

# Notes from Brussels: The Credit Suisse post-mortem



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**“FINMA could have been more effective in its oversight as it is under-resourced and needs more authority over institutions.”**

Investment grade financials specialist Marc Stacey, Managing Director and BlueBay Senior Portfolio Manager engaged with regulators in Brussels, discussing a wide variety of topics, but foremost was the Swiss Financial Market Supervisory Authority’s (FINMA) decision to merge CS with UBS and haircut AT1 bondholders.

Ultimately, the goal for the trip to Brussels was to engage with regulators following the Credit Suisse (CS) debacle, contribute to a dialogue on possible new banking regulations, as well as cover various other macro policy themes. The broad topics included:

1. Bank regulatory/resolution mechanism legislation and macro-prudential policy
2. Energy policy
3. Broader macro-economic policy issues

## **Bank regulatory/resolution mechanism legislation and macro-prudential policy**

During our trip, we engaged in many discussions with regulators about the CS failure and FINMA’s decision to merge CS with UBS and haircut AT1 bondholders. Highlights include:

**FINMA’s ineffective regulation:** FINMA could have been more effective in its oversight as it is under-resourced and needs more authority over institutions. This is in sharp contrast to the system of banking supervision in Europe, which comprises the ECB’s single supervisory mechanism (SSM) and the supervisory strategy and risk (SSR).

The FINMA decision to subvert the CS capital structure is seen as an anomaly and unlikely to happen in Europe, especially given the hurdle for needing agreement from each sovereign and the European Parliament in order to change the resolution laws. EU banking laws and oversight give supervisors far more power to intervene and ensure changes are made than the Swiss regulators had; the comparison between Deutsche Bank (DB) and CS was highlighted as a case in point for successful and unsuccessful approaches.

**Poor oversight reason for CS failure:** It is clear that the Swiss did not have the legal or regulatory framework to allow effective supervisory actions when needed, and post-2008 regulatory change means that the EU has pre-emptively addressed those risks.

The two main reasons for the CS failure were poor internal governance and regulatory oversight. The emphasis that European regulatory bodies and FINMA could not be more different, and there was an emphasis to have the SSM coordinate more with FINMA as it was unfortunate that the CS outcome still had consequences for European banks despite the differences.

**The European approach:** The multi-pronged approach to regulation from capital, liquidity and stringent stress testing means that the vulnerabilities of banks such as Silicon Valley Bank (SVB) and CS are less likely to happen in Europe. There is no need to change the metrics used to monitor banks as they work well. While it would be difficult to argue that in the context of an abrupt 500bps rate hike cycle that no smaller EU bank could need to be put into Resolution, the post-EU supervision framework has been well designed and the risk of the kind of problems that led to the collapse of CS and SVB are much lower in the EU.

**Banks balance sheets:** In Europe, the depositor base is stable and quite different from SVB and CS. It's important to closely monitor the asset side of banks' balance sheets as rates move higher and Covid guarantees roll-off, especially as growth expectations are likely to be lowered for 2023 and 2024.

## Energy policy

After surviving Russia's sizable market power over European supply, Europe's energy crisis has become much less critical. The challenge now for policymakers is to facilitate a transition toward structurally lower gas consumption smoothly:

**Lower inflation tailwinds:** There continue to be tailwinds for lower inflation from base effects and lower energy. Energy wholesale to retail deflation is operating with a lag and will continue to filter through. Wage growth and its impact on inflation is still in question into 2024, but negotiations and expectations are more anchored than in the UK. China's growth has disappointed, an important driver for lower global energy requirements this year and next.

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**Underused next-generation funds:** Next Generation EU (NGEU) is an instrument to repair the economic and social damage caused by the pandemic in the euro area, kick-start the European economy recovery, and prepare a better future for the next generation. However, only 50% of these funds have been dispersed so far, so there is still a significant fiscal impetus with the energy transition front and centre.





**Lower energy costs:** Energy costs are dramatically lower and will continue to trend this way over time. Diversification and supply and the vast investment into renewables mean energy prices will continue to trend lower.

**Energy demand has reduced:** Despite the energy transition highlighted above, there has been significant de-industrialisation from Germany into the US, given the instability around energy supply and cost. Energy demand is -19% since before the Russian invasion of Ukraine. The bulk of this (~15%) is just the reduction in unnecessary excess with no impact on productivity. i.e., ‘wear a jumper and turn down the thermostat’, and this is not expected to revert in the medium term.

**Energy bottlenecks have faded:** Energy supply bottlenecks in Northern Europe have largely been resolved, and reliance on Russia is now only 8%. There is no chance of ever returning to Russian supply.

**Global energy easing:** There has been a significantly reduced demand for energy in China due to lower growth and structurally lower demand for energy post-Covid with elements of WFH etc. The most prominent risks on energy are around the US supply capacity or any disruption from Norway, which is the biggest supplier of EU gas.

**“This ‘reverse tiering’ for European banks is a highly political idea by policymakers and regulators.”**

## Broader macro-economic policy issues

On the trip over the two days with key policy stakeholders in Brussels, macroeconomic issues were also on the agenda:

**Tighter labour market:** Demographics are a key contributor to tighter European labour markets. The year 2000 was the pivot point in Europe, and Covid lockdowns have exacerbated this phenomenon.

**Reverse tiering:** National Central Bank losses are going to be a very significant topic for the ECB to handle over coming months - the IMF suggests this could be between 0.3% and 0.8% of GDP given current interest rates for some of the core Eurozone central banks who bought the most sovereign bonds at zero/negative yields.

There are discussions of negative tiering around cash rates to try and lower the national central bank losses - this would have such significant implications for ECB inflation credibility and their ability to manage the front end of the yield curve. The proposal seems unlikely (but this debate important to watch).

Due to the massive repricing in rates there is in essence a wealth transfer from central banks into commercial banks, given the €3.5 trillion sitting as commercial bank deposits at the ECB. This ‘reverse tiering’ for European banks is a highly political idea by policymakers and regulators. If this idea were ever to be acted upon, it would have consequences for the front end of the government bond curve (lower yields) and bank profitability.



Reverse tiering should continue to be followed closely for any signs this could become a reality. Away from the optics of central banks losing money, this policy does not make much sense because commercial bank deposit rates will increase over time and ultimately it will be commercial bank savers that will benefit from the higher savings rates. It is just a matter of sequencing.

**Reform of deposit insurance:** The EU bank crisis management and deposit insurance (CMDI) framework was discussed at length. This proposal addresses the resolution framework's drawbacks for small/mid-sized banks and has been accelerated given the deposit outflows seen by the US regional banks YTD. This is likely to be established in 2024, and we are actively engaging with regulators and policymakers on the implications of such a proposal. All things being equal, this should lead to wider senior bank spreads and potential rating pressure on senior preferred securities. If approved it would:

- Expand SSM oversight/supervision to most medium and smaller EU banks
- Allow more rapid use of bridge banks in deposit run scenarios
- Make deposits senior to bond senior debt

**China:** The top agenda point for many on both the policy and political side was China, a new development. The tone of discussions about China resembled that of Washington, DC, regarding China, with the need to 'de-risk' a priority. The 'anti-globalisation' trade takes an exceptionally long time to play out, and it is more just about diversifying new investments away from China. Protectionism is increasing and even affecting renewable energy transition such as procurement of solar panels, batteries and EVs. The Inflation Reduction Act in the US and the Chips Act are being replicated tit for tat in Europe.

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**Ukraine:** Finally, the number of Ukraine flags and posters littered all over Brussels is indicative of the political drive behind Ukraine EU accession. Timeline for this this is in 8-10 years from our discussions.





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