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Global Banking Challenges

Thoughts for pension trustees

What happened?

We have seen extraordinary levels of volatility in financial markets across the US and Europe in recent weeks. It began in the US with the collapse of Silicon Valley Bank ("SVB"), followed by the fall of Signature Bank and then Republic Bank. In Europe it was the 167-year-old stalwart institution, Credit Suisse, which quickly became a focus of speculation, culminating in its acquisition (read bail out) by UBS.

These failures highlighted the sensitivity of banks to rising bond yields, and sent shock waves across the global banking industry, once again, highlighting the interconnectivity of markets. This serves as a reminder that despite tightening regulation in the wake of the 2008 global financial crisis, and then subsequent deregulation measures, banks are exposed to market risks.

SVB was a relatively young, regional US bank. By late 2022 it had become one of the 20 largest US banks, being the favoured depository and credit provider for a number of technology start-ups. Many of the deposits held by the bank were uninsured, with some representing a significant

percentage (if not all) of the working capital of the depositing companies. And we note, the federal protection for such uninsured deposits is capped at a relatively low $250,000.

The collapse of SVB was primarily due to the mismatch between its liabilities – instant access bank deposits – and its assets, which were heavily invested in long-dated US government bonds. As a result, SVB was significantly exposed to movements in bond yields, and this started to be felt acutely when the Federal Reserve aggressively increased interest rates to combat inflation. The increased interest rate caused bond values to plummet, leading to more than $17bn in potential losses for SVB. News of this spread quickly, confidence waned, and a run on deposits followed, resulting in $42bn of withdrawals. SVB was forced to sell reserve assets (at a loss) to pay depositors. The result was the insolvency of the bank, with an emergency intervention from US authorities being required and a rescue of the UK arm by HSBC.

Amid the jitters surrounding the collapse of SVB and wider concerns over the US banking system, investors began to look wider afield, with Credit Suisse coming into focus. A string of internal scandals, top management changes, and an uninspiring restructuring plan all contributed to pressure on the Swiss giant.

Credit Suisse turned to its top shareholder and backer, Saudi National Bank, for support. However, the Chair of Saudi National Bank cited regulatory hurdles preventing the injection of more capital. In addition, Credit Suisse reported its largest annual loss of $7.8 bn. This led to a lack of confidence and triggered a deposit run on the bank. In late February, Credit Suisse confirmed investors had withdrawn $119bn. With pressure mounting, the Swiss National Bank provided Credit Suisse with $54bn under a covered loan and liquidity facility. The share price moved significantly higher and credit markets began trading in a more orderly fashion, although bond prices continued to be distressed and the pricing of credit default swaps for banks (a measure of the cost of insuring against bank failure) remained at a premium.

However, the subsequent liquidity pressures were too great. It was announced on 19 March that Credit Suisse and UBS had entered into a merger agreement, with UBS being the surviving entity. Until the completion of the merger, Credit Suisse will continue to conduct business as usual, in collaboration with UBS, and the banks have stressed that they do not expect disruption to client services.

As part of the merger, there was a write-off of $17bn of Credit Suisse Additional Tier 1 (“AT1”) bank debt, sometimes known as contingent convertible bonds, or CoCos. These bonds have, in theory, the option of being converted to shares in Credit Suisse upon an insolvency event. In this instance, the Swiss regulator decided this would not be an option, and bond holders would 'share the pain’ with equity holders. Market commentators have speculated that this move was taken to bolster value in Credit Suisse shares and thereby placate its largest equity holders.

Whilst a move to write down bonds over equity is unusual and is, in theory, against the hierarchy of risk that investors knowingly adopt, it is not entirely unprecedented. That said, these events are high profile and may have longstanding impact. One likely outcome is that yields on similar bank bonds will need to be higher in future to compensate investors for increased ‘regulatory risk’.

So, what does this all mean?

In both the US and Europe, we have seen regulators and authorities intervening in short order to increase market resilience and signal support for the global banking system through their rhetoric. The Biden administration has been clear that it will intervene to provide support to banks where necessary. In Europe the merging of Credit Suisse into UBS Europe has created a ‘super bank’. If Credit Suisse alone was considered too large to fail, then the combined entity certainly is.

What we are seeing is, in effect, a nationalisation of the banking system through regulatory measures. It appears lessons have been learned from the impact of not preventing the failure of Lehman Brothers 15 years ago, but the creation of even greater banking oligopolies in today’s banking system will require diligent regulatory supervision and tighter capital controls to manage market risk.

Robert - stock.adobe.com

Three key takeaways for Pension Scheme Trustees

1. Diversification matters

We have seen an increase in risk across financial markets. This re-emphasises the need to ensure investment portfolios are sufficiently diversified and spread across different return drivers in order to protect against volatility. The perils of not being diversified are indeed illustrated by many of the tech businesses that banked with SVB – some of whom held their entire operating cashflow at SVB, and subsequently wished dearly that they had not.

This is an opportunity for trustees to consider the implications of such volatility on their investments, and to assess their asset, industry, and sector exposures with a view to avoiding any unintended concentrations of risk. And it is worth remembering that at times of market stress, active management can add additional value without adding to overall risk. Current credit spreads mean there are some compelling opportunities within listed and private credit markets.

2. The impact of interest rates on liability hedging

The increase in bond yields we saw during February has reversed. Yields fell during March, with the 20-year annualised government bond yield falling from 4.2% at the start of the month to stabilise at c.3.8% by month end. If inflation continues to fall in line with the Bank of England's projection, and the domestic 'cost of living crisis' continues to dominate, we could see UK bond yields stabilise at current levels, or perhaps even move lower. However, the Bank of England is steadfastly committed to its quantitative tightening programme and the ongoing sale of the bond assets it already holds, in addition to issuing c.£240bn of new bonds in the next year to finance the UK government's deficit. The resultant increased supply of bonds could put upward pressure on UK yields. Putting this all together means we can reasonably expect to see a fall in broad inflation measures, and that volatility in interest rates will remain, although the direction of change for bond yields is far from certain.

To mitigate the impact of this volatility, trustees of defined benefit schemes can consider reviewing their liability hedging strategies, thereby ensuring their scheme's funding level won't be overly impacted by movements in bond yields. As part of this, and in line with recent guidance from the Pensions Regulator, it is sensible to consider the arrangements for managing collateral calls associated with leveraged liability driven investments, and indeed, whether it is appropriate to meet all calls as they come.

Lastly, if a scheme is in the fortunate position to be considering whether to secure members' benefits with an insurance company, then the balance sheet strength of the insurer and the quality of assets that it holds should be key considerations in the decision of whether to move forward.

3. Scheme bank deposits and cashflow

The recent failures in the banking industry highlight the potential regret risk of holding large balances in bank accounts, as many of SVB's customers can testify!

Rather than holding excess funds in scheme bank accounts, these might be invested to generate additional return, or placed into well-diversified money market funds with exposure to numerous assets and counterparties to reduce the impact should any one financial institution run into difficulties.

If you wish to discuss further, please get in touch with:

Paul Francis, Principal
Orega Old Bailey
20 Old Bailey
London
EC4M 7AN
paul.francis@qallp.co.uk

Ben Amenya, Investment Consultant
Orega Old Bailey
20 Old Bailey
London
EC4M 7AN
ben.amenya@qallp.co.uk

Lloyd Penny, Investment Analyst
Cypress House
Pascal Close
St Mellons
Cardiff
CF3 0LW
lloyd.penny@qallp.co.uk

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