the capital and liquidity requirements imposed on systemically important banks.

19 Mar

- UBS announced the takeover of Credit Suisse with the approval from FINMA and liquidity assistance provided by SNB.
- According to a statement by FINMA, the extraordinary government support would trigger a complete write-down of Credit Suisse AT1 bonds in order to increase core capital.

What are the implications to shareholders?

Shareholders of Credit Suisse will receive 1 share in UBS for 22.48 shares in Credit Suisse upon completion of the merger.

What about bondholders?

According to a statement by FINMA, the extraordinary government support would trigger a complete write-down of Credit Suisse AT1 bonds in order to increase core capital.

This effectively means that under the terms of the emergency rescue package, the nominal value of all of Credit Suisse Additional Tier 1 (AT1) bonds amounting close to US$ 17bn would be written-down to zero which is the largest in the history of the asset class.

Why were the AT1s written down?

In the event of a normal write-down scenario, shareholders are the first to take the hit before AT1 bonds face losses. However, in this instance Credit Suisse shareholders would receive US$3.25bn, while A1 bondholders get nothing.

This goes against the established conventional corporate finance pecking order in the payment hierarchy. The decision has provoked a furious response from other AT1 bondholders as it has not accounted for the bond seniority over the lender's shares in the capital structure.

What are AT1 bonds?

AT1 bonds are also known as “contingent convertibles,” or “CoCos”. It is ranked higher than common equity but below senior debt in the capital structure.

When will the merger be completed?

Developments are still fluid and the merger between UBS and Credit Suisse is still pending completion. Media reports suggest that the transaction may only be completed by the end of the year.

What are our views on AT1 bonds as an asset class?

Given the unprecedented action taken by the Swiss regulator to prioritise shareholders over bondholders, this has raised concerns over prospects for other lenders’ AT1s. The European Central Bank has in its statement lent support to other European AT1s, stabilising the whole asset class in the following trading days.

We believe sentiment for AT1s will likely remain poor and expect volatility to persist. On a firm-wide basis, AHAM Capital is looking to reduce overall AT1 exposure into this cycle.

What is our outlook on markets and the macro environment?

The recent banking turmoil would likely result in tighter financial conditions for households and businesses which could in turn impact the US economy. At its FOMC meeting yesterday, the US Federal Reserve (Fed) voted unanimously to hike interest rates by 25 bps to 5%.

US Fed Chair Jerome Powell expressed caution about the recent banking turmoil engulfing markets. Nonetheless, strong inflation data and resilience in the labour market led the FOMC to ultimately decide to raise rates at its recent meeting. *(Read more in our Fundamental Flash: Fed Raises Rates by 25 bps)*

While the US could see a slowdown in economic growth as banks grow more cautious of lending, we could see the limelight shift to Asia which could pull fund flows into the region. Tailwinds from China’s reopening and a weaker US dollar could also provide an additional lift to Asia’s recovery which would be supportive for equities.