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Demise of Credit Suisse

Financial markets remained volatile due to growing concerns regarding the global banking system. Banking stocks were pommeled, led by the continued drop of US and European banks. After many years of decline and mishaps, Credit Suisse finally fell. Its fate was sealed when the Swiss government initiated a takeover by its rival UBS.

From slow erosion to sudden collapse

Credit Suisse is a 166-year old bank with a rich history. It was one of the biggest and most-respected banks in the world. Credit Suisse was a pillar of Swiss banking and was considered a proponent of private banking. It is classified as a systemically important bank, and many thought that a storied bank such as Credit Suisse would not fall. However, it suffered a continuous but steady decline due to bad investments, trading losses, and weak internal controls. In its delayed 2022 annual report, the bank bared that it lost 38% of deposits in 4Q22, and the outflows have yet to reverse. It incurred a loss of $7.8b in 2022 and guided for another substantial loss this year. Credit Suisse closed at 0.8612 last Friday, down 91% year-to-date and a mere 1.1% of its peak of 77.40 in April 2007. The bank's Chairman said that the latest failures of US regional banks hit Credit Suisse at the most unfavorable moment and was the trigger for its eventual collapse.

Shotgun marriage

Sensing the imminent failure of Credit Suisse due to a breakdown in confidence, the Swiss National Bank (SNB) mandated a takeover by UBS. SNB did this to avert a systemic failure in the banking system. Both parties may not have wanted the shotgun marriage, but the Swiss government overruled the country's merger control rules to enable the buyout. The two parties agreed that UBS would acquire Credit Suisse for $3.2b worth of UBS shares. SNB provided significant concessions to UBS, such as a $109b lifeline should UBS need it. Aside from this, SNB guaranteed that it would shoulder up to $9.8b of potential losses arising from the takeover of Credit Suisse. However, Swiss regulator FINMA instructed Credit Suisse to write down $17b of its Additional Tier 1 (AT1) bonds. This sent shockwaves to the AT1 and bond markets, with investors left wondering who the owners of these bonds are and how they will be impacted by these losses.

Too big to fail?

In the aftermath of the Global Financial Crisis, banking regulators bailed-out major troubled banks to prevent the financial system from collapsing. Though they succeeded in doing so, they received backlash both from politicians and their citizens. Recent developments show that regulators are now averse to direct bailouts. As seen in the UBS takeover of Credit Suisse and the rescue of First Republic Bank, regulators would rather push private entities to become the white knights of troubled banks. Systemically important banks such as Credit Suisse were previously considered too big to fail.

Bank jitters continue

Amid contagion fears, banking stocks continued to be volatile, particularly in US and Europe. Due to a surge in its credit default swaps, Deutsche Bank fell by as much as 9% last Friday before recovering. This was triggered by fears that other major banks would suffer the same fate as Credit Suisse. US regional banks slid further after US Treasury Secretary Janet Yellen stated in her congressional testimony that she was not considering a blanket insurance for depositors.

Regulators provide assurance

In response to fears of banking contagion and the precipitous drop of banking stocks, European Central Bank President Christine Lagarde said that the resilience of the euro banking system is underpinned by strong capital ratios and adequate liquidity positions. A day after her testimony, Yellen clarified her previous statements and assured that federal emergency refunds to depositors may be deployed again if needed.

Continued tightening despite recent stepdown

The Fed has stepped down its rate increases with two 25 basis-point-hikes in the last two meetings, a notable slowdown compared to its aggressive pace last year. Fed Chair Jerome Powell signaled a softer policy outlook due to recent banking developments but still indicated continued policy tightening. According to Powell, "It is too soon to determine the extent of these effects and therefore too soon to tell how monetary policy should respond. As a result, we no longer state that we anticipate that ongoing rate increases will be appropriate to quell inflation; instead, we now anticipate that some additional policy firming may be appropriate."

Will the credit crunch trigger a recession?

In our last two articles, we said that the ongoing financial contagion was directly caused by the unprecedented pace of monetary tightening. This exposed the vulnerability of certain banks that are dealing with unique particular risks. However, banks are highly interconnected as they borrow and lend from each other as counterparties. As such, failures caused by idiosyncratic factors have far-reaching implications and therefore contribute to a build-up in systemic risks.

The main investor concern is now a potentially deep recession that may be triggered by the ongoing credit crunch. Nonetheless, reassuring regulators have given us hope that we are in the final act of this banking drama. Bond yields have gone down as investors now expect a pause in monetary tightening and possible rate cut/s later this year. However, this may also be signaling that investors are growing more concerned about economic growth and a potentially deep recession. Banking regulators still have a window to prevent a full-blown financial crisis while also engineering a soft landing. They would have to tread carefully though, as the situation may significantly worsen if regulators commit major policy errors in handling the recent streak of bank failures.