Information for investment professionals

Credit Suisse and the likely impact on banking regulations

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- **Liquidity levels in the banking sector are running at about five times that of 2007, with quantitative easing having added around $10 trillion**
- **Credit Suisse suffered from a combination of governance issues and deposits being concentrated among high-net-worth investors and mostly unguaranteed**
- **Banking spreads are around 11% wider this year, compared with the wider market which is only 1% wider**
- **Regulators will look to liquidity ratios as quantative tightening kicks in**

The past few weeks have seen the most turmoil in banking markets since the global financial crisis (GFC) of 2008 / 09. In the GFC, banks had loaded up with sub-prime mortgages and structured credit. Write-downs of those assets caused a capital problem and investors pulled the funding. Subsequent regulation solved for this, with the intervening years seeing the banking sector building layers of Core Tier 1 capital, Additional Tier 1 capital and loss-absorbing senior debt, so governments are no longer on the hook to provide capital to banks.

As such, the banking sector entered this current crisis period with record levels of capital and strong earnings built upon rising margins. Liquidity is also at record levels. Quantitative easing (QE) has added around $10 trillion of deposits into the system over the past decade. In 2007 the aggregate loans-to-deposits ratio across the UK, the eurozone and the US was in excess of 115%; it is now less than 80%, meaning there are far more deposits than loans in the system. In addition, liquid asset portfolios are running at around five times the levels they were in 2007.

So, if capital and liquidity are at record levels, what happened to Credit Suisse? This crisis didn't follow the GFC playbook, meaning there was no asset quality or capital problem at Credit Suisse. The bank had three layers of loss-absorbing capital – CT1, AT1 and bail-in debt – totalling CHF99 billion (or 40% of risk-weighted assets) to protect depositors. In other words, it could incur CHF100 billion of losses before depositors would be at risk.

Instead, Credit Suisse suffered from a governance problem, compounded by a liquidity problem. Much has been written about the governance at Credit Suisse, from the Mozambique loans case[1] and the Archegos and Greensill scandals[2], to the group's former chair, Antonio Horta-Osorio, breaking Covid quarantine rules to attend the Wimbledon tennis finals[3]. Alongside this, the Credit Suisse liquidity problem was one of deposits being concentrated among high-net-worth investors (around 65% versus a sector average of 10%) and mostly unguaranteed (only 15% versus a sector average of 50%). Such deposits are "flighty" and behave more like wholesale funding than retail deposits. So, from the reputational damage on the governance front to depositors with less sticky money, problems arose despite the huge layers of capital designed to protect investors.

Future banking regulation

This now means that those institutions which are more dependent on such deposits are likely to be under heavier market scrutiny, while those with higher retail deposits are in a more advantageous position. It also means some banks will have to pay more to attract deposits from "safer" competitors and from money market funds – US funds last week saw in excess of $100 billion being deposited[4].

This in turn risks a tightening in lending standards and financial conditions. All in all, increased turmoil means banking spreads are around 11% wider this year on the European senior banks index compared with the wider market, which is only 1% wider.

The Basel III rules, introduced in response to the GFC, addressed liquidity problems through the liquidity coverage ratio (LCR), but it was originally conceived when depositors physically had to visit a branch to withdraw funds, leading to the infamous queues outside Northern Rock. The LCR is designed to ensure banks have enough liquidity to withstand a 30-day period of outflows. However, it only assumes that 10% of the more flighty deposits leave. Credit Suisse reportedly lost more than CHF10 billion or 4% of deposits per day at the end of last week, and SVB lost 25% of uninsured deposits in a single day.

As such, regulators are likely to recalibrate the test to account for the faster movement of deposits in the age of internet banking on mobile phones and events blowing up on social media. It may also penalise concentrations amongst the deposit base. All in all, this should lead to banks holding more cash.

We do not think the focus on deposits will go away anytime soon. As quantitative tightening kicks in, the aggregate banking sector deposit base will shrink. The $10 trillion of QE liquidity

[1] FCA, Credit Suisse fined £147,190,276 and undertakes to the FCA to forgive US$200 million of Mozambican debt, 19 October 2021

[2] Forbes, Credit Suisse, Burned By Archegos And Greensill Scandals, Shifts Focus To Wealth Management In Overhaul, 4 November 2021

[3] BBC, Credit Suisse boss Horta-Osorio resigns over Covid breaches, 17 January 2022

[4] Bloomberg, as at 20 March 2023

across the US, UK and eurozone is equivalent to more than 25% of the current deposit base. We expect the roll-off of funding programs like the European Central Bank's TLTRO[5] (Targeted longer-term refinancing operations) and the Bank of England's TFS[6] (Term Funding Scheme) to add to the tightening.

As liquidity is withdrawn, competition for deposits will hot up. As investors we will certainly be scrutinising management teams more on the relationship between governance and liquidity. We believe the cost of funding is now higher across the sector, especially for banks with a weaker deposit mix. Valuations have, however, adjusted and there are areas where banks look attractive relative to other sectors.

[5] https://www.ecb.europa.eu/mopo/implement/omo/tltro/html/index.en.html

[6] Bank of England, Quarterly Bulletin – The Term Funding Scheme: design, operation and impact, Q4 2018