CANDRIAM
A NEW YORK LIFE INVESTMENTS COMPANY

Impact of Credit Suisse takeover.

20 March 2023

- **Portfolios managed by Candriam have no exposure to any Credit Suisse security, OTC exposure or stock-lending exposure.**
- **In particular there is no exposure to any Credit Suisse bonds, including AT1s or any other hybrid instruments in portfolios managed by Candriam.**
- **Candriam's ESG analysis has excluded Credit Suisse from our ESG universe since 2014**.

- In a matter of days, investors' attention shifted from improving growth prospects to concerns about **financial stability**
- In the European banking system, Credit Suisse was the weak link.
- While Credit Suisse was a global systemically important bank (G-SIB), its weaknesses were known and, we believe, **were not representative** of Europe's banking sector as a whole.
- The contagion risk **should now be limited** by its acquisition over the weekend.
- As this is primarily a matter of confidence in the banking sector, we are watching market history being written over the next few days.

FAST ACTION: UBS TAKES OVER CREDIT SUISSE

In our view, the swift takeover by UBS was the only short-term solution. A muddle-through would have caused more stress and uncertainty in financial markets and could have led to a bank resolution scenario, the worst-case for market participants.

The market had reacted positively to the deal with UBS on Monday, as sentiment did not show further deterioration. It is a relief and an indication that market participants are prepared to "wait and see" for the Fed meeting on the 22nd of March.

The contagion involving other banks remains rather limited for now as we observe the evolution of CDS. **Equity markets have** been more severely impacted, with the bank index in Europe falling by 15% since the beginning of March, **which had offset entirely its gains made since the beginning of the year.**[1]

[1] Data: STXE 600 Banks – Source: Bloomberg, data as of 20.03.23

Central banks including the US Federal Reserve, the ECB, the Bank of England, the Bank of Japan and the Swiss National Bank (SNB) are also providing liquidity to markets enhancing dollar swap lines in a coordinated response. **This appears to be a very pre-emptive action** as the SNB awarded USD101m in a daily seven-day maturity repo operation, while the ECB allotted just USD5m to a single bidder while the BOE and the BOJ received zero bids.

THE TERMS OF THE DEAL

After weekend negotiations between FINMA, Swiss National Bank, Swiss Government, UBS and Credit Suisse, **UBS acquires Credit Suisse (CS) in a CHF3bn all-share deal, as the bank was no more considered as stand-alone viable**. The transaction involves a 59% discount to Friday's 17 March close and **trigger a complete write-down** of the nominal value of all AT1 shares of Credit Suisse in the amount of **around CHF16bn, and thus an increase in core capital.**

In addition**, Swiss National Bank (SNB) will support UBS with an additional CHF 100bn** of ELA liquidity while the Swiss Government will provide UBS with a CHF9bn guarantee on CS losses as a second tranche, with UBS at risk of the first CHF5bn of losses (if losses are higher, they will be split between UBS and Switzerland).

In terms of additional details**: UBS confirmed that it will shrink the investment bank to <25% of the group's risk-weighted assets (RWAs)** and expect an annual cost reduction of more than USD8bn by 2027. UBS will keep paying dividends but suspend buybacks temporarily and expect the merger to be EPS accretive by 2027.[2]

This deal will turn UBS as the largest bank in Switzerland managing over USD 5 trillion, including the asset management and the wealth management divisions. **This takeover will create the second wealth manager in the world and the third asset manager in Europe.**

Given that the takeover will result in a larger bank, it will be subject to higher capital buffers. FINMA will grant appropriate transitional periods for these to be built up. It should lead the combined UBS-CS entity to likely have an increase in its G-SIB bucket – from bucket 1 (1.0% of RWAs) to at least bucket 2 (1.5%). **The deal should be finalised during Q2 2023**.

Over the short term, **and while the US regional banks situation is not yet solved**, this deal appears to have reassured investors. **However, this solution has shaken the AT1 market** as investors are reassessing the risks of these instruments. This is a USD 275 bn market. In the future, this could increase the cost of capital for the banks. We view this issue as relatively contained though because these instruments could represent maximum 18.75% of the total regulatory capital of a bank and managements still have the possibility to use pure (core) equity which might be the end of the game if AT1 costs are too high. Furthermore, already issued AT1 bonds are perpetual instruments with no obligation to call and so there are no refinancing risks. **Finally, so far, the exposure of insurance companies to AT1 bonds appears negligible**.

[2] Source: UBS to acquire Credit Suisse | UBS Global

IMPACT ON OUR ECONOMIC SCENARIO AND MARKET VIEWS

The action of the authorities to maintain public confidence in the banking system and the speed with which the crisis is resolved are key for our scenario. **While we continue to believe that our main scenario (slow growth both in the US and euro area) remains the most likely, we must acknowledge that the risk of a much more adverse scenario has increased**. In any case, the events of the last few days are likely to lead to a further tightening of financial conditions and, if they linger, lower terminal rates.

Given recent financial events in the US, this could lead to an additional 5% to 10% decline in commercial and industrial lending (USD140 to 280 billion declines in bank credit, **or 0.5% to 1% of GDP**). The impact on the economy will of course depend on the depth and length of the shock. In the euro area, a tightening of credit conditions was also at work, and we were expecting a 5% contraction of residential investment **(-0.3% of GDP).** This impact could be more important if credit conditions were to tighten further.

Central banks will adjust their monetary tightening to financial developments. While their determination to fight inflation remains untouched, the current trade-off between inflation and financial stability should lead them to slow the pace of their tightening – or even stop tightening – as long as financial turbulences are ongoing.

From a market point of view, we consider that risks are still present but not of the same nature between the United States and Europe: **the stress on small banks in the US increases the risk of recession but does not appear as systemic yet, while in Europe we had to deal with a more systemic risk.**

It will take a few days to see if the risk is really contained and for the dust to settle.

- **In our allocation** we keep a **neutral view on equities** considering both upside and downside risks in a still rather binary situation.

- **In our bonds allocation**, we have **increased the duration of our portfolios**. We keep **a preference for Investment grade credit but are more cautious on High yield bonds**. More specifically, as a result of this move, AT1 markets could come under significant stress and even the senior tranches of bank credit are likely could be negatively impacted as a result of a knock-on effect. Another very important development is the statement issued by the European Banking Authority saying that "common equity instruments are the first ones to absorb losses, and only after their full use would Additional Tier One be required to be written down."

- **In our equity allocation we have a preference for quality style in the markets**. Investors will prefer structural growth over cyclicity for now given the risks financial vulnerability poses to growth. We shall therefore prefer the following sectors: **Healthcare** (globally and particularly US), **Staples** (with European leaders). We also favor **innovative companies and / or quality** (profitability, visibility and solid solvency).

- **Our view on banks**: we still prefer banks with very high solvency and high profitability. These two buffers allow them to withstand higher shocks. We also have a focus on retail banks notably because a higher proportion of retail deposits offers a better stability and a higher liquidity than investment banking models. We note that higher short-term rates provide the sector with a higher profitability even when accounting for higher potential solvency requirements.