Recent Banking Crisis and De-Risking of Global Bond Fund

With the recent market developments, this newsletter captures the events that brought down the global banking giant – Credit Suisse, and another two US regional banks, and their impacts on the Scheme. In addition, we would like to provide an update on the de-risking of the Global Bond Fund after the latest investment strategy review of the Scheme.

1. Recent Banking Crisis - The Fall of Silicon Valley Bank, Signature Bank and Credit Suisse

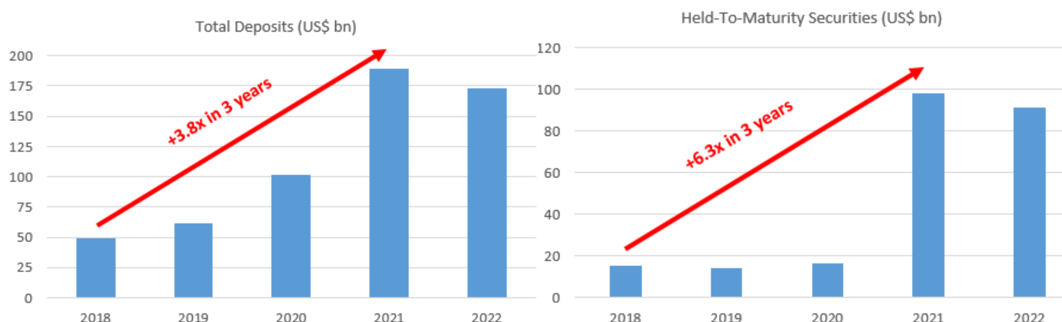
Global markets remained volatile year-to-date ("YTD") and March was no exception. Investors continued to navigate through uncertainties including weakening economic outlook and interest rate hikes amid inflationary concerns. To exacerbate the situation, the 16th largest bank in the US, Silicon Valley Bank ("SVB"), was ordered to be shut down by regulators on 10 March. Two days later, regulators also closed New York-based Signature Bank ("Signature"), the 29th largest bank in the US, from doing business. The failure of SVB and Signature sparked concerns on the stability of US regional banks while the large players were relatively unscathed.

While investors thought the situation was limited to US regional banks, the following weekend saw the "shotgun marriage" between two Swiss banking giants. On 19 March, UBS announced that it would acquire fellow Swiss bank, Credit Suisse ("CS"), for CHF3 billion in stock, under an emergency deal brokered by the Swiss government and regulator.

Given the recent developments, some market observers wondered if this is similar to the 2008 global financial crisis ("GFC"). While there are similarities between the recent situation and GFC in a sense that multiple banks failed, there are also distinct differences. For example, during GFC, banks failed because of the devaluation of mortgage-backed securities ("MBS") as a result of: 1.) lax lending practices; 2.) falling property prices, and; 3.) rising number of borrowers failing to repay their loans, among several other issues. Valuation of many MBS collapsed and were considered subprime, leading to significant losses for financial institutions which held them.

SVB

Unlike many of the banks that collapsed or on the verge of collapse during GFC, the primary reason for SVB's failure was not due to subprime assets. SVB's profile was somewhat different from ordinary commercial bank as majority of its business (i.e. deposit base) was concentrated in certain sectors – technology and healthcare startups backed by venture capital funds – based in Northern California. While one may argue that other regional banks have similar concentration, it is usually not in sectors and regions that are both highly volatile. During a low interest rate environment, there were abundant liquidity to support startup firms and, as a result, saw a rapid increase in deposits at SVB prior to the interest rate hikes in 2022.



Source: HAPFS Office, SVB 10-K filings

With the rising deposit base, SVB allocated a large portion towards held-to-maturity ("HTM") securities, which are debt securities that SVB intends to hold to their maturity – these tend to be longer-term in nature (i.e. 10 years+ maturity). According to SVB's filings, the majority of HTM securities were issued by the US government (> 90%) while the remaining were municipal bonds (8%) and corporate bonds (1%). Although the portfolio had minimal default risks (mostly US government-backed), the valuation was subject to market risks such as interest rate movements. The interest rate hikes negatively impacted the valuation of HTM securities portfolio.

As high growth businesses fell out of favour in 2022 amid rising interest rates, startup firms struggled to raise fresh capital while continuing to draw down deposits, causing deposits at SVB to decline. To exacerbate this, a large portion of SVB's portfolio was invested into long-duration securities, which had low fixed rates. As interest rates climbed, it needed to chase deposits by offering higher rates, compressing SVB's profitability. As the situation worsened, this exacerbated depositor confidence, especially since SVB had high average balances being above the limits insured by Federal Deposit Insurance Corporation ("FDIC"), and eventually accelerated withdrawals that forced SVB to liquidate its available-for-sale and HTM securities portfolios at a sizeable loss.

Based on these observations, it appears that SVB's failure is predominantly driven by its concentrated deposit base, unfavorable market environment (rising interest rates), and poor asset and liability management rather than subprime-related issues.

Signature Bank

Like SVB, Signature also suffered from similar funding pressures as well as having a large depositor base where average balances were above the FDIC-insured limit of US$250,000. In addition to this, a little over a month before Signature collapsed, the bank was accused of substantially facilitating the fraud committed by FTX – a firm that operated a cryptocurrency exchange and crypto hedge fund.

Credit Suisse

A week after the failure of SVB and Signature, UBS announced to acquire the troubled Swiss bank, Credit Suisse ("CS"). CS had been facing confidence crisis in the last few years as a result of risk management issues (i.e. financing to a troubled family office and a supply chain finance company), which led to multi-billion USD losses. Other concerns include money laundering charges and rotating group of executives. Accordingly, CS announced in early 2023 that it would look to shore up liquidity to boost investor confidence. However, by mid-March, CS' largest shareholder, Saudi National Bank, said that it would not invest further into CS due to regulatory barriers. These negative developments, together with the collapse of SVB and Signature, caused the spread of CS credit default swap ("CDS201D, which is the cost to insure against non-payment of a bond) spiked to a level beyond the GFC level. To prevent a collapse and the potential effect on the broader global financial system, the Swiss government and regulator brokered a deal for UBS to acquire CS. However, as part of the deal, the CS additional tier 1 ("AT1") bonds were wiped out.

Minimal impact on the Scheme

As at the end of February 2023 (before the collapse of the three banks), the Scheme's total exposure (i.e. equities and bonds) to SVB, Signature and CS was approximately 0.25%, with the bulk coming from CS senior bonds (0.24%). The Scheme Office has discussed with the relevant asset managers about these exposures following the events. In summary, the asset managers plan to hold the senior bonds until they are assumed by UBS when the deal is closed, which is expected to happen in around 2Q/3Q 2023.

While we are disappointed with the wipeout of the CS' AT1 bonds and the significantly reduced value of the equity, we note that the senior bonds reacted differently, with prices hitting YTD high (e.g. a bond maturing in 2031; price at the end of 2022 was approximately 78s, hit all-time low of 63s prior to the UBS deal and was trading at 88s at the end of March 2023) as investors were feeling more optimistic with CS' debt profile following UBS' buyout announcement. While the key rating agencies have kept CS' credit ratings unchanged, S&P placed CS' outlook on "CreditWatch Positive" while Moody's placed CS' outlook on "Under review for upgrade". One of the key reasons is that they believe the CS' acquisition by the stronger UBS should stabilize the franchise and its funding/liquidity needs while strengthening its governance and risk management standards.

The Scheme Office will continue to monitor the market developments and the Scheme's exposure to these banks closely.

2. De-Risking of the Global Bond Fund

In 2022, an investment consultant was engaged to assist on the review of the investment strategy of the Scheme. One of the key recommendations was to reduce the risk level of the Global Bond Fund ("GBF") such that it aligns better between the risk profiles of the Conservative Fund ("CF") and the Money Market Fund ("MMF"), by including the short-term bond strategies in the GBF, just like what the CF currently has. The Board of Trustees and the Investment Committee of the Scheme confirmed the change in March 2023.

Global Bond Fund	Weight
Medium-/long-term bonds	61.7%
Global fixed income	*55.1%*
Global inflation-linked bonds	*3.3%*
High yield bonds	*3.3%*
Short-term bonds	33.3%
Alternatives	5%
Total	**100%**

Adding short-term bond strategies, which focus on bonds maturing in 1 to 3 years, can help lower volatility and enhance downside protection of the GBF that predominantly holds medium- to longer-term bond strategies. Short-term bonds tend to be less volatile since they are closer to maturity and less sensitive to interest rate changes compared to medium- to long-term bonds. Following the changes, the target asset allocation to medium-/long-term bond strategies, short-term bond strategies, and alternative strategies will be 61.7%, 33.3% and 5%, respectively, within GBF. Please note the actual allocations across various strategies vary from time to time due to market movement, asset managers' performance, etc.

While the GBF is expected to exhibit lower volatility going forward, it should be noted that it is not principal-protected/guaranteed and is subject to market fluctuations.

With the updates and information provided above, we hope it helps members understand the recent market developments, its impact of the Scheme, and the recent de-risking of the GBF.

HAPFS Office
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