Broadstone

Bank failures and stress – key issues for trustees and sponsors

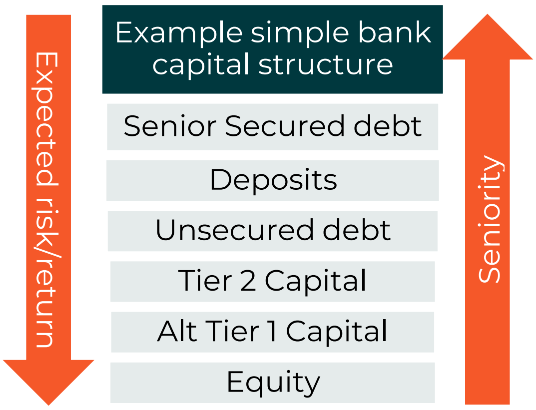
March 2023

Introduction

The collapse of Silicon Valley Bank, Signature Bank and Silvergate in the US, followed by the forced sale of Credit Suisse last weekend has had a significant impact on global markets.

In the case of Credit Suisse a rapid takeover deal with UBS was put in place with the help of the Swiss regulators in a deal that has defied conventional thinking on capital structure hierarchy. Under the deal, the Credit Suisse equity holders receive some compensation whilst the holders of Alternative Tier 1 debt (AT1, or contingent convertible bonds 'CoCos') will see their investments completely written off. The holders of more senior bonds (those with higher priority) will see the obligations effectively transfer to UBS.

Whilst the relevant UK and European Union authorities have confirmed that capital structure hierarchy will be respected within their jurisdictions, the takeover of Credit Suisse has had a material impact on markets, at least in the short term. It also serves as a reminder of the importance of trust and confidence in the banking sector, as well as being alert to the inherent risks and how these can be managed.



Despite some reassurances, there are no guarantees that the pressures facing the banking sector are over and that we will not see further issues in the face of higher interest rates and an uncertain economic outlook.

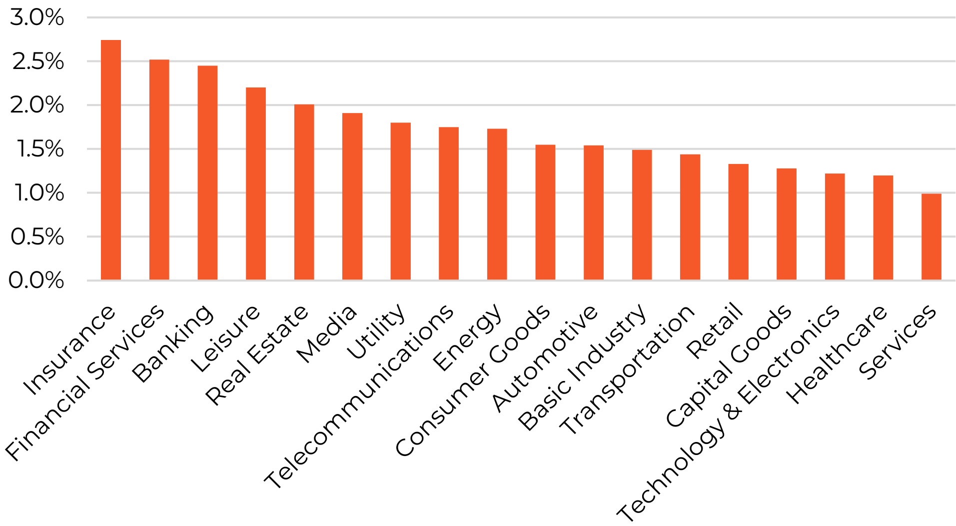
In this note we discuss some of the impacts of the current environment and the key areas that we believe trustees of pension schemes and corporate sponsors should consider.

Impact on corporate bond markets

The write-down of Credit Suisse's AT1 bonds came as a surprise to many of the bond managers that we have spoken to. The exposure to these bonds is likely to be modest, if any, for the average defined benefit pension scheme as their fixed income allocations tend to be more heavily weighted to investment grade bonds. However, the AT1 bond market is extremely large, and more senior investment grade bonds issued by banks and other financial sector issuers makes up a relatively large proportion of the Sterling corporate bond market.

The recent banking sector issues have had a material immediate impact on the yields and credit spreads (the excess yield over a comparable government bond) of bonds issued by financial sector companies.

UK corporate bond spreads by sector (yield versus government bonds - 20 March 2023)

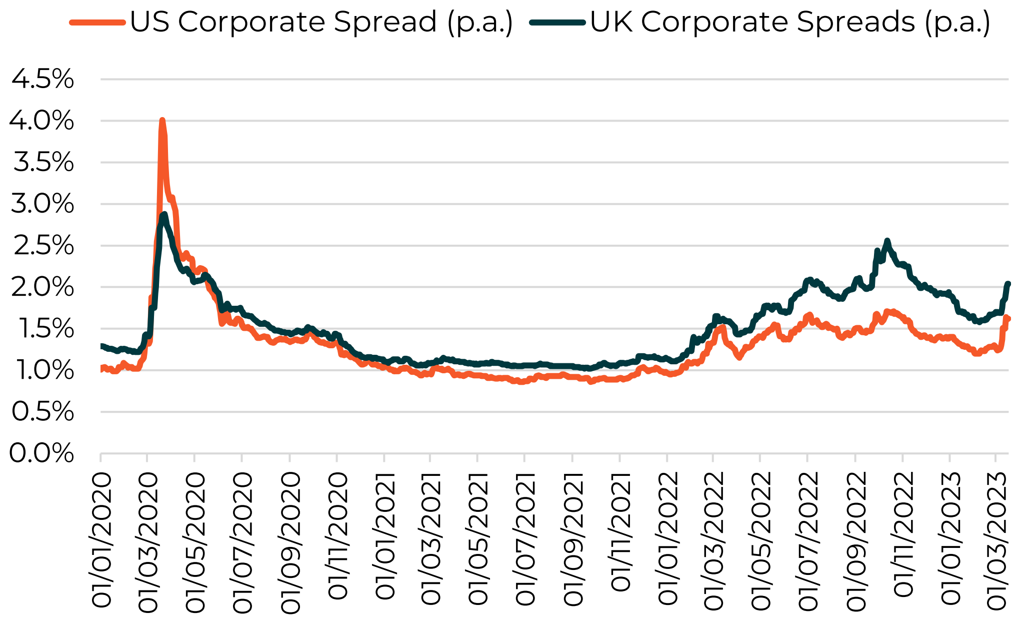


Credit spreads of financial sector bonds (Insurance, Financial Services and Banking) have increased recently, which has helped push the spreads on corporate bond indices higher.

Source: ICE BofA ML Sterling Corporate Index

High quality investment grade corporate bonds are a key element of most pension scheme investment portfolios and are likely to feature heavily in a 'low-risk' target investment policy. The market response to recent events within the banking sector highlights some important considerations for investors in corporate bonds.

Corporate bond yields versus government bonds



Credit spreads have generally been elevated and more volatile since 2022. The recent events in the banking sector have pushed spreads higher in US and UK markets.

Source: ICE BofA ML Sterling Corporate Index

Some of the key issues associated with UK corporate bond investing together with our comments for addressing these are set out below.

Issue	Description	Preferred approach
Sector concentration risk	The Sterling corporate bond market is heavily weighted to financial sectors. Financials represent more than 50% of certain UK corporate bond indices.	Avoid index-based approaches. We prefer unconstrained approaches, including ‘buy and maintain’.
Limited universe	The UK corporate bond market is relatively small (c.5% of issuers out of a global market of c.£40tn based on data collected by the International Capital Market Association in 2020).	To ensure adequate diversification, our preference is for a global investment universe with non-Sterling interest rate and currency exposure hedged.
Credit risk and downgrades	Investment grade borrowers can default and be downgraded. The capital structure of issuers can also be complex.	Employ the use of highly capable investment managers who fundamentally assess bond issuers and monitor them over time.

As the table above highlights, we believe it is important to consider the approach used for corporate bond investing to avoid unintended risks and costs of sub-optimal approaches.

Trustee bank account operations

The main objective for pension scheme trustees is to ensure that members receive their benefits in full and on time. The processing of the monthly pensioner payroll often happens seamlessly with no issues. However, outside of any insolvency event, it may be sensible to consider what would happen if there were an issue outside of the trustees' control that delays or prevents the payment of benefits.

Considerations for trustees	
Risk register	We suggest adding bank related risks to the risk register if these are not already covered.
Contingency planning	Consider what steps would be necessary to fulfil the obligations to members in the event of operational or insolvency related issues (including receiving banks). For example, does the sponsor have alternative banking relationships and could the payroll be processed using these in an extreme scenario.
Avoid excessive balances	Whilst a sensible working bank balance is required, we would caution against holding excessive balances in traditional bank accounts when bank failure is a genuine concern. It should be noted that the statutory compensation cap (£85,000) will be lower than the working balance of many schemes and could give rise to risk in an insolvency event.

Counterparty risk and treasury management for corporate clients

As highlighted by recent events, the current market environment is characterised by concerns around interest-rates and inflation, uncertain equity markets, fast-moving regulation and the general liquidity and solvency of banks.

We have been helping corporate clients move away from bank risk to government risk via UK Treasury Bills (T-bills). Where clients maintain exposure to bank risk, we suggest a robust, defensible, and regular counterparty credit risk monitoring system.

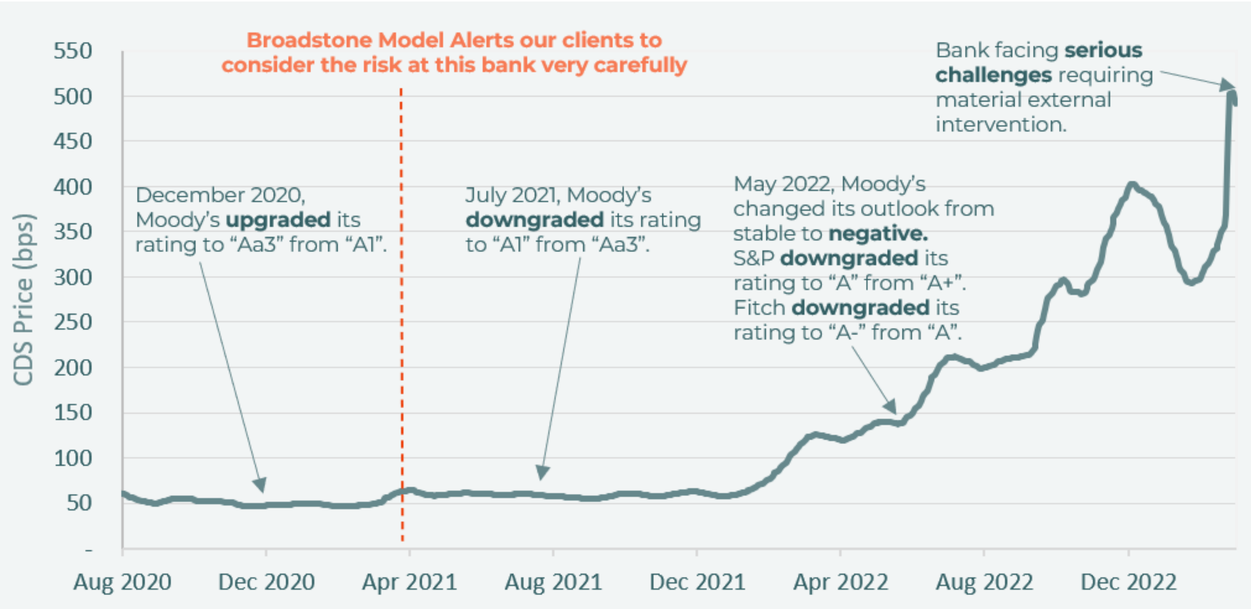
We discuss both below.

Robust, defensible, and regular counterparty credit risk monitoring system

Where banks are used for treasury management purposes, we believe independent evaluation of counterparty strength is essential. Credit ratings are widely used as a measure of financial strength; however, the insights provided by these are limited and have been significantly challenged, especially following the 2008 Global Financial Crisis (GFC).

Many investors rely solely on credit ratings to determine the risk of their cash investments; this can lead to the omission of key information regarding a counterparty's creditworthiness. The example below highlights the use of our proprietary credit risk model, which used live market data alongside fundamental analysis, to flag a very recent collapse at a globally renowned bank. As demonstrated, this analysis can help identify risk factors in many cases much earlier than using credit ratings alone.

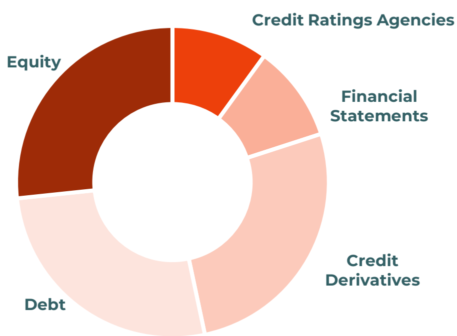
Case Study: a recent bank collapse



Broadstone's proprietary **counterparty strength model** incorporates a range of live measures (such as equity, bond, and Credit Default Swap (CDS) indicators), and non-live measures (information from financial statements and credit rating agencies). Our model provides clients with the following benefits:

- **Greater comfort around the banks used**, typically identifying issues with financial strength much sooner than would be the case by simply relying on credit ratings;
- A **structured, robust and objective approach to risk management**, which can be documented and is defensible against challenge;
- The ability to **rank the banks that meet minimum criteria in a way that allows the setting of appropriate deposit limits** in terms of amount and period to maturity;

Broadstone's Counterparty Risk Analysis Model inputs



- **Enhanced quality information to inform decisions** on an ongoing basis about the relative attractiveness of returns offered by different institutions; and
- A **method of testing the profile of new counterparties** to assess whether they **offer more efficient returns at a similar level of risk** to current deposits.

Diversification away from bank risk

Current market levels show that bank risk indicators have recently risen to levels similar to those seen at the outset of the Covid-19 pandemic. Also, as deposit rates have increased, it has made the decisions with regard to the banks used, and what risk cash investors are exposed to, of even greater importance. We have been helping clients navigate the market volatility with regard to their cash investments using the approaches detailed below.

We have helped many of our institutional clients to move some of their cash into government risk via the purchase of UK Treasury Bills (UK T-Bills), whilst of course maintaining a mixture of carefully chosen counterparties for the rest of their cash

The use of UK T-Bills gives the following key benefits to investors:

- **Diversification away from bank risk**, with a focus on UK government risk;
- The **ability to tailor maturities**, if required, ensuring cash flow needs are met;
- Even if the funds are not deposited immediately, **having the infrastructure in place** means that, should you need to move **away from bank risk at short notice**, you will be **able to do so immediately.** This will allow you **access to safe-haven assets** without having to undertake any new account opening, which we saw after the 2008 GFC could take a long time if everyone is trying to set this up at the same time.
- Additionally, UK T-Bills currently offer **competitive yields**.

In order to purchase UK T-Bills, clients need suitable **custody and brokerage facilities**. Having this infrastructure in place before market risks increase and others are also trying to do so in a haste, as it happened during the financial crisis in 2008, is **advisable practice**. UK T-Bills can be purchased at Debt Management Office (DMO) auctions or on the secondary market. In either case, a broker will be required to facilitate purchases, and it will then need to be held in a suitable custody account.

How we can help:

- We can assist in setting-up the suitable infrastructure to invest in UK T-Bills. This step involves **selecting a financial institution** capable of providing the required level of guidance / advice via a tendering process.
- Your preference and ultimate choice of the **required level of guidance / advice** can be explored throughout the tendering process.

Summary

The banking sector plays an integral role in the economy.

However, as we have seen the banking sector is not immune to risks which can lead to even the largest global banks running into difficulties. The ultimate risk of failure can impact specific investments which are mainstream for many institutional and retail investors. The impacts can also be felt in broader markets and the policies of central banks and regulators.

Banks have complex capital structures and often finance their operations through the issuance of different tranches of bonds as well as cash deposits. Bonds issued by financial entities account for a large proportion of the UK corporate bond market. In our view it is therefore important to ensure the approach to bond investing is adequately diversified and managed by high quality investment managers who carry out the right level of fundamental analysis.

In addition, analysis of bank counterparties can provide a valuable extra layer of protection and add value when considering risk-adjusted returns for cash deposits. UK T-Bills can provide an attractive additional option for managing risk, liquidity and short-term treasury needs.

Having the necessary contingency plans may also be sensible to mitigate against large risks which may seem unlikely.

Find out more

For more information on how Broadstone can help you, please contact your Broadstone consultant

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