XPS Investment

Investment briefing

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Near Collapse of Credit Suisse: Implications for UK Pension Schemes

XPS's Chief Investment Officer Simeon Willis reviews the near collapse of Credit Suisse on defined benefit pension schemes and highlights some key considerations for trustees and corporate sponsors of UK pension schemes.

On Monday, it was announced that UBS agreed to buy Credit Suisse (CS) following a loss of confidence in the CS's depositor base, which had led to outflows of deposits potentially compromising its solvency.

CS was loss-making prior to the recent turmoil. UBS, a more highly rated Swiss bank, took the opportunity to buy CS at a discount. The banks will operate independently until the deal is complete and both are able to continue all business activities, although the value of some of CS's specialist debt (Additional Tier 1 capital) has been written down to zero in the process. Additional Tier 1 capital is also known as AT1, Contingent Convertibles or CoCos, and are a type of convertible debt that pay an investor a coupon unless the bank runs into financial trouble, in which case the debt can be converted to equity or written off. As part of the deal UBS will receive a credit line from the Swiss National Bank.

This development follows the unrelated collapse of Silicon Valley Bank in the US a week ago following losses resulting primarily from an economic mismatch between its assets and liabilities, and the failure of Signature bank due to losses on crypto assets.

A desire to manage any negative impact from higher and rising interest rates on banks has created an incentive for the Bank of England to temper its rate raising plans. The current market expectations are still for a rise but not by as much as before. The market is split on whether the Bank of England's Monetary Policy Committee will increase rates by 0.25% or keep them the same at this Thursday's announcement.

This market view has been reflected in a fall in gilt yields in the last few days with 20 year gilt yields now around 3.8%. However this level is by no means extreme, it is about the level of yields in September 2022 before the ill-fated 'mini-budget'. Yields also dipped this low in February this year so is not particularly unusual given the extent of fluctuations we have become accustomed to of late.

Key points for trustees and pension schemes

1

Counterparty exposure

Credit Suisse is a well know counterparty for Liability Driven Investment managers. As a package has been arranged with UBS there is no disruption in this market. That said, if CS had defaulted, the implications for pension schemes in terms of losses would likely have been very modest given the extensive safeguards that are built into collateral arrangements. These include counterparty diversification, high quality collateral, over collateralisation (i.e. haircuts), and daily rebalancing of capital so that potential losses only relate to market movements over 1 day.

2

Losses on CS bonds and equity

Most CS debt holders will not have been 'zero'd' by the market activity as both CS senior bond holders and equity holders are expected to be compensated by the deal with UBS, although the financial value of these assets will have changed. Holders of CS's AT1 debt will have lost the value of that investment; these assets may be held within specialist fixed income portfolios.

3

Wider bond market performance

More broadly, investment grade corporate bond spreads have widened over the last week or so and now offer an increased yield of 2% above government bonds. That said, the level is only back where it was in November and some way off the recent peaks of over 2.5% seen in October.

4

Bank account security

The concerns in the banking sector highlights the importance of avoiding having large allocations in trustee bank accounts. Whilst the deposits at SVB US had their deposits guaranteed by the US's equivalent of the UK's Financial Services Compensation Scheme (FSCS), this is not assured and in the UK where guarantees are limited to £85,000 per client in the event a bank goes under. A far safer place for large amount of trustee cash assets would be a money markets fund. These invest in a diversified pool of short term money market instruments – which earns a cash return with very low levels of exposure to any one bank.

5

General equities performance

Equity markets-wise, the banking sector in particular is suffering and global equities more generally have given back most of the gains in January and February and are now close to where they started the year. This will have negatively affected pension funding positions in general over March so far. The extent of performance impact will depend on exposure to equities but in the main this impact will be modest for most schemes when looking since the start of the year.

6

Changes in liabilities

Long term bond yields have fallen steeply during March, whilst inflation expectations have only dipped modestly and as such a typical scheme's liabilities will have increased in March so far, by about 5-6%, and so funding levels are likely to have dipped depending on the level of hedging. A typical scheme's funding position will have deteriorated by around 3% since the start of March, and reduced by about 2% since the start of the year.

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