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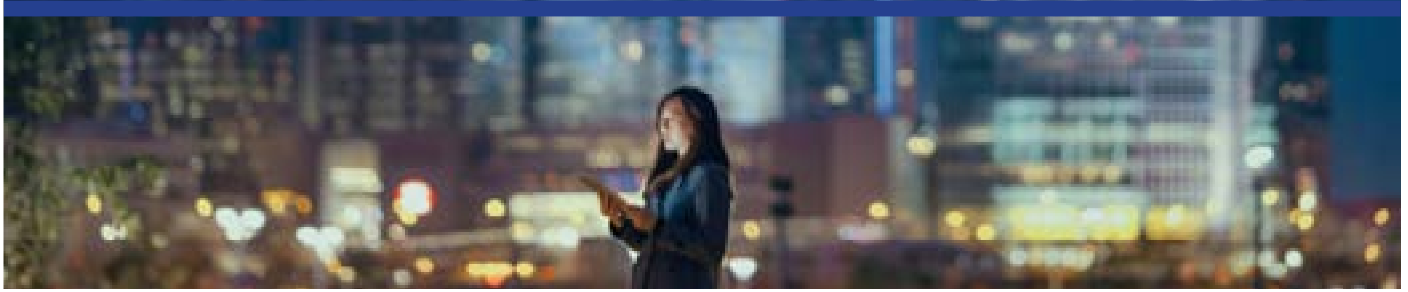

March 22, 2023

CIO Briefing Note

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Reducing Tail Risks

SUMMARY

Equity markets in Europe and the US rallied on Monday and Tuesday as UBS's takeover of Credit Suisse eliminated the negative tail risk related to a potential failure of a systemically important global bank. UBS management, in its Sunday evening press conference alongside Swiss regulators, appeared committed to making this acquisition work. The transaction required significant concessions and government guarantees. The direct involvement of the Swiss regulators and the speed of the deal were notable and parallel to events associated with Silicon Valley Bank in the US.

While senior Credit Suisse bonds and notes rallied on Monday, $17bn of Additional Tier 1 (AT1) bonds were completely written down by Swiss regulators. (These bonds are also sometimes referred to as "CoCos," which is short-hand for "contingent capital," and are designed to convert into an equity when a lender fails.) The wipeout of Credit Suisse AT1s may have the potential to alter the way this market trades, with a higher future risk premium likely to be required for investors to invest in potentially "loss-absorbing" capital. When the relevant regulator determines a Point of Non-Viability (one of the risks of AT1s applicable to the Credit Suisse situation), these subordinated securities essentially disappear, with the objective of protecting depositors and more senior bank liabilities.

Subsequent to the events Sunday night, European regulators (European Banking Authority and European Central Bank) clarified 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. This approach has been consistently used in past cases*." The Bank of England made a similarly unequivocal statement on Monday. It is likely that this clarification helped the junior bank debt market pare some losses during Monday's session, as the Credit Suisse AT1 write-down appears to be a Swiss-specific provision.

US preferreds have a very different structure from European AT1s, though they share similar features and are often lumped together in the broad category of "junior" bank debt. US preferreds traded slightly weaker on Monday, but in general outperformed European AT1s. **We continue to see long-term value in investment grade rated US preferreds, but see the potential for further volatility in the coming weeks and months**. Within our current GIC asset allocation framework, we hold IG preferreds as a yield enhancer within a diversified portfolio, held at a 2% overall weight. This is to offset our underweight in high yield bonds.

In the US, price action on Friday and Monday (17 and 20 March) suggested that the infusion of deposits by a consortium of large banks into First Republic may not be enough to fully restore confidence. First Republic was further downgraded to B+ by rating agencies over the weekend. Fed Chair Powell and Treasury Secretary Yellen issued a generic statement on Sunday in support of the UBS-Credit Suisse deal, but gave no indication at that time of further actions on the US side to shore up depositor confidence.

As discussed in this week's CIO Bulletin, there have now been two weekends in a row where "unrelated" bank emergencies brought regulatory action. While Silicon Valley Bank, Signature Bank of New York, Credit Suisse and now First Republic Bank had their own idiosyncratic issues, the underlying macro basis for this turmoil was the aggressive rate hikes and monetary tightening experienced over the past year.

We remain concerned that market volatility will stay elevated unless more comprehensive actions are taken by regulators. A more explicit deposit backstop, as was floated in the press Monday evening, coupled with a durable shift away from monetary tightening, may restore confidence. Treasury Secretary Yellen said at a conference Tuesday that "*Our intervention was necessary to protect the broader US banking system, and similar actions could be warranted if smaller institutions suffer deposit runs that pose the risk of contagion*." After sparking troubling ambiguity earlier, we see Yellen's latest comments as a clearly positive sign of support from US officials. However, irrespective of government support, banks are likely to curtail lending even further in the near term as they focus on shoring up their balance sheets, which may accelerate the slowdown in the real economy.

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High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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