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DE FACTO GOVERNMENTAL GUARANTEE AND SPREADS ON CREDIT SUISSE BONDS

Implicit state guarantee does not imply that bank's bond yields have to be the same as yields on government bonds

Credit Suisse and government guarantee

In an interview to Sonntagszeitung of 15.10.2009, Hans-Ueli Dörig, the president of board of Credit Suisse, stated that Credit Suisse possesses no state guarantee. The latter has formally never been extended to the bank over its long history, and, according to Mr. Dörig, a consistent spread of 2-3% on the bank's bonds over Swiss government bonds is an evident manifestation of the absence of such guarantee.

To make a long story short, an implicit state guarantee to rescue a major bank in case of financial distress does not preclude a noticeable spread on bank's bond yields over governmental bonds.

The issue of state guarantee refers to a small probability event of a major financial institution defaulting on its payments as a result of severe liquidity shortage or massive withdrawals by account holders. Even American agencies (e.g., Private Export Funding Corp.) with direct and exhaustive state guarantees have higher yields than those of US Treasuries. In that case, the spreads likely reflect lower liquidity (Treasury bond market is one of the most liquid in the world) and a slight risk of some administrative delays in reimbursement or guarantee modifications in case of agency defaulting on its payments.

The issue with CS and governmental guarantee refers to a small probability event that CS is incapable of fulfilling its obligations and that the Swiss State enters as a "lender of last resort" to provide funds in an emergency fashion. This is a typical “too big too fail” situation, in which major banks are very likely to be bailed out by their national government, as a collapse would destabilize financial system. Even more importantly, the mere existence of such a financial rescue would prevent a bank run even before a problem actually unwinds, as creditors assume that their funds are protected by the government (this primarily refers to depositors, but also increases confidence of other less-protected claimholders). Unfortunately, this did not work in Bear Stearns case, when market fears led to fatal lack of liquidity for this reputable bank.

In case of largest Swiss banks, there is no formal state guarantee, but the implicit one is certainly present. According to FitchRatings report (October 2009), “Credit Suisse’s domestic and international importance means that there is an extremely high probability of support from the authorities, if necessary” (at the same time, in case of the holding, CS Group, support from the authorities, although possible, cannot be relied upon). In a similar vein, Moody’s concurrent report underscores that the current ratings “reflect the bank's very high systemic importance in Switzerland, which provides two notches of uplift from the bank's Aa3 stand-alone baseline credit assessment”. In other words, the Moody’s credit rating increases by two notches to reach Aa1, as Credit Suisse clearly belongs to the “too big to fail” category. Yet, we should recognize that for reputational concerns no bank would ever admit or make an impression that it could ever be subject to a bailout. Not surprisingly, the executives of Credit Suisse and other large banks would refute the existence of the state guarantee, although such view refers de facto to the absence of the *formal* guarantee.

As the guarantee exists implicitly, but not formally, its modality and scope lack certainty, in particular if the bank defaults in a turbulent period of global financial instability. Indeed, we can suppose that the depositor claims will be covered if the funds from the depositor insurance body appear to be insufficient. Further, the bank is very likely to receive aid in relation to loans extended to the consumers, real and financial sector, as the bank acts as a provider of liquidity to the economy and thus bears systemic risk of many borrowers defaulting as a result of deteriorating business conditions. The extension of state guarantee to other asset classes may be limited to specific security types (e.g., securitized mortgages), while it leaves a lot of uncertainty as to the overall amount and speed of providing funds.

Thus, the uncertainty of the ultimate form of state aid and incomplete coverage are the two factors that suffice to account for most of the observed spread between CS bonds and Swiss obligations.

Finally, the most important drawback of the potential rescue is that in anticipation of a bailout in the worst case scenario, bankers may take undue risks that increase bank

profits to benefit employees and shareholders in the short-run. The moral hazard problem of excessive risk taking results in higher probability of default, while the state and taxpayers implicitly hold part of these risks. Thus, distortion of incentives due to the implicit guarantee is another factor that further contributes to the spreads on bank debt.