RUBRICS

A Crisis of Confidence

Fixed Income Macro View

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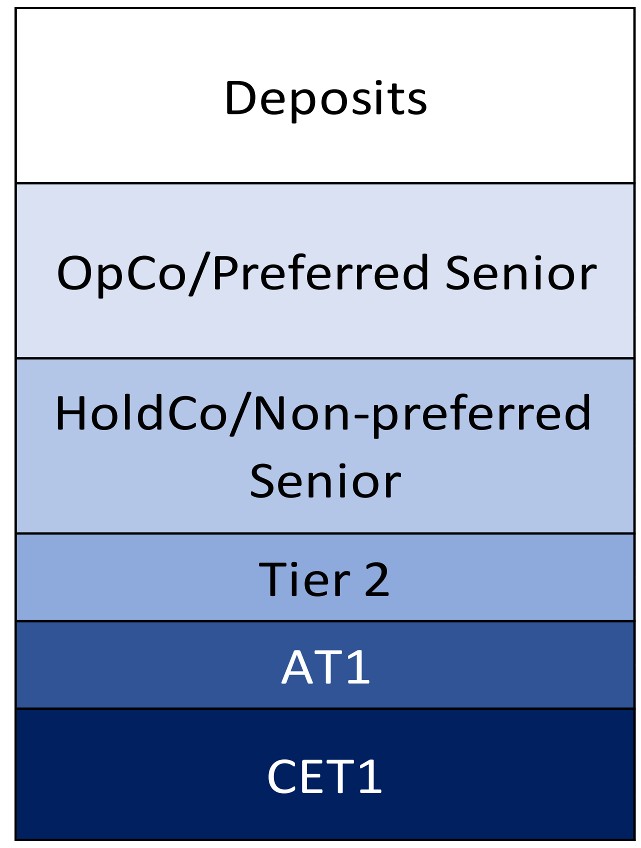
Following a tumultuous week which saw the failure of two regional US banks and volatility across the whole sector, the market shifted its gaze towards Europe with 'error prone' Credit Suisse firmly in their sights. While the Swiss bank has suffered several failures of risk management in recent years (with equity holders repeatedly punished) what finally pushed it over the edge was not a problem with its asset book - some hidden exposure to an illiquid asset class – but rather a crisis of confidence. So why Credit Suisse? Put simply because it was the perceived runt of the litter. Had Silicon Valley Bank risk managed its fixed income book correctly would we even be in this position? Probably not. Ifs and buts notwithstanding, the harsh economic realities have been felt by the Junior Subordinated bond holders as we discuss below. However 2008 this is not. Banks remain extremely well capitalised with loan impairments at the major European institutions at eminently manageable levels[1]. As we wrote in our last piece on the **SVB collapse**, this is not a fundamental crisis of asset quality across the global banking system, but rather an unwanted side effect of aggressive Central Bank tightening following a decade plus of $trlns in QE and negative interest rates.

What Happened to Credit Suisse

Following several weeks of concern over the fate of Credit Suisse, the volume of deposit outflows became too much for the bank to deal with and the Swiss regulator FINMA stepped in quickly to broker a deal with Swiss rival UBS over the weekend.

Chart 1: European Bank Creditor Hierarchy



UBS is acquiring Credit Suisse in an all stock deal valued at CHF 3bn vs its closing market cap of CHF 7.4bn on Friday. This outcome was preferable to a disorderly bankruptcy for the bank or the regulator seizing direct control which could have had implications for the wider banking sector and depositors at Credit Suisse. UBS will absorb the Credit Suisse Holding company ("HoldCo") and Operating Company ("OpCo") bonds. The Swiss authorities passed an emergency law over the weekend which allowed the takeover to take place without a shareholder vote and also for the regulator to trigger and write down the Additional Tier 1 ("AT1") bonds such that its holders will now receive zero. This provides an additional CHF 16bn of capital to UBS to absorb its rival. This action has provoked some controversy among AT1 investors since the typical credit hierarchy has not been respected with equity investors receiving some compensation while the theoretically higher ranked AT1 investors are losing 100% of their investment (see chart above).

1. Per latest earnings releases for FY22

Swiss AT1 vs the Rest of European AT1s

Swiss AT1 bonds come with two different levels of Common Equity Tier 1 (“CET1”) triggers. High trigger AT1s are triggered when CET1 capital falls below 7%, low trigger when CET1 capital falls below 5.125%. Both have ‘bail-in’ language where the regulator can step in and write down the AT1 bonds before the capital triggers are reached, typically when the bank has suffered a viability event. This is what happened to Credit Suisse AT1 bonds when, as aforementioned, the regulator decided the bank’s ability to conduct business had been impaired given the severity of the deposit outflows. Swiss AT1 bonds are unusual in that the action upon triggering is a full permanent write down, while the documentation also gives the regulator wide powers to write down instruments and specifically allows for AT1 investors to receive less than shareholders – another unusual feature of the Credit Suisse write-down. Unlike the Swiss bonds, most European and UK AT1 bonds have either equity conversion or temporary write down. Any conversion or write down of AT1 comes at the point of non-viability and a write down to zero requires that shareholders have been wiped out. Furthermore, there is little prospect of the EU quickly changing these laws to allow a similar outcome to CS AT1, nor is there a desire to do so with the ECB Banking Supervision arm, SRB and EBA releasing a statement on 20th March 2023 highlighting the point that only after shareholders have fully absorbed losses can AT1 be written down. **They also reiterated that AT1 will remain an important part of the capital structure of European banks.**

Market Impact

Credit Suisse had USD ~17bn of AT1 outstanding which has been written down to zero. This naturally constitutes a blow to investor confidence in the asset class. After the news on Sunday evening, AT1 bonds opened trading Monday on average 10-15pts lower. However as the market digested the news flow, helped somewhat by the ECB statement, sentiment has recovered and prices are recouping some of their earlier losses. It is worth noting spreads on senior bank debt have barely moved at all, highlighting the fact that sentiment is concentrated on AT1. Bond ETFs which invest solely in Bank CoCos have naturally suffered most, although we would note that one such product has seen intra day mark-to-market go from -16% to -6% at the time of writing[2]. Despite the volatility, European regulators have worked hard to establish AT1 as an important part of the capital structure and will be keen to see the market return to some sense of stability. With a number of bonds due to be called in 2023, market confidence would go some way to being restored if these bonds were called as previously expected, particularly for those banks which have already pre-financed the call with AT1 issuance. While it is too early too call time on the volatility within AT1s, we do feel a similar outcome elsewhere in Europe or the UK in terms of punitive regulatory treatment is unlikely. The extent to which the markets view Credit Suisse and the treatment of their AT1s as an isolated issue will go a long way to improving sentiment within the broader asset class.

Rubrics Portfolio Exposure

As mentioned previously, Rubrics has tended to focus our bank holdings on large, systemically important money centre institutions. Over the past 12 months as rates have increased, we have tended to reinvest proceeds of maturing bonds into shorter dated government bonds or higher quality senior investment grade paper. As a result the funds have a very high allocation to government bonds and cash-like instruments.

Fund	Credit Suisse Exposure	AT1 Exposure	Duration AT1 Exposure	Cash + Govt Bonds
Rubrics Global Credit UCITS Fund	0.0%	6.1%	1.2	40%
Rubrics Enhanced Yield UCITS Fund	0.0%	0.0%	N/A	65%
Rubrics Global Fixed Income UCITS Fund	0.0%	1.6%	0.6	73%
Rubrics Emerging Markets UCITS Fund	0.0%	0.0%	N/A	26%

Source: Rubrics AM as at 20/03/2022

At the time of writing, Rubrics have no exposure to Credit Suisse bonds with broader Bank AT1 holdings limited to the Global Credit UCITS Fund (6.1%) and Global Fixed Income UCITS Fund (1.6%). Exposure in both funds is concentrated in larger UK (e.g. Lloyds, Barclays) and French (e.g. Soc Gen, Credit Agricole) issuers. Furthermore exposure has been deliberately kept short dated (typically 18 months or less to call date) with average duration of 1.2. While it has been a volatile day in the asset class, current indications are that levels on AT1 bonds are very broadly 5-10 points lower on the day. Given the nature of our holdings we would expect the mark-to-market impact on securities to be towards the less severe end of this scale. More broadly as the impacts of tightening continue to be felt we would expect the weakest parts of the credit market to come under pressure. While this has certainly been a trying time for AT1 bank bonds, what we can say is that yields have adjusted to levels which are more reflective of increased macro risks.

IMPORTANT INFORMATION

March 2023

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Additional Information for Switzerland: The prospectus and the Key Investor Information Documents for Switzerland, the articles of association, the annual and semi-annual report in French, and further information can be obtained free of charge from the representative in Switzerland: Carnegie Fund Services S.A., 11, rue du Général-Dufour, CH-1204 Geneva, Switzerland, tel.: + 41 22 7051178, fax: + 41 22 7051179, web: www.carnegie-fund-services.ch. The Swiss paying agent is: Banque Cantonale de Genève, 17, quai de l'Ile, CH-1204 Geneva. The last share prices can be found on www.fundinfo.com. For the shares of the Funds distributed to non-qualified investors in and from Switzerland and for the shares of the Funds distributed to qualified investors in Switzerland, the place of performance is Geneva. Carne Global Fund Managers (Ireland Limited reserves the right to terminate the arrangements made for the marketing of this product in any EEA jurisdiction in accordance with the UCITS Directive.