WEEKLY ANALYSIS

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SVB BANKRUPTCY: A NEW PARADIGM IN MONETARY POLICY?

The bankruptcy of the SVB has various consequences. The systemic risk seems to be ruled out by central banks. CS is a global systemic bank. SNB support was expected. A likely new paradigm for rates.

Key points

- Silicon Valley Bank (SVB) bankruptcy will affect US monetary policy
- The next US rate hike could be the last
- European Central Bank stays the course and reassures
- Systemic risk ruled out by central banks
- CS's solvency seems assured despite its performance and repositioning strategy
- FINMA and SNB reassure and support CS
- A new, more favorable paradigm for interest rates is taking hold in the short term

Silicon Valley Bank (SVB) bankruptcy will affect US monetary policy

The failure of the Silicon Valley Bank has already pushed the American authorities and the Fed to act very quickly to avoid a panic. The former, through the voice of President Biden, sought to reassure by noting that the banking system was solid, while the latter also reassured by making liquidity available to institutions that might need it.

But for the next few weeks, the SVB's bankruptcy could have more significant effects by significantly altering investors' expectations regarding monetary policy. If only a few days ago, the probability of a Fed rate hike of 50 bps, instead of the initially expected 25 bps, had become very high due to the development of the increasingly consensual no landing scenario, it has become practically zero after this event.

Indeed, it is now likely that the US Federal Reserve will put its role as a stabilizer of the financial system back at the forefront of its risk analysis and interest weighing in the face of its hitherto stated desire to fight inflation as a priority.

In one weekend, terminal rate expectations have already been adjusted downwards, with the September 2023 Fed Funds rate dropping from 5.6% to 4.2%.

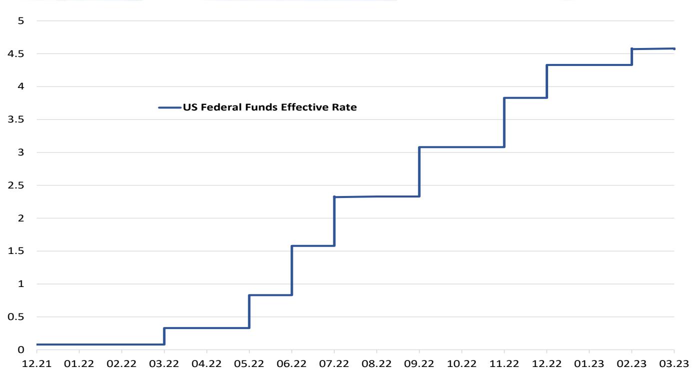
Such an adjustment now even suggests that a cut in policy rates could already take place during the summer, with the September and December Fed Funds now lower than in March, possibly constituting the first phase of monetary easing after the cycle started in March 2022.

This 180-degree turn in policy rates could open up new prospects for financial assets, especially those that were severely affected in February and early March by the rebound in financing costs driven by the inflationary no landing scenario.

After having suffered from tightening monetary conditions well into 2022, an unexpected easing would offer completely different conditions for the valuation of financial assets.

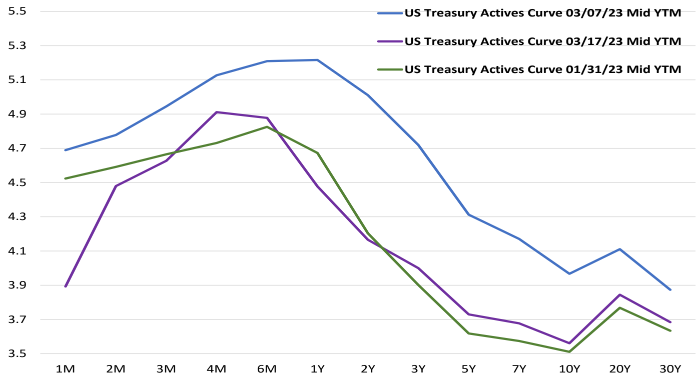
The historic drop in yields this weekend could help revive interest in risky assets, especially banks, real estate companies and technology or digital stocks.

Evolution of the Fed Funds rates



Sources: Bloomberg, BBGI Group SA

US Treasury rate curves



Sources: Bloomberg, BBGI Group SA

European Central Bank stays the course and reassures

The European Central Bank raised its key interest rates as expected by 0.5% on Thursday 16th of March, bringing them to 3% and explaining that the decline in inflation was underway but that the pace of decline was still insufficient. Inflation is still too high and thus justifies further rate hikes in the coming months. President Christine Lagarde noted that there were no other options to consider given the inflation situation, even in the specific context of the recent turbulent days of the SVB and other US banks' bankruptcy. The decision was fairly unanimous. The ECB's monetary policy is therefore following the expected path because the stability of the European financial system is not considered by the European monetary authorities to be endangered by the events in the United States or by the problem posed by the fall of the Credit Suisse share and its possible systemic implications in the event of increasing difficulties or bankruptcy.

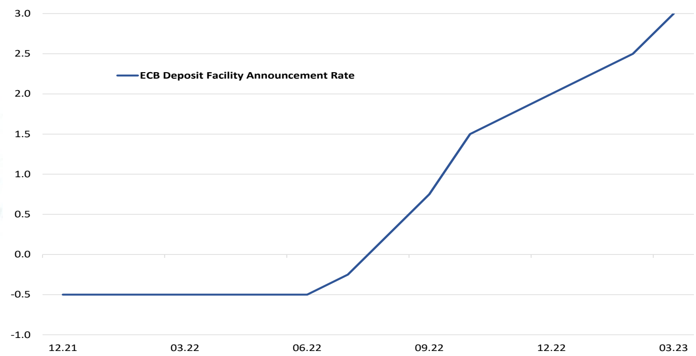
The European interest rate markets have not reacted dramatically to this central bank decision, but the problem encountered by the SVB could nevertheless concern some European banking entities, albeit at a lower level of risk given the strict rules put in place in Europe over the last few years, which should enable European regulators to highlight deviations and breaches of legal requirements during their regular audits.

The European banking sector has been particularly hard hit in recent days in anticipation of possible contagion between banks and by investors' desire to reduce risks logically considered difficult to control in the short term in an uncertain and sometimes insufficiently transparent environment. The -15% drop in European banking stocks may however already seem excessive in the context of the assured stability of the European financial system very clearly underlined by the ECB in its press conference.

The ECB also emphasized that in the current context of new uncertainties, monetary policy decisions would be taken at each meeting without giving any indication of the institution's specific intentions for the coming months. By adopting this new strategy, the ECB is giving itself more flexibility but also increasing the risks of greater volatility in the financial markets.

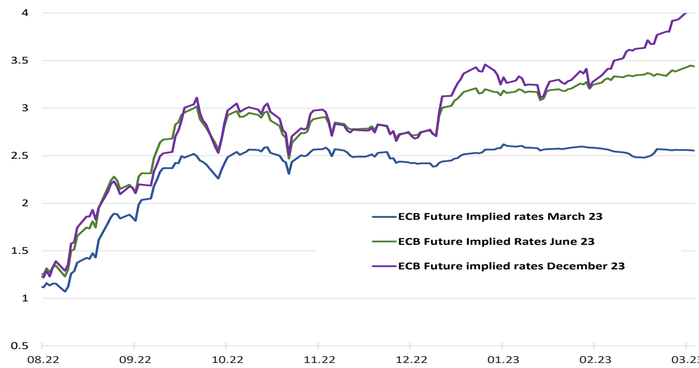
Finally, we believe that the peak of the monetary tightening cycle could turn out to be lower than previously envisaged due to these new uncertainties without significantly reducing our expectation of terminal rates. The European situation remains more serious in terms of inflation, which clearly justifies further monetary tightening by the ECB in contrast to the Federal Reserve's policy, which is now close to its zenith.

Key ECB rates



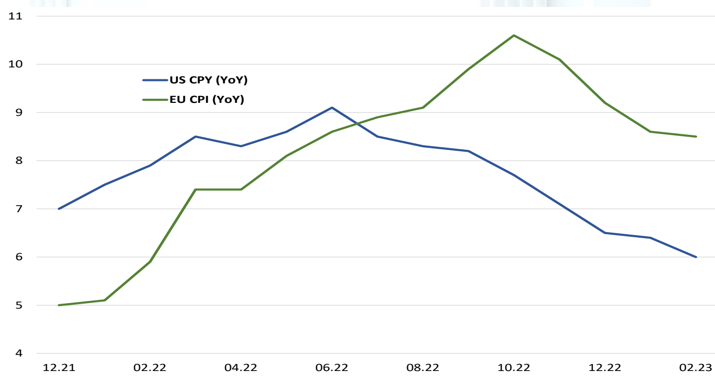
Sources: Bloomberg, BBGI Group SA

European forward rates (March-June-December)



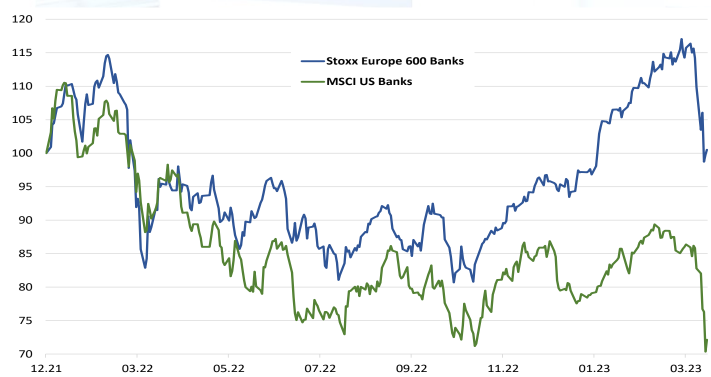
Sources: Bloomberg, BBGI Group SA

Inflation Europe—USA



Sources: Bloomberg, BBGI Group SA

Banking sector Europe-USA



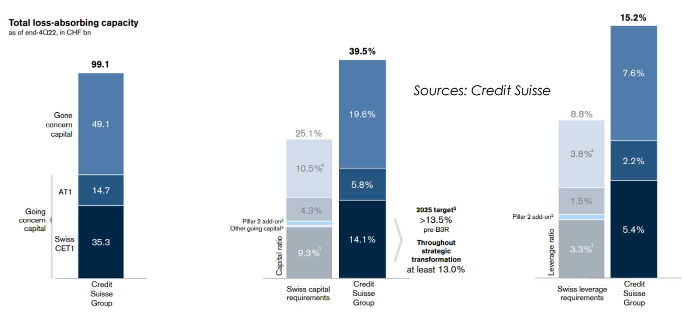
Sources: Bloomberg, BBGI Group SA

Solvency ratio situation of the CS

The communication from CS to its clients to clarify the situation regarding solvency ratios does not mention the CHF 50 billion of support granted by the SNB in this period of crisis. This is a very important decision, however, and immediately strengthens CS's ability to cope with possible liquidity problems and is a decisive factor in its ability to deal with possible difficulties. The SNB's decision considerably improves the assessment and the level of risks carried by the CS. This communication presents the situation of the bank in terms of solvency ratios in comparison with the other main international institutions, clearly underlining that the bank is in a rather good position relative to its peers, which seems justified after analysis of the data presented and those in the possession of the SNB and the FINMA.

Bank solvency ratios must make it possible to determine, in particular, the degree of financial soundness, taking into account the effects of a possible failure of a bank on the stability of the entire financial system and, beyond that, of the economy as a whole. This financial soundness is essentially measured by the amount of the bank's own funds, which determines its capacity to face the possible risks linked to its activities (non-repayment of distributed credits or other losses in value of its assets). Banks must be permanently solvent, i.e. able to meet their commitments at any time. Indeed, if the bank's customers who have deposited their money with it (demand deposits) doubt its financial soundness, they may lose confidence and withdraw their deposits, precipitating the bank (and the whole system if it is a large bank) into major difficulties. This is why the Bank for International Settlements (BIS), based in Basel, Switzerland, has established solvency ratios that all banks must meet. The Basel 3 capital requirements have established ratios (minimum, cushion, minimum total, countercyclical cushion, systemic risk cushion and total global) applying to the various levels (Core Tier 1, Additional Tier 1, Tier 2 and total capital). According to Credit Suisse's communication, the results of the comparisons made show a similar positioning to that of UBS for example in terms of the CET1 ratio, slightly lower in terms of the short-term liquidity ratio (144%), but a leverage ratio of 7.7%, which is the highest in their comparison universe. The loss-absorbing capacity measure stands at 99.1%, the Swiss capital requirements (25.1%) are largely exceeded (39.5%), as is also the case for the leverage requirements in Switzerland. The CS communication therefore notes that its situation is good according to the various ratios commonly applied to major banks, like those of its comparison universe at the end of the 4th quarter 2022.

Capital exceeding regulatory requirements



Sources: Credit Suisse

FINMA and SNB press release

The conclusions of this CS communication are in fact corroborated by the positions of FINMA and the SNB in their March 15th statement regarding market uncertainties:

« The Swiss Financial Market Supervisory Authority FINMA and the Swiss National Bank SNB report that there is no risk of direct contagion between the problems faced by some banks in the US and the Swiss financial market. The strict capital and liquidity requirements for Swiss financial institutions ensure their stability. Credit Suisse meets the capital and liquidity requirements for systemically important banks. The SNB will make liquidity available to CS if required.

In this joint position paper, FINMA and the SNB state that the current turmoil in the US banking market does not suggest that there is a risk of direct contagion for Swiss institutions.

Swiss regulations stipulate that all banks must hold capital and liquidity buffers that meet or exceed the minimum requirements of the Basel standards. In addition, systemically important banks must meet special capital and liquidity requirements. This is to absorb the negative effects of large-scale crises and shocks.

Credit Suisse meets regulatory capital and liquidity requirements.

The market reactions have had a particular impact on the market value and the price of Credit Suisse's debt securities in recent days. FINMA is in close contact with the bank and has all the relevant information from a supervisory perspective. In this context, FINMA confirms that Credit Suisse meets the special capital and liquidity requirements for systemically important banks. In addition, the SNB will make sufficient liquidity available to the globally active bank if needed. FINMA and the SNB are monitoring developments very closely and are also in close contact with the Federal Department of Finance in order to ensure financial stability. »

The SNB has since confirmed its support for the bank by granting it facilities amounting to 50 billion francs in case of need.

BBGI Group analysis and outlook

From our point of view, this decision of the SNB is by far not a surprise considering that CS was indeed considered as a systemic bank not only at the Swiss level, but also as one of the 30 most important international systemic banks. CS is therefore logically considered by the SNB as being too big to fail and should therefore be supported by the SNB in case of difficulties.

We were indeed expecting such an action from our national central bank, which should have several positive effects in the long run. First of all, by reiterating that the SC met the solvency requirements, the SNB gave a guarantee of security to investors who might have doubted the statements of SC representatives. Secondly, by providing support of 50 billion, the SNB offered new flexibility to the SC and above all time to implement its restructuring phase, already underway since October 2022.

CS has been restructuring its activities and undergoing a strategic transformation for some time, which has negatively affected the stock market performance of its shares. But while it has been under the spotlight several times recently, it would appear that the 2nd largest Swiss bank has at least been able to meet the regulatory capital requirements so far, even though its financial results were particularly bad in 2022 and will probably remain negative in 2023. In times of high uncertainty, such as that caused by the failures of the SVB and other banks in the USA, doubts quickly spread to the entire global banking sector. Switzerland did not fail to do so, and it was not surprising that CS was in the spotlight in this context. The bank's management had difficulty in reassuring and convincing investors in their press releases, even though they emphasized the solidity of CS's balance sheet, while the main shareholder (the Saudi National Bank) declared at the same time that it was not ready to increase its stake beyond 10%. It was thus unintentionally implying that it may no longer have confidence in the stock's ability to turn around and recover, which had the effect of exacerbating investors' short-term fears.

The expected SNB support has already clearly had a positive impact on the CS share, which is now up +19.15% after Wednesday's -24.24% drop. CS may only have partial recourse in the future to the funds promised by the SNB in case of need, as the declared support of the Swiss central bank may be enough to reassure its clients and avoid the risks of forced losses of value that could lead to fears of a similarity with the SVB case.

Financial market outlook

We believe that at this point in time, it still appears that the SVB failure should not have a major impact on the major players in the US financial sector. The stricter US regulations for large institutions should limit these risks very significantly, although they remain for regional institutions subject to less stringent controls and capital ratio requirements. We believe that contagion in Europe is also largely unlikely. However, vigilance is naturally still required in these times of high uncertainty. The risks of losses in value on assets held by banks caused by the rapid rise in interest rates cannot be ruled out.

The historic fall in bond yields observed in recent days in all markets has paradoxically had a highly moderating and positive effect on these risks. Indeed, a downward adjustment of bond yields on most maturities will have as a direct consequence an increase in the price of bonds held by banks and a decrease in their theoretical losses or marked to market.

However, we believe that the failure of the SVB will have a greater impact on all financial assets than on the securitized banking sector itself.

Indeed, the U.S. Federal Reserve, which had already reacted by providing the necessary liquidity to the financial sector, was clearly concerned about the risks to the stability of the system. Its main concern now is not quite the same. It will certainly be reluctant to raise policy rates by 50 basis points, as it had previously been considering in order to fight inflation, because it is now a little clearer about the risk that its policy of raising rates poses to the value of the assets held by banks and to the financial system. It is likely that the next 0.25% hike on March 22nd will ultimately be the last, especially if inflation measures continue their downward trend.

This week will therefore be heavy with consequences for US monetary policy, which will change course and may finally see the last key rate hike of 0.25% materialize on March 22nd.

But in Switzerland too, the CS case will in our view have similar effects on the implementation of the SNB's monetary policy on the 23rd of March and beyond. The risks of rate hikes have clearly been revised downwards, a paradigm shift in the medium term that should favor financial assets.

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