Insights on UBS Deal to Buy Credit Suisse

PGIM FIXED INCOME

March 2023

UBS's agreement over the weekend to buy Credit Suisse has raised questions around the terms of the merger, the treatment of the AT1 bonds, and the potential investment implications.

BACKGROUND

UBS will acquire Credit Suisse for CHF3bn ($3.25bn) in an all-share merger (1 UBS share for every 22.48 Credit Suisse shares), creating a business with more than $5 trillion in total invested assets. Closing is expected in Q2 2023 subject to expedited regulatory approval. The Swiss National Bank is offering CHF100bn in liquidity assistance and the government is granting a CHF9bn guarantee for potential losses from assets that UBS is taking over.

The Swiss Financial Market Supervisory Authority (FINMA) said about CHF16bn ($17.3bn) in Credit Suisse AT1 bonds will be written down in order to increase core capital, while valuing the equity at CHF3bn. The controversial decision by FINMA to give recovery to shareholders and not to AT1 holders was a negative surprise to the market and flies in the face of convention but is allowable under the terms and conditions of Credit Suisse's AT1 bond documents in which there was a provision that allows for their write off when Credit Suisse "has received an irrevocable commitment of extraordinary support from the public sector."

AT1 bonds, also known as Contingent Convertible Bonds (CoCos), were introduced after the Global Financial Crisis and are designed to impose losses on bondholders or be converted to equity if a bank's capital ratios fall below a predetermined level. With a total size of approximately $275bn, the full write down of Credit Suisse AT1 bonds will likely have negative implications for the wider European Bank AT1 market, with investors likely to demand a higher risk premium going forward.

The EU regulatory Authorities (ECB SSM, SRB and EBA) put out a joint statement this morning that appeared to suggest that they do not approve of FINMA's treatment of AT1 holders and would not take such an action themselves. "In particular, common equity instruments are the first ones to absorb losses, and only after their full use would Additional Tier 1 be required to be written down. This approach has been consistently applied in past cases and will continue to guide the actions of the SRB and ECB banking supervision in crisis interventions."

MARKET PERSPECTIVES AND IMPACT

With the intended acquisition backed by the authorities (Swiss Federal Government, the Swiss National Bank and FINMA), the senior bonds issued by holding company (HoldCo) CS Group AG and the senior unsecured bonds issued by the main operating company (OpCo) Credit Suisse AG and its branches and guaranteed entities will become senior bonds of HoldCo UBS Group AG and senior unsecured bonds of OpCo UBS AG respectively. In both cases the subsuming entities are higher rated than the equivalent Credit Suisse entities.

The announcement of the transaction—which brings enormous relief to financial markets given the possible contagion risks—was accompanied by decisions by the Swiss Federal Council (a multi-party equivalent of a cabinet) to suspend the requirement to hold shareholders votes in the interest of banking stability and expediency and to provide a CHF9bn guarantee to assume potential losses arising from certain assets (mainly relating to investment banking activities) should any losses on the unwind or sale of these assets exceed the threshold of CHF5bn. The various liquidity facilities made available immediately to ensure liquidity to both banks amount to CHF200bn. This is intended to cover any deposit outflows that may continue (particularly from Credit Suisse) until and after closing of the deal. Taking into consideration the extent to which PGIM FI understands the liquidity outflows to date, the liquidity facility seems well scaled to ensure the continuation of the normal functioning of the two banks.

The closing of the deal is intended to take some months as it requires approvals in a number of jurisdictions where the two banks operate and for retroactive approval by Switzerland's two legislative chambers of the guarantee provided and for the suspension of the requirement to hold shareholder votes. Given the possible systemic implications from changing the terms of the deal the time to debate allowed by a maximum six-month deadline for approval allows, in PGIM Fixed Income's view, a high degree of probability of this transaction closing. Before the deal closes, what should be helpful for confidence among Credit Suisse depositors and counterparties is the immediate oversight of its operations and balance sheet by a join committee of UBS management and FINMA. While securing matters for most obligors and all depositors and trading counterparties of Credit Suisse, the transaction offers significant potential upside for UBS and its shareholders and with it its bondholders.

In a somewhat surprising move, FINMA - the regulator - decided to invoke a clause in the resolution decree (and reflected in bond documents) that the Additional Tier 1 (AT1) hybrid capital issued by Credit Suisse Group AG should be written down to zero because special financial assistance by the Federal Government (as opposed to only liquidity facilities being offered by the Swiss National Bank. UBS' share exchange offer of approximately CH3bn is for a group whose equity and Common Equity Tier 1 (CET1) capital (which was CHF35.3bn or $38.2bn at end 2022) being bolstered by approximately CHF16bn of debt being written off.

All of this is immediately capital ratio accretive for UBS. The simplest calculation without taking into account the indicated, but as yet not fully enumerated, benefits of Credit Suisse' asset disposal transactions at end year, would boost the CET1 ratio of UBS from 14.2% at year end to 17.0% at a proforma end 2022 basis.

All of this leaves a lot of room for UBS to absorb restructuring charges and disposal losses as it aims to:

1. achieve a $8bn reduction on top of the $2.7bn reduction in costs already planned by Credit Suisse, compared to a combined proforma cost base of $44.8bn. This is indicated as requiring between $10bn and $12bn of early termination charges on top of the $2.9bn of existing charges planned by Credit Suisse;
2. top up litigation reserves at Credit Suisse which at $1.3bn are at half the level of UBS, which would now seem to face overall less potential litigation losses;
3. reduce the combined exposure to investment banking for the purposes of capital calculation to under 25% from 31% proforma currently and in so doing realize losses that it envisages at below the CHF5bn level before the attachment point of losses to be absorbed by the above-mentioned guarantee by the Federal Government.

UBS currently needs a CET1 capital ratio capital of 10.2%. This may eventually rise as the combination will likely move it to a higher "bucket" of Globally Systemically Important Banks (G-SIBs) that will need to have a 1.5% additional CET1 ratio rather than 1.0% currently. UBS will be given time to reach target, but it is highly unlikely that it will need this time. Per PGIMFI estimates, it would take losses, additional costs, and post-merger adjustments of $20bn to reach its "optimal" target ratio of 13.5% and it would take $36bn to reach a ratio of 10.7% (the requirement after the higher G-SIB surcharge).

The combined UBS + CS Group **USD equivalent, m unless otherwise stated**	**UBS y/e 31 Dec 2022**	**CS y/e 30 Dec 2022**	**UBS +CS day unadjusted on the basis of end year and conversion of AT1**
Total Assets	1,104,364	574,770	1,679,134
Total Deposits	525,051	252,290	777,341
Total Interational and Domestic Wealth Management AuM	2,815,000	1,153,417	3,968,417
Total Institutional Asset Management AuM	832,000	574,770	1,406,770
Total gross loans	388,311	435,276	823,587
Risk weighted assets	319,585	271,009	590,594
CET1 capital	45,457	38,173	99,570
CET1 ratio	14.2%	14.1%	16.9%
Tangible book value	47,722	43,965	43,965
Market Capitalisation	61,783	3,311	65,094
Market Cap/ TBV, x	1.29	0.08	1.48

Leverage ratio exposure	1,028,461	703,701	1,732,162
Total T1 capital	57,132	54,113	108,980
T1 leverage ratio	5.6%	7.7%	6.3%
Investment banking business line leverage ratio exposure	316,600	228,889	545,489
Investment banking business % of leverage ratio exposure	31%	33%	31%
Total NPLs	2,455	3,704	6,159
NPL ratio	0.6%	0.9%	0.7%
LTM Revenues	34,545	16,140	50,685
LTM reported operating costs including litigation and restructuring	-24,930	-19,647	-44,577

Source: from Credit Suisse Group AG and UBS Group AG Annual reports, calculations by PGIM Fixed Income

As for the impacts on the broader European bank sector:

1. The avoidance of the collapse of a systemically connected major counterparty is a major positive as is the supportive involvement of the home government and of regulators and central banks in the main other jurisdictions where Credit Suisse and UBS operate.
2. The disregard of the hierarchy of creditors in AT1 holders being written down to zero while shareholders will share some of the upside (given the share exchange rather than cash acquisition) has clearly affected sentiment in the market for AT1 and for other subordinated bonds and may cause difficulties in refinancing for such capital instruments for a number of banks. The European Central Bank has already reacted to reassure these markets indicating that any resolution involving the Euro Area banks will involve shareholders bearing losses ahead of AT1 holders, but the uncertainty is set to remain

NOTICE: IMPORTANT INFORMATION

Source(s) of data (unless otherwise noted): PGIM Fixed Income, as of 03/20/2023.

For Professional Investors only. Past performance is not a guarantee or a reliable indicator of future results and an investment could lose value. All investments involve risk, including the possible loss of capital.

PGIM Fixed Income operates primarily through PGIM, Inc., a registered investment adviser under the U.S. Investment Advisers Act of 1940, as amended, and a Prudential Financial, Inc. ("PFI") company. Registration as a registered investment adviser does not imply a certain level or skill or training. PGIM Fixed Income is headquartered in Newark, New Jersey and also includes the following businesses globally: (i) the public fixed income unit within PGIM Limited, located in London; (ii) PGIM Netherlands B.V., located in Amsterdam; (iii) PGIM Japan Co., Ltd. ("PGIM Japan"), located in Tokyo; (iv) the public fixed income unit within PGIM (Hong Kong) Ltd. located in Hong Kong; and (v) the public fixed income unit within PGIM (Singapore) Pte. Ltd., located in Singapore ("PGIM Singapore"). PFI of the United States is not affiliated in any manner with Prudential plc, incorporated in the United Kingdom or with Prudential Assurance Company, a subsidiary of M&G plc, incorporated in the United Kingdom. Prudential, PGIM, their respective logos, and the Rock symbol are service marks of PFI and its related entities, registered in many jurisdictions worldwide.

These materials are for informational or educational purposes only. The information is not intended as investment advice and is not a recommendation about managing or investing assets. In providing these materials, PGIM is not acting as your fiduciary. PGIM Fixed Income as a general matter provides services to qualified institutions, financial intermediaries and institutional investors. Investors seeking information regarding their particular investment needs should contact their own financial professional.

These materials represent the views and opinions of the author(s) regarding the economic conditions, asset classes, securities, issuers or financial instruments referenced herein. Distribution of this information to any person other than the person to whom it was originally delivered and to such person's advisers is unauthorized, and any reproduction of these materials, in whole or in part, or the divulgence of any of the contents hereof, without prior consent of PGIM Fixed Income is prohibited. Certain information contained herein has been obtained from sources that PGIM Fixed Income believes to be reliable as of the date presented; however, PGIM Fixed Income cannot guarantee the accuracy of such information, assure its completeness, or warrant such information will not be changed. The information contained herein is current as of the date of issuance (or such earlier date as referenced herein) and is subject to change without notice. PGIM Fixed Income has no obligation to update any or all of such information; nor do we make any express or implied warranties or representations as to the completeness or accuracy.

Any forecasts, estimates and certain information contained herein are based upon proprietary research and should not be interpreted as investment advice, as an offer or solicitation, nor as the purchase or sale of any financial instrument. Forecasts and estimates have certain inherent limitations, and unlike an actual performance record, do not reflect actual trading, liquidity constraints, fee. These materials are not intended as an offer or solicitation with respect to the purchase or sale of any security or other financial instrument or any investment management services and should not be used as the basis for any investment decision. PGIM Fixed Income and its affiliates may make investment decisions that are inconsistent with the recommendations or views expressed herein, including for proprietary accounts of PGIM Fixed Income or its affiliates.

Investing in the **bond market** is subject to risks, including market, interest rate, issuer, credit, inflation risk, and liquidity risk. The value of most bonds and bond strategies are impacted by changes in interest rates. Bonds and bond strategies with longer durations tend to be more sensitive and volatile than those with shorter durations; bond prices generally fall as interest rates rise, and low interest rate environments increase this risk. Reductions in bond counterparty capacity may contribute to decreased market liquidity and increased price volatility. Bond investments may be worth more or less than the original cost when redeemed. **Mortgage- and asset-backed securities** may be sensitive to changes in interest rates, subject to early repayment risk, and while generally supported by a government, government agency or private guarantor, there is no assurance that the guarantor will meet its obligations. **High yield, lower-rated securities** involve greater risk than higher-rated securities; portfolios that invest in them may be subject to greater levels of credit and liquidity risk than portfolios that do not. Investing in **foreign-denominated and/or -domiciled securities** may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. Currency rates may fluctuate significantly over short periods of time and may reduce the returns of a portfolio. **Commodities** contain heightened risk, including market, political, regulatory and natural conditions, and may not be suitable for all investors. **Diversification** does not ensure against loss.

In the **United Kingdom**, information is issued by PGIM Limited with registered office: Grand Buildings, 1-3 Strand, Trafalgar Square, London, WC2N 5HR.PGIM Limited is authorised and regulated by the Financial Conduct Authority ("FCA") of the United Kingdom (Firm Reference Number 193418). In the **European Economic Area** ("EEA"), information is issued by PGIM Netherlands B.V., an entity authorised by the Autoriteit Financiële Markten ("AFM") in the Netherlands and operating on the basis of a European passport. In certain EEA countries, information is, where permitted, presented by PGIM Limited in reliance of provisions, exemptions or licenses available to PGIM Limited including those available under temporary permission arrangements following the exit of the United Kingdom from the European Union. These materials are issued by PGIM Limited and/or PGIM Netherlands B.V. to persons who are professional clients as defined under the rules of the FCA and/or to persons who are professional clients as defined in the relevant local implementation of Directive 2014/65/EU (MiFID II). In **Switzerland,** information is issued by PGIM Limited, London, through its Representative Office in Zurich with registered office: Kappelergasse 14, CH-8001 Zurich, Switzerland. PGIM Limited, London, Representative Office in Zurich is authorised and regulated by the Swiss

Financial Market Supervisory Authority FINMA and these materials are issued to persons who are professional or institutional clients within the meaning of Art.4 para 3 and 4 FinSA in Switzerland. In certain countries in **Asia-Pacific**, information is presented by PGIM (Singapore) Pte. Ltd., a Singapore investment manager registered with and licensed by the Monetary Authority of Singapore. In **Japan,** information is presented by PGIM Japan Co. Ltd., registered investment adviser with the Japanese Financial Services Agency. In **South Korea**, information is presented by PGIM, Inc., which is licensed to provide discretionary investment management services directly to South Korean investors. In **Hong Kong**, information is provided by PGIM (Hong Kong) Limited, a regulated entity with the Securities & Futures Commission in Hong Kong to professional investors as defined in Section 1 of Part 1 of Schedule 1 (paragraph (a) to (i) of the Securities and Futures Ordinance (Cap.571). In **Australia**, this information is presented by PGIM (Australia) Pty Ltd ("PGIM Australia") for the general information of its "wholesale" customers (as defined in the Corporations Act 2001). PGIM Australia is a representative of PGIM Limited, which is exempt from the requirement to hold an Australian Financial Services License under the Australian Corporations Act 2001 in respect of financial services. PGIM Limited is exempt by virtue of its regulation by the FCA (Reg: 193418) under the laws of the United Kingdom and the application of ASIC Class Order 03/1099. The laws of the United Kingdom differ from Australian laws. In **Canada**, pursuant to the international adviser registration exemption in National Instrument 31-103, PGIM, Inc. is informing you that: (1) PGIM, Inc. is not registered in Canada and is advising you in reliance upon an exemption from the adviser registration requirement under National Instrument 31-103; (2) PGIM, Inc.'s jurisdiction of residence is New Jersey, U.S.A.; (3) there may be difficulty enforcing legal rights against PGIM, Inc. because it is resident outside of Canada and all or substantially all of its assets may be situated outside of Canada; and (4) the name and address of the agent for service of process of PGIM, Inc. in the applicable Provinces of Canada are as follows: in **Québec**: Borden Ladner Gervais LLP, 1000 de La Gauchetière Street West, Suite 900 Montréal, QC H3B 5H4; in **British Columbia**: Borden Ladner Gervais LLP, 1200 Waterfront Centre, 200 Burrard Street, Vancouver, BC V7X 1T2; in **Ontario**: Borden Ladner Gervais LLP, 22 Adelaide Street West, Suite 3400, Toronto, ON M5H 4E3; in **Nova Scotia**: Cox & Palmer, Q.C., 1100 Purdy's Wharf Tower One, 1959 Upper Water Street, P.O. Box 2380 - Stn Central RPO, Halifax, NS B3J 3E5; in **Alberta**: Borden Ladner Gervais LLP, 530 Third Avenue S.W., Calgary, AB T2P R3.

2023-2427

留意事項

※本資料はPGIMフィクト・インカムが市場動向に関する情報提供としてプロの投資家向けに作成したものです。PGIMフィクスト・インカムは、米国SECの登録投資顧問会社であるPGIMインクの債券運用部門です。

※本資料は情報提供を目的としたものであり、特定の金融商品の勧誘又は販売を目的としたものではありません。また、本資料に記載された内容等については今後変更されることもあります。

※記載されている市場動向等は現時点での見解であり、これらは今後変更することもあります。また、その結果の確実性を表明するものではなく、将来の市場環境の変動等を保証するものでもありません。

※本資料で言及されている個別銘柄は例示のみを目的とするものであり、特定の個別銘柄への投資を推奨するものではありません。

※本資料に記載されている市場関連データ及び情報等は信頼できると判断した各種情報源から入手したものですが、その情報の正確性、確実性について当社が保証するものではありません。

※過去の運用実績は必ずしも将来の運用成果等を保証するものではありません。

※本資料は法務、会計、税務上のアドバイスあるいは投資推奨等を行うために作成されたものではありません。

※PGIMジャパン株式会社は、世界最大級の金融サービス機関プルデンシャル・ファイナンシャルの一員であり、英国プルーデンシャル社とはなんら関係がありません。

PGIMジャパン株式会社
金融商品取引業者 関東財務局長（金商）第392号
加入協会 一般社団法人日本投資顧問業協会、一般社団法人投資信託協会
PGIMJ97686