A "bailout" bigger than Switzerland

William Xiao,
Alessandra Vollmer,
Federico Mejía Enriquez,
Nico Enzmann,
Karan Rastogi

"This acquisition is attractive for UBS shareholders but let us be clear, as far as Credit Suisse is concerned, this is an emergency rescue. (…). Acquiring Credit Suisse's capabilities (…) will augment UBS's strategy of growing its capital-light businesses." – Colm Kelleher, UBS chairman

Deal Overview

- **Acquirer**: UBS Group AG
- **Target**: Credit Suisse Group AG
- **Industry**: Financial Institutions
- **Transaction amount**: CHF 3 billion
- **Announcement date:** 19th March 2023
- **Acquirer Advisors**: Morgan Stanley, JPMorgan Chase & Co.
- **Target Advisor**: Centerview Partners

On Sunday, 19th of March, Mr. Berset, the president of Switzerland, announced the merger between UBS and Credit Suisse. After an initial bid for CHF 1 billion from UBS to purchase its rival, which was rapidly turned down, the two banks finally agreed on an all-shares transaction where the exchange ratio is fixed at 1 UBS share of 22.48 Credit Suisse (CS) shares. This translates to a sales price of CHF 3 billion. The CS shares were therefore valued at CHF 0.76 per share, only 41% of its closing price of CHF 1.86 on Friday evening. It is expected that UBS will have to release new shares to be able to complete this transaction. The deal is still subject to the usual closing requirements, but both sides are confident that all requirements can be fulfilled by the end of 2023.

This deal is exceptional as other actors were involved, specifically the Swiss National Bank (SNB). Already on Thursday 16th of March, Saudi investors announced that they would not provide additional liquidity to CS. To calm markets and investors down, the SNB offered a CHF 50 billion lifeline to Credit Suisse. However, the support was not enough to save CS. Consequently, to ensure the deal goes through, the SNB has made different promises to UBS. The bank can obtain a liquidity assistance loan with privileged creditor status in bankruptcy for up to CHF 100 billion. The SNB justifies this liquidity lifeline because it enables it to fulfill its mandate to contribute to the stability of the financial system. Furthermore, to lessen the risk for UBS, the federal government is also granting UBS a guarantee of CHF 9 billion to assume potential losses over a certain threshold that UBS may incur due to the transaction.

This unordinary government support has the consequence of triggering a complete write-down of all Additional Tier 1 (AT1) debt (also called CoCo bonds) of CS, valued at around CHF 16 billion – meaning that these bondholders would lose the entirety of their investments. This also sweetened the deal for UBS as it did not have to take over AT1 debt with the purchase of CS. Typically, when a company goes bankrupt, the bondholders are repaid before the shareholders as they are ranked above equity holders. In CS & UBS merger, the priorities were inversed, as the shareholders will receive UBS shares, and the AT1 debt holders will be left with nothing.

Another abnormal aspect of this transaction is the complete ignoration of the shareholders' right to vote on the transaction. In fact, the necessary approval of the shareholders of both banks is not required for this transaction. Due to the unique circumstances, the Swiss Federal Council issued an emergency ordinance enabling the otherwise necessary approval of the shareholders of both banks to be disregarded. The reason for this change in the law is to ensure that this crucial transaction will go through in time.

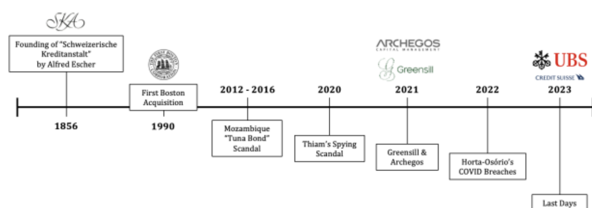
Rise and Fall Credit Suisse

Credit Suisse, once a symbol of Swiss financial power, stability, and prestige, was founded in 1856 by Alfred Escher under the name of "Schweizerische Kreditanstalt". The bank played a pivotal role in the Swiss economic growth, helping develop the nation's currency, electrical grid, and railway system. However, following the financial crisis, the bank began a downward spiral marked by a series of self-inflicted scandals that tarnished its reputation.

Through a series of increasingly aggressive acquisitions, such as the controlling stake of First Boston in 1990, the bank established a foothold in Zürich, London, and New York. While these transactions undoubtedly solidified its position in the "bulge brackets" of international investment

banks, it came at the cost of introducing it to a high-risk culture which persisted for the next three decades.

Figure 1: Timeline of Credit Suisse's Rise and Fall



Source: Own illustration based on Financial Times data

Despite surviving the financial crisis relatively unscathed compared to the other merging company, this led to overconfidence in their business model and an unwillingness to change. As a result, the bank became embroiled in numerous scandals that eventually led to its downfall.

One of the most notable scandals was the Mozambique "tuna bond" scandal. Credit Suisse organized $1.3 billion in loans for Mozambique, one of the world's poorest countries, ostensibly to develop a tuna fishing industry. Unfortunately, a significant proportion of the funds were siphoned as bribes to the bankers and local officials involved in the deal. The bank ultimately paid $475 million in US and UK fines, but the cost to Mozambique's people was far more significant.

In 2020, the bank faced a corporate espionage scandal involving then-CEO Tidjane Thiam and head of wealth management Iqbal Khan. The two had a neighborly dispute that escalated, resulting in Khan moving to UBS. Prior to joining the rival, however, Khan and his family were followed through the city of Zurich by private investigators hired by Credit Suisse themselves, over concerns that the former head was poaching clients and employees. The revelation of additional corporate espionage incidents led to Thiam's ousting in early 2020.

The bank's decline continued in 2021 with the Greensill Capital and Archegos Capital scandals. Credit Suisse was forced to close $10 billion of funds linked to the defunct specialised finance company Greensill Capital, in which it had convinced hundreds of its wealthiest clients to invest on the assurance of attractive returns over almost no risk. The family office Archegos Capital collapsed a couple of weeks later, causing additional $5.5 billion losses to Credit Suisse.

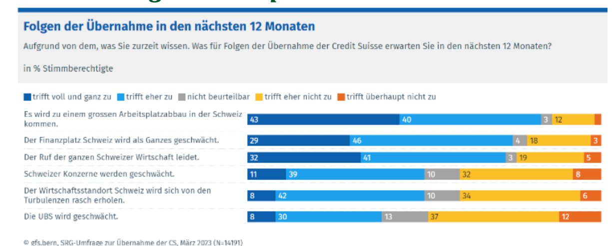
In 2022, António Horta-Osorio resigned as Credit Suisse chair only nine months after its promise to de-risk the bank, due to an investigation revealing that he had broken UK Covid restrictions while visiting London to watch the Wimbledon tennis final the year before. Later, it was discovered that he also attended the European Championship football final that day at Wembley.

By 2023, Credit Suisse was on the brink of bankruptcy and was rescued by local rival UBS in a government-brokered takeover. This marked the end of a 167-year-old institution that was once a symbol of Swiss financial power, stability, and prestige. The series of scandals in its final years underscored the fragility of its reputation and served as a cautionary tale for the global financial industry.

Political implications of the deal

The acquisition of Credit Suisse by UBS has led many Swiss to express concerns that this crisis would have a negative impact on the Swiss financial sector and its reputation, with many fearing numerous banking job losses. The demand of the Swiss population to hold the CS management board accountable only illustrates the widespread disappointment and disillusionment with this political and economic fiasco.

Figure 2: Population Sentiment



Source: Swissinfo

In reaction to the merger, political parties have described the situation as a somber occasion for Switzerland. The parties have called for a thorough investigation at all levels, and they have assigned responsibility to both management and authorities. However, the merger of the two major banks is also a cause of concern from a competition law perspective, as it creates new challenges for open and fair competition. The Federal Council relied on emergency powers to effectively expropriate the shareholders of Credit Suisse through an emergency legislation that contradicts merger law (Regulation of 16.03.2023, amended by Article 10a).

Interestingly, the finance minister emphasised that during a typical bank run situation the government did not deem it sensible to communicate that Credit Suisse had been promised further billions in liquidity assistance before the merger. Whether this chosen course of action will restore confidence in the Swiss financial centre and the rule of law remains highly questionable. Although criticising the current "too big to fail" legislation for being inadequate, which currently includes special capital requirements for systemically important banks (going-concern capital and gone-concern funds), an increase in loss-absorbing capacity, and a creation of comprehensive national resolution regimes, among others, the parliament failed to quickly enact an effective alternative. As a result, a monstrous bank has emerged, and the finance minister has been unable to answer questions concerning the risks associated with it. Now, several parties have stressed the need for stricter legislation, which will be discussed in an extraordinary session in April. Almost all political parties have expressed support for a tightening of the current "too big to fail" legislation and another prominent proposal by the SP and Greens is the introduction of a so-called separated banking system, meaning commercial banks should be clearly separated from investment banks. While the likelihood of the latter proposal being implemented remains uncertain, a comprehensive review of the Banking Act is certainly on the agenda for the upcoming parliamentary session.

UBS's post-merger strategy and competition

The wealth management division is the largest business segment of UBS, accounting for around 54.9% of sales, with investment banking being the second-largest segment, accounting for around 25.2% of sales in FY22. Personal & Corporate Banking and Asset Management Business are the third and smallest segments with around 12% and 8% respectively.

Not only is wealth management UBS' largest segment, but the bank is also the largest wealth management firm in the world. As of December 2021, UBS managed approximately $3.9 trillion in invested assets, with Morgan Stanley and Bank of America managing $2.7 trillion and $2.6 trillion, respectively. UBS's leading position can also be measured using the number of Ultra High Net Worth Individual (UHNWI) clients of which UBS has 10,860, followed by Morgan Stanley with 10'675 and Bank of America with 9'975 according to a report by Wealth-X. In the HNWI segment, UBS and Credit Suisse lead with 102.9k and 88.5k clients, respectively, followed by Morgan Stanley and Bank of America Scorpio Partnership as of 2020.

According to PwC's global wealth management report, the wealth management industry is expected to grow at a CAGR of around 5.7% between 2020 and 2025, driven by factors such as increasing wealth levels, demographic changes, and the growth of digital channels. Deloitte predicts the APAC region, to be the fastest-growing wealth management region, with China being the clear growth engine with an expected CAGR of 16.7% again between 2020 and 2025. As a comparison, the global investment banking revenue pool is expected to grow at a compound annual growth rate (CAGR) of 2-3% between 2020 and 2025, according to a report by McKinsey & Company.

In April 2022 Colm Kelleher replaced Axel Weber as UBS Chairman. Kelleher had an illustrious 30-year career at Morgan Stanley, where he oversaw the Institutional Securities and Wealth Management businesses and played a key role in the bank's handling of the 2008 financial crisis and negotiating a bailout deal with Mitsubishi UFJ Financial Group. Kelleher has taken UBS CEO Ralph Hamers on a series of investor roadshows in an effort to attract US fund managers and increase the bank's price-to-book ratio. He believes that UBS's valuation can be improved to match that of US banks such as JPMorgan.

Regarding the merger between UBS and Credit Suisse, Kelleher drove the takeover talks, with CEO Ralph Hamers playing a supporting role. Most recently and unexpectedly, Sergio Ermotti the former UBS CEO who brought UBS back to great strength after the Great Financial crisis, was appointed again as the CEO of the merged bank, while Hamers will stay as an advisor during the transition period. "I cannot emphasise how big a deal this is in terms of financial history and financial engineering that's required," Kelleher said of the Credit Suisse takeover on Wednesday as UBS announced Ermotti's return. "It's about having the best person in our opinion to effect the execution of this merger."

Ermotti is also a good choice concerning receiving the backing of shareholders and can convincingly

stand for bringing the UBS culture to the combined company. Ermotti commented: "I always felt that the next chapter [for UBS] was a transaction like this one. It would be a bit of a contradiction from me not to accept the job to execute on what I believe was the right next move for UBS."

Despite the acquisition, the UBS strategy remains unchanged, including a focus on growth in the Americas and APAC. UBS' share repurchase program will be temporarily suspended, but the bank will continue to implement its progressive cash dividend policy. Credit Suisse Board bonuses will be cancelled, and second and third-level management salaries will be cut by 50% and 25%, respectively, according to measures set by the Swiss Government.

Kelleher emphasized the favourable financial terms of the deal, including downside protection, and the good price-to-book value of the transaction. Furthermore, UBS anticipates that the deal will be EPS accretive by 2027, and the bank is well-capitalized, exceeding its target of 13%.

UBS has announced plans to maintain a focused Investment Bank and retain the Global Banking businesses of Credit Suisse. The CEO of UBS has confirmed that this acquisition reinforces their strategy of growing capital-light businesses. To "derisk and downsize" the company, the majority of Credit Suisse's market positions will be moved to non-core businesses. UBS intends to align Credit Suisse's investment banking business with its own conservative risk culture, resulting in combined investment banking businesses accounting for about 25% of the Group's risk-weighted assets. This allows UBS to selectively choose the best investment bankers and complementary teams, such as Credit Suisse's TMT Advisory teams in the US. However, the Credit Suisse brand is going to continue to exist for the next few years despite the original plans to spin off the Investment bank under the name "First Boston".

Nearly 50,500 Credit Suisse employees are set to be added to UBS's existing workforce of 74,000, resulting in a combined staff amount of 120k people. The merged bank is poised to reduce its workforce by 20%-30%, potentially resulting in up to 35,000 job losses globally, including 11,000 in Switzerland. After the cuts, this would leave the combined company with a staff size of 85k people, compared to around 215k employees at Bank of America, more than 240k people at JP Morgan, 80k at Morgan Stanley, and 48k at Goldman Sachs.

The merger will result in a combined bank with assets totalling $1.6 trillion (CHF1.45 trillion) and will make UBS a leading global wealth manager with $5 trillion in invested assets across the Group, allowing the bank to compete more effectively with rivals like Bank of America and Morgan Stanley, even in the US market. The US market has historically been dominated by them and other domestic, with UBS only coming at 5th place being the only foreign wealth manager with a significant market share. In Europe and Asia, however, UBS is number one, and Credit Suisse also consistently ranks among the top spots. Credit Suisse has a particularly big wealth management business in Asia. Iqbal Khan, the president of global wealth management at UBS, is currently traveling around the world to offer retention packages to private bankers of Credit Suisse to remain with the firm until the deal is completed because UBS wants to retain their clients.

If UBS manages to keep the Credit Suisse staff onboard in the wealth management division and prevents the remaining investment banking rainmakers from leaving, it will reach its next evolutionary stage - the biggest "Swiss Banking" behemoth the world has seen so far.

European Banks – Outlook for Europe's Bank Equities following Credit Suisse's takeover

The failure of both SVB and Credit Suisse have caused great concern that we are heading into the next banking crisis. The initial market reactions were strongly in favor of this scenario. Nevertheless, over the course of the next few weeks markets stabilized, making it more likely that a banking crisis remains a tail risk. The first victim amongst European Banks after Credit Suisse seemed to be Deutsche Bank. Costs to insure against a default on Deutsche's bonds measured by Credit Default Swaps (CDS) surged and correspondingly, its stock fell by more than 11% over the two-day period thereafter.

Fears that Deutsche Bank would suffer a similar fate as Credit Suisse were however overstated. It was revealed that likely single trade in an illiquid, opaque, and 'quirky' market was behind the move, something not indicative of a contagion. Andrea Enria, the ECBs top oversight official said at a conference hosted by Handelsblatt: 'With a few million, you can move the CDS spreads "of a major bank" and contaminate also stock prices and possibly also deposit outflows.' At the time of

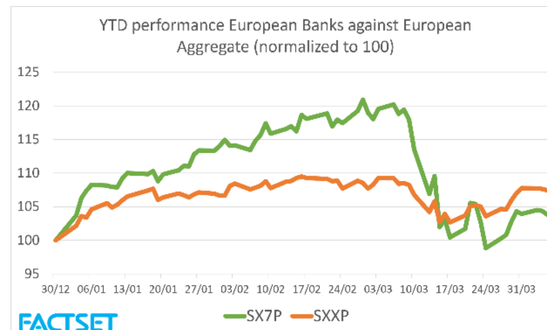
writing, it is yet not clear who was behind the trade. Jonathan Guthrie from the Financial Times summed it up eloquently: Investors, in the guise of Chicken Little, seemed not to notice. An acorn, in the form of a CDS spike, had fallen on their heads. They were convinced the sky was falling. Regulators suspect that someone — vulpine short sellers, presumably — dropped that acorn deliberately.'

All in all, it seems therefore that panic over a banking crisis in Europe as supposedly made evident by Deutsche Bank being the next bank to fail was overexaggerated. Nevertheless, drawing these parallels between Credit Suisse and Deutsche Bank is not entirely unwarranted. Both have been notable underperformers in the European banking sector. With this in mind, we look to find out what's ahead for the European Banking Sector with a focus on equities.

What is the Outlook for Europe's Banks?

It helps during these times to remind ourselves of how European banks were actually strongly outperforming other sectors in Europe from the beginning of the year until the news on SVB and subsequently Credit Suisse came to the public. The main index for European Banks STOXX Europe 600 banks (SX7P) consists of 600 European Bank stocks ranging across all market capitalizations. Comparing it to the aggregate index for European Stocks STOXX Europe 600 (SXXP) - up until the day SVB had to be taken over by US regulators - European Banks outperformed by almost 11%.

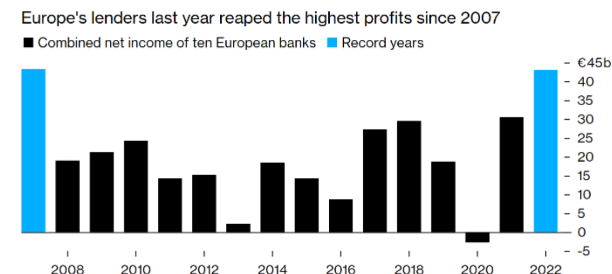
Figure 3: SX7P vs SXXP



Source: FactSet

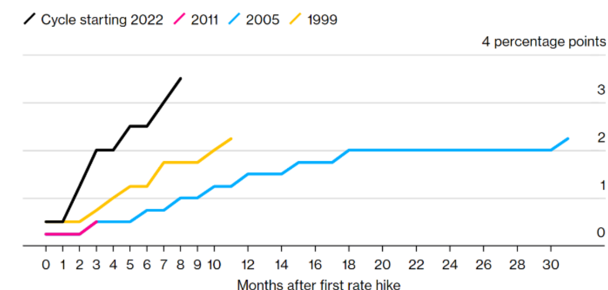
The strong outperformance can be traced to banks' bread-and-butter business of maturity transformation: taking short-term deposits on which they pay interest and using the funds to make longer-term loans to businesses and consumers. The difference in interest rates charged on those loans and paid to the deposits is called the net interest income. When the ECB raised its key interest rate for the first time in eleven years on July 27 2022 from 0.00% to 0.50%, banks were quick to catch up by charging higher interest rates on credit while keeping interest paid to deposits close to zero. By the end of February 2023, the ECB's target interest rate has reached 3.00%. This windfall in profits due to higher interest rates meant that European banks have not been as profitable as in 2022 since 2007, a year which preceded another well-known financial crisis. The ECB has never in its history raised interest rates at such a pace as it had been doing since last July. As the ECB continued hiking alongside the Federal Reserve, banks kept outperforming for the first two and a half months of 2023.

Figure 4: Banks Cash in on Higher Rates



Source: Bloomberg Intelligence

Figure 5: ECB Interest Rates Have Never Risen Faster



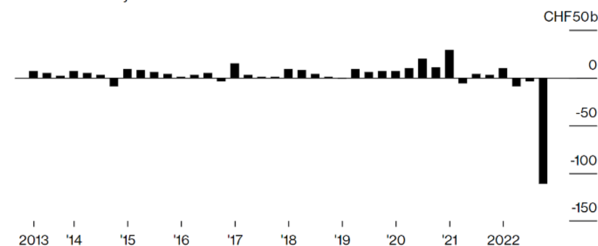
Source: ECB

A series of bank failures then ensued in the middle of March. Most importantly, Silicon Valley Bank (SVB) collapsed as clients withdrew their money in a classical bank run. A few weeks thereafter, Credit Suisse had to be rescued. The strong performance of European Banks against their peers was quickly wiped out.

Can we view Credit Suisse as an isolated incident?

In our view, Credit Suisse's failure can be traced to a series of major scandals which, combined with a worsening global macroeconomic outlook throughout 2022 and already damaged credibility - caused substantial deposits and net asset outflows, ultimately leading to liquidity problems. A substantial portion of these outflows was incurred in the fourth quarter of 2022 according to their annual report, published just one and a half months before the takeover announcement in March: 'Credit Suisse began experiencing significantly higher withdrawals of cash deposits, non-renewal of maturing time deposits and net asset outflows at levels that substantially exceeded the rates incurred in the third quarter of 2022.'

Figure 6: Mammoth Outflows



Source: Bloomberg Intelligence

It must be noted that the economic drivers behind the outflow are not isolated to Credit Suisse but affect other European banks as well. Its closest peer and competitor (and now soon-to-be parent) UBS recorded similar outflows - albeit not to the same scale as Credit Suisse - according to their 2022 annual report: '[...]However, as returns on alternatives to deposits increase with rising interest rates, such as returns on money market funds, UBS has experienced outflows from customer deposits and shifts of deposits from lower-interest account types [...]'.

While global macroeconomic conditions affect all banks equally, it is more appropriate to view Credit Suisse's downfall as an idiosyncratic risk. Due to the scale of outflows, despite the higher interest rate, Credit Suisse actually saw a contraction in its net interest income in 2022, falling by 8.1\%. This stands in stark contrast to its peers such as UBS (+17\%), Deutsche (+39\%) or HSCB (+21\%), according to their respective annual reports. Finally, Credit Suisse was well aware of this issue and foreshadowed its own downfall in the same report: 'Although deposits have been, over time, a stable source of funding, this may not continue, and we may experience, as we did in the fourth quarter of 2022, deposit outflows at levels that substantially exceed rates typically incurred. [...] A failure to reverse these outflows and to restore our assets under management and deposits could have a material adverse effect on our results of operations and financial condition.'

The final straw was the downfall of SVB. Fears of contagion spread and Credit Suisse - being Credit Suisse - was the next victim. Reuters reported outflows out of Credit Suisse's net assets of USD 450mn over two days from March 13 - 15. Further news on 'material weakness' in its reporting did not exactly help to reverse these trends. While all banks were affected by these exogenous developments, Credit Suisse's weak positioning in the market owing to scandals, poor profitability over the past few years, continuous need for new capital to cover liquidity needs from client outflows as well as its inability to profit from higher interest rates meant it was unable to withstand the market panic which ensued. Hence, we believe Credit Suisse to have been in a uniquely 'unlucky' (though self-inflicted) position, unlike other European banks.

Far more important for us, therefore, is the outlook for overall bank profitability. Other European banks do not suffer the same low credibility as Credit Suisse, and most of them have sufficiently larger capital buffers to absorb losses. The base case risk is therefore not a full-blown crisis, but a potential hit to their earnings. In the subsequent sections, we point out a few key risks related to bank profitability which investors should take into account.

Deposit Beta Risk

Deposit Beta is the portion of the increase in an interest rate (for instance the Fed or the ECB's main target rate) which is passed on to depositors. It seems depositors are now slowly waking up to the fact they are being 'played'. One alternative to bank deposits are very short-term and highly liquid investments into the money market or 'cash-like' ETFs. In recent months, more and more depositors have found the money market as a good alternative to park their cash as opposed to deposit accounts at banks. As the money market invests in very short-term assets with very little duration risk (synonymously: little interest rate risks) while earning them a yield above that which is offered by deposits at banks, it seems depositors have found a win-win bargain (a free lunch, an arbitrage, more

return for less risk) by simply shifting their cash away from deposits into these funds. This led to an outflow totalling EUR 214bn over the last five months for banks in the Eurozone, adding more pressure on banks to increase their deposit beta sooner than expected. Money Markets in the US at the same time recorded a record inflow of USD 286bn. Barclays Strategist Joseph Abate sums up the ongoing process concisely: *'(The) recent tumult regarding deposit safety may have awakened "sleepy" depositors and started what we believe will be a second wave of deposit departures, with balances moving into money market funds. Until this week, depositors appear to have paid little attention to the unsecured risk they faced with balances above the insurance cap. And they seem to have largely ignored the low interest rate paid on their deposits.'*

In their note, Abate noted that during all hiking cycles, depositors are slow - but do eventually - catch up to the higher interest rates they can earn which then pushes banks to increase deposit betas. This means banks will have to pass on the higher interest rates to customers and drag down their net interest income.

To make this even worse, more ECB officials are predicting that interest rate increases in the Eurozone will soon come to an end. According to Christine Lagarde, President of the ECB, three or four officials did not support the 50bps hike in March to 3.00%. Bloomberg reported on April 5 that traders seem to be betting on about two additional 25bps hikes. European Central Bank Governor Robert Holzmann argued in favor of 50bps should things in May if' 'not become really more terrible', citing the recent events in the banking sector and the lingering uncertainty. The next decision regarding interest rates by the ECB will be held in May. As it stands now, it seems nevertheless that a peak interest rate is slowly visible on the horizon for Europe. For European banks, this means the windfall from the suddenly increased interest rates on their net interest income is slowly coming to an end as well.

Non-interest Income for Banks also remains weak

Compared to the traditional bread-and-butter business for banks, other sources of revenue make up a substantial portion of their revenue. However, as other segments which generate non-interest income such as investment & corporate banking or asset and wealth management are highly sensitive to global macroeconomic conditions, European banks' profits come under even more scrutiny. Dealmaking and investment banking activity has dried up significantly compared to the levels observed during the pandemic. For asset management, unlike the year of 2022 which saw its biggest outflows in a decade and a sharp drop in profits, 2023 so far has seen strong inflows for European asset managers, according to a report by BofA.

Interest Rate Risk

What about the negative effect of higher interest rates for banks? Apart from the fact that higher interest rates negatively affect all valuations for all equities mechanically through a higher discount rate for their future cashflows, the main risk pertains to their portfolios often holding a substantial amount of government bonds. Higher interest rates result in unrealized losses for these securities. This was partially responsible for the failure of SVB, as the bank had to liquidate its vast bond portfolios and therefore realize a heavy loss in order to be able to meet deposit outflows. The risk here is much less pronounced in Europe compared to the US: Moody's noted that a third of European banks' government bond holdings mature within the next two years, ensuring a continuous inflow of cash and reducing the need to sell assets. The statement was accompanied by a downgrade of the entire US banking sector by Moody's, while its rating on Europe remained unchanged. Overall, European banks' bond holdings are much lower compared to their peers in the US.

Nevertheless, both SVB and Credit Suisse have made it evident that the risk to European bank equities has increased while the profit outlook has weakened relative to 2022. It is therefore prudent - in my view - to cut exposure to European banks for the foreseeable future. Forward guidance by both American and European banks during the earnings season starting next week on Friday, April 14, 2023, with JP Morgan's 1Q 2023 results will shed more light on this sector's earnings picture. Indeed, many banks in their annual report for 2022 have already pointed out that the windfall profits from higher interest rates is unlikely to stay as competition forces them to increase their deposit beta.

Earnings Calendar 1Q 2023 Bank

The next known catalysts for banks start with the publication for bank Q1 2023 earnings, provided there are no surprise news in between. JP Morgan, being the most systemically important bank, will kick off the earnings season by reporting on April 14. In Europe, Santander reports on 25 April, Barclays on 27 April, Natwest on 28 April, HSBC and UniCredit on 2 May. UBS will report on April 25 and Credit Suisse - as the deal has not yet been completed and therefore remains its own firm - will report on April 27.