Investment market update

March 2023

Over recent days, banking crises in the US and Switzerland have captured headlines and shaken markets. As the situation stands though, our assessment is that the impact on UK pension schemes has been modest.

Background

Silicon Valley Bank (SVB), based in California, announced on 8 March that it had been forced to sell securities at a loss, and that a share issuance was required to raise new capital. This news triggered depositor panic, a run on the bank, and brought about the collapse of the 16th largest bank in the US.

Many of the fixed income assets held by SVB, including long-dated US government bonds, had fallen in value due to recent rises in interest rates. Under the US regulations applying to a bank of its size, SVB did not need to recognise these losses on its balance sheet – the rationale being that the fall in value was temporary and the assets could be held to maturity and redeemed at full value. However, as depositors sought to withdraw their money, SVB was forced to sell the assets and crystalise the hitherto unrecognised losses.

To avoid the risk of contagion, and as evidence mounted that investors were moving money out of regional US banks, the US authorities announced measures intended to shore up the banking sector. These included a guarantee that all deposits with SVB, regardless of size, would be secure. On the whole, these measures seemed to work and outright panic was averted – although not before the collapse of both Signature Bank and Silvergate Capital.

Nevertheless, the global banking sector was operating in a febrile atmosphere and bank shares fell significantly in value. Around two weeks ago, problems surfaced at Credit Suisse. While not directly linked to the issues at SVB, there were similarities in that the value of long-dated assets on Credit Suisse's balance sheet had been reduced by rising interest rates, and that those assets had to be sold at a loss as depositors started to move money away from the bank.

Credit Suisse, a much larger institution than the US regional banks, fell into the 'too big to fail' category. This prompted the Swiss authorities to force through a takeover by UBS. This appears to have been successful in terms of protecting depositor assets and investments in Credit Suisse's senior and secure debt (values of which rallied significantly).

However, the terms of the takeover imposed by the Swiss authorities have proven controversial in one area – additional tier 1 (AT1) debt. Ordinarily, in a corporate distress situation, the expectation would be that all creditors would fare better than, or at least as well as, shareholders. In this instance, however, Swiss authorities allowed a specific type of credit investment (the AT1 debt) to become worthless, while Credit Suisse shares maintained some residual value.

AT1 debt is specifically designed to be the first credit instrument to absorb bank losses, so the fact that it was wiped out in a distressed situation is not particularly surprising. More controversial though was the adverse treatment relative to equity investors. This upending of the normal capital structure has provoked some nervousness in credit markets, although European regulators have since highlighted that, unlike the Credit Suisse model, their expectation is that for other banks, equity investors would bear losses before holders to AT1 debt.

Central banks around the world have also been keen to stress over recent days that banks are well-capitalised and that we are not facing a systemic banking problem.

Impact on UK pension schemes

The impact of market volatility on a scheme's funding position is something that will have been considered when setting the investment strategy. It remains the case that taking action to match assets to liabilities and diversify a scheme's investments will help reduce that volatility.

You should consider whether the potential volatility identified at your last investment strategy review remains appropriate. However, in many cases, we would expect trustees to conclude that a period of market uncertainty is not particularly unexpected and that no immediate action is required.

A separate consideration is whether action is required in response to the specific problems facing the banking industry. In this regard, our research suggests that the answer is likely to be 'no'.

We set out below the impact on various asset classes:

LDI

All the LDI managers used by our clients have reported that counterparty exposure to Credit Suisse was either very low or nil. The purchase of Credit Suisse by UBS is likely to have reduced counterparty risk associated with such exposures.

Counterparty risk is, in any case, well mitigated by the daily positing of cash or government bonds as margin. This structure ensures that, should a counterparty default, they can typically be replaced at very limited cost. Indeed, the LDI market experienced such a scenario in 2008 when Lehman Brothers collapsed; the impact on LDI fund performance was not material.

Diversified credit and diversified growth funds

These funds certainly had scope to invest in AT1 debt, including that of Credit Suisse. The higher yields available would have been appealing, but if a manager had invested, we would have expected the allocation to individual banks to have been very low in recognition of the associated risks. We are not expecting these funds to have suffered materially from defaults or from being forced sellers of credit at a depressed price. We have requested information from all the diversified credit funds (DGF) and diversified growth funds (DGF) that we routinely research. That will allow us to confirm this to be the case. In the unlikely event that this analysis raises any concerns in respect of the funds you invest in, we will let you know.

Buy & maintain credit

Buy & maintain credit funds tend to be quite heavily exposed to the banking sector, with a typical allocation being between 20% and 30%. However, the bonds held are high quality, and the providers who have responded to our queries have confirmed they had minimal or no exposure to Credit Suisse. The AT1 bonds that have been written off as part of the Credit Suisse acquisition are not held within buy & maintain bond funds. Indeed, the very existence of these instruments provides security for the highest ranking debt holders such as buy & maintain investors.

None of the buy & maintain managers used by our clients plan to make any changes to their funds in response to recent events.

Equity

Shares in Credit Suisse and other banks have been volatile and have fallen in value recently. However, equity investments are inherently volatile and the impact on globally diversified equity portfolios has not been unduly concerning. As always though, global equity performance is linked to the fortunes of the global economy, the outlook for which remains uncertain. Inflation remains stubbornly high, and it is unclear how material the impact of recent events on the banking sector will eventually prove to be. As a consequence, it seems likely that equity markets will continue to be volatile.

If you have any questions regarding the points raised in this briefing, please get in touch with your usual First Actuarial contact.

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