FUTUREGROWTH
/ASSET MANAGEMENT

THE IMPACT OF THE CREDIT SUISSE SITUATION ON SOUTH AFRICAN BANKS

Author: Craig Ivy, Head: Listed Credit
Published: April 2023

The approval of the takeover of Credit Suisse by UBS was announced by the Swiss Financial Market Supervisory Authority (FINMA) on 19 March 2023. This involved a permanent write-down of around CHF 16 billion (Swiss francs) of Additional Tier 1 (AT1) bonds to zero.

In order to evaluate the impact of this development on our local banking sector, it may be helpful to understand the instruments and banking regulations involved.

Brief history of AT1 and Tier 2 instruments

Additional Tier 1 (AT1) and Tier 2 (T2) capital instruments were established by financial market regulations following the global financial crisis (GFC) in 2008. The purpose of these instruments was to ensure that banks have sufficient capital to:

- mitigate the risk of failure;
- protect the stability of the financial system; and
- ensure that losses following a failure are primarily borne by the bank's investors rather than taxpayers.

To achieve this, banks were required to be sufficiently capitalised, and loss-absorbing capital instruments, such as AT1 and T2, were introduced. These instruments contained contractual loss-absorption clauses that could be "bailed-in" (i.e., converted to equity or written-down) at the point of non-viability or bank resolution to return a bank to a viable state.

Bank regulatory body powers

The key attributes of effective resolution regimes for financial institutions were developed by the global Financial Stability Board (FSB), an international regulatory body. These attributes indicate two points at which regulators can exercise certain powers: a) to stabilise a bank and return it to viability, and b) to initiate the resolution of a bank. These points are known as the point of non-viability (PONV) and the point of resolution (POR), respectively.

a) PONV

A PONV can be triggered qualitatively or quantitatively (e.g., when a bank's Common Equity Tier 1 (CET1) ratio falls below a certain percentage). At this point, a regulator can decide that instruments with contractual loss absorption clauses need to be bailed-in to return a bank to viability, which means that the creditor hierarchy does not need to be followed at PONV.

For example, in the case of Credit Suisse, AT1 bondholders were written off before equity was written off.

b) POR

If these actions by the regulator are not enough to return the bank to viability, the bank enters resolution (POR), and the resolution authority would manage the resolution process in accordance with a normal creditor hierarchy that respects the "no creditor worse off than in liquidation" (NCWOL) principle, meaning that equity would need to be wiped off first before debt holders lose out. It is important to note that these contractual loss absorption clauses are agreed upon by bondholders in these instruments' legal agreements.

What happened with Credit Suisse?

In the case of Credit Suisse, on 19 March 2023, the FINMA press release outlined the contractual basis (qualitative reason) for the AT1 write-down: *"On March 19th, 2023, the Federal Council enacted the Emergency Ordinance on Additional Liquidity Assistance Loans and the Granting of Federal Default Guarantees for Liquidity Assistance Loans by the Swiss National Bank to Systemically Important Banks. The Ordinance also authorizes FINMA to order the borrower and the financial group to write down Additional Tier 1 capital."* The extraordinary government support (liquidity assistance and guarantees for potential losses of certain assets that UBS would acquire as part of its takeover of Credit Suisse) was the qualitative point that triggered a viability event (i.e., PONV), and as a result, the regulator exercised its PONV powers to bail-in the bank's AT1 bonds. It is important to note that Credit Suisse investors have suffered a loss in value for years due to the bank's mismanagement, resulting in substantial outflows of client funds over the years. This loss of confidence increased with the issues and risks arising from the US banking sector drama due to the failure of Silicon Valley Bank. Therefore, because of the additional risks to Credit Suisse, it became necessary for the Swiss authorities to take action to prevent damage to the Swiss and international financial markets, which resulted in the extraordinary government support.

Source: Investing.com

We believe the regulators opted for the merger with UBS instead of completely writing off the equity in order to stabilise the banking sector, as opposed to the potentially chaotic alternative of placing Credit Suisse into resolution. This decision was likely influenced by the existing apprehension surrounding the global banking system.

How is the South African situation different?

In July 2019, the South African Reserve Bank (SARB) released a draft discussion document outlining its approach to dealing with the failure of systemically important banks. According to current regulations, the Prudential Authority (PA) has the power to intervene if a bank is non-viable or likely to become non-viable, also known as the point of non-viability (PONV). In such cases, the PA can activate the contractual write-down or conversion loss-absorbing clauses in the AT1 and T2 regulatory capital instruments, leading to a regulatory bail-in without requiring equity to be written off, as was the case with Credit Suisse.

However, the PA has noted that for South Africa's systemically important banks, PONV is unlikely to be a successful recovery option. As a result, the PA proposes that at PONV, the bank will enter resolution (POR) instead. This decision is based on several factors, including the potential for investor reluctance to invest in similar instruments of other South African banks, which could impact the pricing of bank funding. Additionally, SARB is uncertain about the amount of AT1 and T2 that could be written off through regulatory bail-in, as the values of instruments issued by global standards are considered low, and may not be sufficient to restore the bank to viability. Finally, any systemically important bank that reaches PONV could trigger a market reaction that could potentially freeze access to funding for the bank.

FUTUREGROWTH
/ASSET MANAGEMENT

As a result, in that same July 2019 note, SARB noted that PONV is unlikely to be a successful recovery option for the country's systemically important banks and proposed that at PONV, it would trigger POR (i.e., PONV = POR). This means that shareholders (equity) would take losses before AT1 and T2 instruments, in line with the creditor hierarchy and NCWOL principle. Although in theory, AT1 could be written off before equity, it is highly unlikely that the PA would take a different approach in the exercise of its regulatory bail-in powers, given the "No creditor worse off" principle included in the Financial Sector Regulation Act of 2017. **However, it is important to note the risk that subordinated debt (AT1 and Tier 2) can be written off in full without it being classified as an event of default. Therefore, Investors should price accordingly for these risks.**

Some comfort

On 24 March 2023, the Minister of Finance gazetted the commencement of certain provisions of the Financial Sector Laws Amendment Act of 2021, which establishes the resolution authority in South Africa. One of these provisions ensures that no creditor or shareholder of a designated institution in resolution will receive less than they would have in liquidation, thereby providing investors with comfort that they will not take losses before lower-ranking creditors. While there is a possibility that AT1 and T2 could be permanently and fully written off to zero, our South African banks are better run than Credit Suisse, and, in the worst-case scenario, the normal creditor hierarchy would be followed.

Published on www.futuregrowth.co.za/insights.

Futuregrowth Asset Management (Pty) Ltd ("Futuregrowth") is a licensed discretionary financial services provider, FSP 520, approved by the Registrar of the Financial Sector Conduct Authority to provide intermediary services and advice in terms of the Financial Advisory and Intermediary Services Act 37 of 2002. The fund values may be market linked or policy based. Market fluctuations and changes in exchange rates may have an impact on fund values, prices and income and these are therefore not guaranteed. Past performance is not necessarily a guide to future performance. Futuregrowth has comprehensive crime and professional indemnity in place. Performance figures are sourced from Futuregrowth and IRESS.