HOW TO SCREW UP A GOOD THING – WHAT THE FINANCIAL INDUSTRY SHOULD CONSIDER IN THE WAKE OF CREDIT SUISSE

by Mark S. Redinger[1]

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Having had a front-row seat in the last banking crisis in 2008/9, one of the lessons that I thought everyone learned was the need for stable and consistent regulations regarding bank capitalization.

In that crisis, as in any banking crisis, what separates the 'winners' from the 'losers' is the amount of capital left in the safe after everyone has left the building. Simply stated, banks that can retain or obtain sufficient capital to absorb withdrawals or defaults can generally withstand any typical banking crisis[2].

Therefore it boggles the mind why the Swiss financial regulator (FINMA), having been to war in the last financial crisis, would do so much to undermine the financial system by subordinating Credit Suisse's (CS') AT1 Bondholders in favor of CS' equity investors effectively writing them down to zero.

In the 1946 film "It's a Wonderful Life", the Bailey Building and Loan experiences a classic 'bank run' associated with a fictional portrayal of the Great Crash of 1929. In the character of George Bailey, Jimmy Stewart works with depositors of the thrift society to limit their withdrawals so that at the end of the day, the bank closes with a net positive balance (in this case, two dollars). The bank survives because it still has the capital left to run another day. We never see what happens the next day, but presumably, deposits come in, and the business continues as usual.

While we don't have all the facts surrounding this past weekend's deliberations (and probably never will), FINMA's decision will have long-term ramifications beyond the immediately forced merger of CS and UBS. Without further clarity, it will very likely be the subject of lawsuits in the near future, casting more doubt on the financial system and will likely impact the ability of the banks to raise needed Tier 1 Capital (T1 Capital).

Readers will be forgiven if they don't understand or have never heard of T1 Capital. In very simplistic terms, T1 Capital is the number of assets, usually highly liquid[3] and very safe financial assets, that a bank must retain on its balance sheet to satisfy its obligations. Regulators can (and do) adjust the amount of required T1 Capital in connection with their oversight of the financial system.

The written down T1 Capital in CS' case was also a specific type, known as 'CoCos' which were devised in the wake of the 2008/9 financial crisis to absorb losses by being convertible into equity or written off entirely. It was commonly assumed (and CS seems to have assured its investors) that these instruments would only be written off after the banks' common equity absorbed the first loss of any write-offs. In terms of creditor ranking, the T1 Capital is intended to rank in priority to the common equity of the bank but subordinate to other obligations of the bank

Understandably, many stakeholders are interested in the capital adequacy of banks, including the bank's themselves, their shareholders, bond investors, deposit holders, regulatory interests, and political considerations. Each party has its own agenda and sometimes conflicting or overriding interests. For example, when a Regulator requires excessive capital to be retained, banks complain of a drag on earnings and profitability. Conversely, in the case of too little capital or capital of the wrong type there is more risk to the system and investors and depositors are rightly concerned about the bank's financial ability to withstand shocks.

The T1 Capital market is a niche investment space primarily dominated by institutions (insurance companies, pension funds, and other banks) and private investors who invest in long-term bonds or debentures with a stable return. CoCos represent a sub-set of this market that pay a higher interest rate, reflecting their implied risk. The demand for T1 Capital is significant, with estimates as high as $250bln USD worldwide, with instruments trading broadly and widely held.

What can this latest crisis mean for Main Street?

While CS' equity investors (including its sovereign investors) may immediately be 'marginally' happy with the outcome, the longer term implications of this crisis remain to be worked through.

As problems on Wall Street or Bay Street rarely stay there a likely by-product of the current financial crisis is that regulators will now seek to reexamine banks' capital adequacy with the possible outcome that additional capital will be required.

In that context, the impact of FINMA's decision could range from a tightening of available banking credit to customers as the T1 Capital market dries up from a lack of investor interest and banks have less money to lend; to reduced banking profits resulting from the bank's need to pay higher returns to T1 Capital investors to induce them to participate.

It is also very likely that T1 Investors that have experienced losses through the CS decision will seek to pass those costs onto parties that are probably unaware of their exposure or shore up their capital. A significant component of investors in this area are pension funds already reeling from losses in the alternative money space.

What Should North American Regulators do now?

To assuage any concerns of any similar action by regulators in Canada and the United States, these institutions, in a concerted and coordinated effort, should reiterate their commitment to abide by 'normal'

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[2] I am referring to a typical scenario where economic shocks affecting the financial sector result in deposit withdraws in excess of normal rates.
[3] This is usually true but as we can see in the Silicon Valley Bank run, not necessarily true, or accurate at the time you most need liquidity.

bankruptcy rules and refrain from tampering with any institution's structured priorities.

Central Banks should, if necessary, and for the short term, consider extending credit security to holders of T1 Capital to prevent outflows and to ensure the market for these instruments remains robust and stable.

Regulators globally should recommit themselves to establishing global standards for banking operations that represent sound business practices and commit to enforcing those rules consistently and not changing them on an ad-hoc basis.

Finally, there needs to be better coordination between Central Bankers (and their institutions) to avoid unforeseeable consequences of individual actions. This is especially apparent as our post-2008/9 financial system has become more globalized, with many players operating in the unregulated financial space.

KEY CONTACT

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