Rathbones
Look forward

Review of the week

20 March 2023

Poof, like magic

Banks are very powerful, but very fragile. That's because they are dependent on people and their ability to believe.

Banking is a confidence game. That doesn't mean it's a con, or duplicitous to its core, as some conspiracists argue. Magic is also a confidence trick. It draws you in and allows the impossible to become real: it creates something out of nothing.

Banking is a sort of magic too, except it's usually as dull as bricks. Banking draws in millions of people, instilling enough trust to convince them to give all that they own, without even a pause, to someone they have never met. Banking takes all this money and it makes it go further: it lends it to other people, allowing them to buy things that they otherwise wouldn't be able to afford for many years. Cars, homes, education, the capital to start a new business. It drags all the things, that would otherwise have to wait many, many years, from the future to the present. And in doing so, it boosts the wealth and activity of everyone. Suddenly there's more work for mechanics, builders, teachers, and more jobs at new businesses. Things are created out of nothing, like magic.

The magic of banking is extremely simple, really. It gathers all the cash of society and lumps it together, creating a huge float of money that can be more easily put to good use by lending to people with good or profitable ideas for it. Because when all that money is kept under everyone's mattress, it can only be used when it's spent. It's the same argument that car-sharing apps use when enticing you to list your Nissan: your vehicle is a wasted resource 95% of the time because it's sat in your driveway not being used. It's better for you and everyone else if you allow it to be borrowed by those who could make use of it. Banking made the pitch for this business model more than 2,000 years ago. The helpful thing about money is that it is the easiest thing in the world to move (it's just numbers on a ledger) and it is completely fungible (every pound sterling is identical, which can't be said for cars). This financial fluidity has only increased in the digital age, with the ability to transfer money instantly and open accounts with the tap of a button.

The other thing banking shares with magic is that it quickly becomes messy when things go wrong. It may sound as jarring as one of those awful ads with horses running on beaches talking about how banks are all people. But it's true: at the heart of banking is people. But not in the way that banks' marketing departments portray. Banks are an agglomeration of society, all its hopes, all its quirks, all its fears. **They are heavily dependent on psychological phenomena.**

Last week, investors and depositors, jittery after the unexpected failure of three US banks, panicked when a cornerstone investor in huge multinational lender Credit Suisse said in an interview that it wouldn't invest more in the bank. The reasons were pedestrian and non-threatening: the shareholder was at a regulatory limit for ownership and Credit Suisse wasn't asking for more money because it didn't need it. Yet all investors and depositors and talking heads heard was "largest investor won't invest more in Credit Suisse". The rest is history: Credit Suisse shares and bonds went into freefall, ending in a forced merger by rival UBS, which paid $3.2 billion in UBS shares for complete ownership of Credit Suisse.

This deal, brokered by the Swiss National Bank, included about $27bn of central bank guarantees for UBS, according to UBS, against losses it may sustain from taking on Credit Suisse. Investors weren't sure what to make of such a big over-a-weekend deal at first. UBS shares slumped 14% at the opening, but they had completely recovered by lunchtime. Another volatile area was a form of bank bond, or debt, called Additional Tier 1 (AT1). These bonds are very junior in the credit hierarchy, which runs from senior bonds at the top (they get paid back first in a default), through to shareholders at the bottom (they get paid back last). AT1 is a bond that's right above shares in the hierarchy, i.e. they should get paid back before shareholders. These AT1 bonds are issued solely by financial institutions and they are there to create an automatic injection of equity capital when a company needs it. If a company loses enough to reduce its equity capital below a trigger point, the AT1s convert into equity i.e. they switch from being a debt of the company and become shares instead.

Under the terms of the merger with UBS, the $17bn of issued Credit Suisse AT1s didn't convert into equity. Instead, the Swiss regulator wiped them out completely, even while leaving shareholders something (the admittedly small 0.76 Swiss francs a share, or roughly a quarter of what they were worth a month ago). This is a highly unusual subversion of the credit hierarchy and it caused large falls in the value of the $250bn market for AT1s from other banks. However, it appears this is a unique situation due to the complexities of Switzerland's financial markets' set-up. We believe such a move would be impossible in any UK or EU market, because AT1 holders are protected by statute. Regardless, the uncertainty has already increased the cost of banks' borrowing, which will no doubt flow through to tighter lending conditions for households and businesses.

At the end of the day, you can put in place all the regulation, protections and safeguards you want, but if everyone takes fright banks can become fragile very quickly. And all the great tech that makes personal banking so simple and easy suddenly starts to be a curse. Silicon Valley Bank crumpled under $42bn of withdrawals - a quarter of its total - in a day; the world's first social-media-driven bank run. Credit Suisse - a much larger, much more important bank - was reportedly bleeding 10bn Swiss francs (£8.8bn) of deposits each day last week. Credit Suisse was solid. It was a terrible bank in terms of profitability, and a running joke in financial services for epic slip-ups. Yet it had more than enough capital to facilitate withdrawals and take large amounts of losses on any loans it had made (or whoopsies its investment bankers had cooked up). Regardless, it couldn't survive once it had lost the confidence of its customers. Like a magician on a stage, with fake coins pouring out of his pockets, it was done. The magic was gone.

Now, this doesn't mean regulation is futile - quite the contrary! Because Credit Suisse is such a large, important bank with connections throughout the global financial system, it is subject to hefty rules created in the aftermath of the Global Financial Crisis. It's monitored and assessed regularly for its capacity to take losses on the chin, on its ability to meet withdrawals and whether the maturity of its assets chime with the date its debts come due. Because Credit Suisse was meeting these regulatory requirements, it meant the relatively orderly merger with UBS - these things are always messy - could go ahead over a weekend. Regulation can feel cumbersome and inhibiting in the good times, but it comes with huge benefits in the bad. Still, this is a telling reminder that regulation is no sinecure. Nothing can save a bank that loses the confidence of its depositors.

Goodbye lifetime allowance

UK Chancellor Jeremy Hunt unveiled some of the largest overhauls to pensions in many years last week.

After cutting several tax allowances and thresholds in his Autumn Statement back in November, this time around Hunt was able to offer more to households and businesses. In one of the most wide-reaching pension reform in many years, the Chancellor has essentially abolished the pensions lifetime allowance.

Currently set at £1,073,100, the allowance sets a ceiling for your pension pot, above which you must pay extra tax generally when you withdraw it (or when you reach age 75). This ceiling includes both what you pay in and investment returns that increase your pension pot. Currently, that penalty rate is 55% for lump sum withdrawals and 25% if you take the excess as income (in addition to any income tax you pay). However, Hunt's changes mean these tax charges will no longer be applicable from 6 April, regardless of the size of your pension savings.

Meanwhile, the amount you can add to your pension each year will be increased from £40,000 to £60,000 from 6 April. This is the first rise in 13 years. With tax relief rules remaining the same, this increases the incentive for people around the higher and additional rate income tax thresholds to not only save more into pensions each year, but also to optimise their tax position through pension contributions.

Some of the major announcements from the Chancellor's statement in November are due to come into effect from 6 April too, including an increase to the rate of corporation tax and reductions to the Capital Gains Tax (CGT) annual exempt amount, dividend allowance and the additional rate income tax threshold. These will all go ahead as planned following the Budget announcement. The changes announced on 17 November will result in higher levels of tax and an even greater need for financial planning to ensure tax allowances can be utilised while they're still available. We've put together a checklist ahead of the 5 April deadline here.

The Chancellor's "Budget for Growth" also sensibly addressed some of the factors holding back the UK economy: labour supply and business investment. In both cases, it's encouraging to see politicians acknowledge the problem. Still, these measures will need to be followed up with other policies if the issues are to be solved.

To get people back into the labour force, Hunt announced a raft of measures including a £5bn childcare plan (comprising expanding free childcare in England, aiming to boost the number of childminders and more) and changes to the benefits system. However, the big factor keeping people out of the labour force is long-term illness. The NHS needs a lot of work.

To encourage business investment, a 100% capital allowance was unveiled. This allows businesses to write off investment in new plant and machinery against their taxable profits, i.e. reduce the tax they pay.

If you want to hear more about the banking sector wobbles, the outlook for inflation and interest rates, along with a review of China, you can register for our 12 April Investment Insights webinar here.

If you have any questions or comments, or if there's anything you would like to see covered, please get in touch by emailing review@rathbones.com. We'd love to hear from you.

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