FT Alphaville European banks

Who killed Credit Suisse?

The legality of liquidity versus solvency

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Jerôme Legras MARCH 21 2023

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Corporate finance used to be simple. In a bankruptcy, bondholders would get their money first, then subordinated bondholders, and eventually shareholders. But the 2008 crisis happened, and a lot of old-style corporate finance was thrown out of the window.

The 2010 G20 summit in Washington created a new world order for bank failures, based on a few key principles:

- Avoid the use of taxpayer money
- Implement far-reaching crisis resolution tools to avoid contagion
- In any case, treat all investors fairly and maintain the "no creditor worse off" principle, ie, no one should be worse off in a crisis resolution than in a bankruptcy

This was all very nice, but quickly clashed with *realpolitik*. The no-creditor-worse-off principle, designed to protect investors, turned into a license to kill. An estimate that bankruptcy would give zero recovery was enough for regulators to be allowed to do anything. The goal-seek approach to resolution is how we ended up with the Portuguese authorities bailing in senior bonds based on their ISIN codes starting in XS instead of PT.

Another reason for this is that "bank failure" is now a fuzzy and moving legal concept, with multiple legal routes available to justify bondholder losses. Voluntary liquidation, bankruptcy, precautionary recapitalisation, resolution, restructuring, burden sharing, point of non-viability . . . they all mean the same thing: a bank is failing, something must be done, and for the greater good someone must lose money.

Let us set aside legal geekery for now, and focus on the fact that the common-sense legal hierarchy was set aside. AT1 bondholders were wiped out while shareholders got Sfr3bn. Is this fair? Is this legal? Is this right?

It is difficult to answer this without simply confirming your priors. Investors not owning the bonds will gleefully state that "it's what they were created for, just read the docs!", whereas bondholders will explain how unfair this has been and how Switzerland has turned into a banana republic. I will do my best to objectively explain what I think really happened and the issues this raises.

Yes, AT1 bonds were created to absorb losses. That is fair and no investor will deny it. AT1 holders should not expect to be bailed out. But while Credit Suisse had a very long list of problems, where are the losses? UBS itself said they would recognize Sfr61bn of badwill and no one made any mention of any loss.

Maybe litigations will cost more than what they have been provisioned for? But the smartest litigation analyst I know, Elliot Stein, estimates around Sfr1.2bn of extra costs. Even tripling that number would not significantly impair CS's equity.

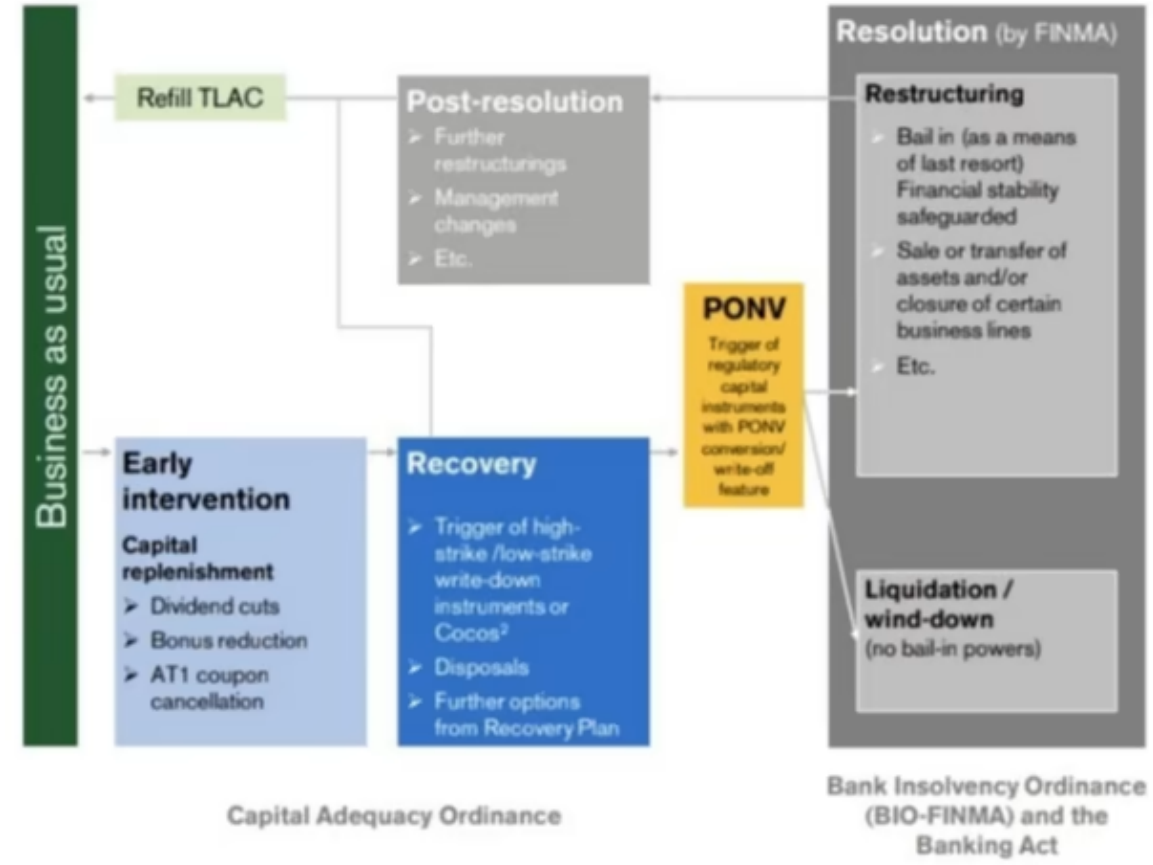
The truth is that no one, and especially not the supervisor, suggested that Credit Suisse was facing losses that needed to be "absorbed". We all know this was a liquidity crisis triggered by the most expensive couple of words in financial history: "absolutely not".

Another headache comes from the decision to subordinate AT1 holders versus shareholders. Again, we should differentiate legalities and market expectations. Those were very clear: like it or not, when the FT broke the story that UBS planned to offer more than zero for CS equity, everyone believed AT1 bonds would be left untouched and prices soared.

Maybe AT1 investors are dumb, and they should be aware that they are junior to shareholders. But apparently, the ECB, the EBA, the SRB and the BOE disagree. They have all come up with a statement on Monday confirming that AT1 holders should expect to be senior to shareholders;

> 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.

Marketing docs did add clarity to market expectations: I mean, who does not understand immediately who is senior and who is junior on this beautiful chart?



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But let us assume that marketing leaflets are not relevant and what matters is only the law and the documentation, which, unless you are a retail holder, is probably true.

What did the law say? Relevant Swiss legislations include the Banking Insolvency Ordinance and the Swiss Banking act. Both deal with bank bankruptcies and restructuring measures, and neither gives the impression that AT1 is junior to equity. For example, Article 30.b.5, dealing with recapitalisation measures within a restructuring, provides that debt can be written down only if equity is entirely wiped out.

5 La conversion de fonds de tiers en fonds propres et la réduction de créances sont uniquement possibles lorsque, au préalable:

a. le capital convertible au sens de l'art. 11, al. 1, let. b, est entièrement converti en fonds propres et que les emprunts assortis d'un abandon de créances au sens de l'art. 11, al. 2, sont entièrement réduits, et que

131 Introduit par le ch. I de la LF du 17 déc. 2021 (Insolvabilité et garantie des dépôts), en vigueur depuis le 1er janv. 2023 (RO **2022** 732; FF **2020** 6151).
132 RS **281.1**

27 / 48

952.0 Banques et caisses d'épargne

b. le capital social est entièrement réduit.

6 Le Conseil fédéral peut désigner les instruments de dette qui, en dérogation à l'al. 5, let. b, sont réduits avant que le capital social soit entièrement réduit, pour autant que ces instruments soient émis par une banque cantonale et qu'ils prévoient une compensation ultérieure appropriée des créanciers.

The insolvency ordinance, which also deals with restructuring in Chapter 3, includes Article 47 and 48:

Art. 47 General provisions

1 If the restructuring plan allows corporate actions in accordance with this Section, it is necessary to ensure that:

a. the creditors' interests take precedence over the interests of the owners and the hierarchy of creditors is respected;

b. the provisions of the Swiss Code of Obligations[30] apply *mutatis mutandis*.

2 Where granting pre-emption rights may endanger the restructuring, they may be denied to the owners.

Art. 48 Principles for converting debt capital into equity capital

1 If the restructuring plan provides for the conversion of debt capital into equity capital then:

a. sufficient debt capital must be converted into equity capital to ensure that the bank holds the required capital to continue its business activities after the restructuring is completed;

b. share capital must be completely written down before converting debt capital into equity capital;

Note that Article 48.c explicitly says that Cocos or AT1 are debt instruments:

c. debt capital may be converted into equity capital only if the debt instruments issued by the bank which are part of additional core capital or supplementary capital have already been converted into equity capital, in particular contingent convertible bonds;

"Ah, but this is about *conversion*," I hear you object. "AT1 were wiped out, not converted." That's where Article 50 comes to the rescue:

> **– Art. 50 Reduction in claims**
>
> In addition to or instead of converting debt capital into equity capital, FINMA may order a partial or full reduction in claims. Article 48 letters a–c and Article 49 apply equally.

I am not a lawyer. There might be highly subtle legal loopholes. Nevertheless, there is more than enough here for the market to understand that a reduction in claims in AT1 bonds comes after wiping out shareholders —mostly because it is what is written. Blame AT1 holders for not looking for loopholes, maybe, but not for having the wrong expectations; and wrongfooting market expectations is a risky business.

But wait, there is ANOTHER possibility. What if Credit Suisse was not in a restructuring, not in a resolution, not in anything. What if all those articles were moot? Indeed, there are two words missing in the FINMA release: "resolution" and "restructuring".

If none of those articles apply, we would only have the contracts to rely on. Could it be that the prospectus was sufficient to trigger the write-down of the bonds?

As the FT's Robert Smith pointed out, there is indeed a provision in the risk factors that would suggest an inversion of the hierarchy is possible. Obviously, the fact that it comes three lines after a sentence that states the exact opposite does not make it any clearer, but at least it was in there, somehow:

> Additionally, since 1 January 2016, under certain circumstances, FINMA has the power to open restructuring proceedings with respect to CSG under Swiss banking laws (see "*Risk Factors — Since 1 January 2016, CSG is subject to the resolution regime under Swiss banking laws and regulations*" below),
>
> and could convert the Notes into equity or cancel the Notes, in each case, in whole or in part. Holders should be aware that, in the case of any such conversion into equity, FINMA would follow the order of priority set out under Swiss banking laws, which means, among other things, that the Notes would have to be converted prior to the conversion of any of CSG's subordinated debt that does not qualify as regulatory capital with a contractual write-down or conversion feature. Furthermore, in the case of any such cancellation, FINMA may not be required to follow any order of priority, which means, among other things, that the Notes could be cancelled in whole or in part prior to the cancellation of any or all of CSG's equity capital.

Still, risk factors are not clauses, and this might not be what we are looking for: if there was no restructuring, a risk factor about restructuring is not hugely relevant. What matters more is the article on "write-down", which if applied is the contractual basis for wiping out bondholders. It can be found in almost identical terms in all AT1 prospectuses.

Write-downs can be triggered by a “Contingency event” or a “Viability event”.

(i) Write-down Event

If a Contingency Event or, subject to Condition 7(c), a Viability Event (any such event, a "**Write-down Event**") occurs at any time while the Notes are outstanding and prior to a Statutory Loss Absorption Date (if any), a Write-down shall, subject to and as provided in this Condition 7, occur on the relevant Write-down Date.

Contingency events are easily dealt with: the CET1 ratio of CS did not change during the weekend and this was not triggered.

Viability events are trickier. Again, there are two branches. The first one is this:

(A) the Regulator has notified CSG that it has determined that a write-down of the Notes, together with the conversion or write-down/off of holders' claims in respect of any and all other Going Concern Capital Instruments, Tier 1 Instruments and Tier 2 Instruments that, pursuant to their terms or by operation of law, are capable of being converted into equity or written-down/off at that time, is, because customary measures to improve CSG's capital adequacy are at the time inadequate or unfeasible, an essential requirement to prevent CSG from becoming insolvent, bankrupt or unable to pay a material part of its debts as they fall due, or from ceasing to carry on its business; or

Not an easy one to trigger: FINMA confirmed on Wednesday that CS was solvent and SNB gave it Sfr50bn of liquidity; no measure to improve capital seems to have been envisaged and Tier 2 instruments were not converted. Maybe this changed in two days, but it is not the easiest thing to prove.

The second one is the one that is most often quoted as being the reason for the non-viability event:

(B) customary measures to improve CSG's capital adequacy being at the time inadequate or unfeasible, CSG has received an irrevocable commitment of extraordinary support from the Public Sector (beyond customary transactions and arrangements in the ordinary course) that has, or imminently will have, the effect of improving CSG's capital adequacy and without which, in the determination of the Regulator, CSG would have become insolvent, bankrupt, unable to pay a material part of its debts as they fall due or unable to carry on its business.

But does it really hold? Nothing the government did improved CS’s capital adequacy — especially not a second loss guarantee on litigations that are not in the balance sheet. Again, not an easy thing to prove — which by no way means it cannot be argued in court.

If the prospectus language is not strong enough to explain the wipeout, then what is? Looking carefully at the FINMA statement we get a hint of what I think happened.

> The Credit Suisse Group is experiencing a crisis of confidence, which has manifested in considerable outflows of client funds. This was intensified by the upheavals in the US banking market in March 2023. There was a risk of the bank becoming illiquid, even if it remained solvent, and it was necessary for the authorities to take action in order to prevent serious damage to the Swiss and international financial markets.

If you are a supervisor, about to wipe out Sfr16bn of securities based on a complex interpretation of a prospectus and likely to face hundreds of lawsuits, why would you kill your strongest argument and say that Credit Suisse is solvent?!

The reason is probably very simple: because the prospectus is *not* your legal basis for wiping out the bonds. And this is where we go back to the initial question: how did the Swiss do this, was it legal, could it be expected and was it fair?

On March 16, after the statement of support for Credit Suisse was issued and the new liquidity line was decided, the Swiss passed a new law about emergency liquidity funding for systemic banks. This included two key elements: Article 4.c requires that the bank is solvent . . .

> suite de l'activite de l'emprunteuse;
>
> c. la FINMA confirme la solvabilité de l'emprunteuse ou confirme l'existence d'un plan d'assainissement. Si l'emprunteuse fait partie d'un groupe financier, la confirmation de la FINMA concerne l'ensemble du groupe.

(Ah! Maybe the reason for that FINMA statement is clearer now!)

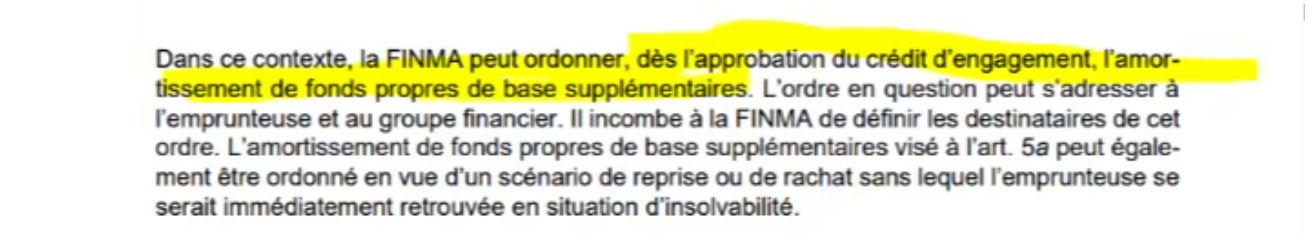
And . . . Article 6 follows Article 5:

> **Art. 5** Approbation de crédits
>
> L'approbation du crédit d'engagement nécessaire se fonde sur l'art. 28 de la loi du 7 octobre 2005 sur les finances[5].
>
> **Art. 6** Échange d'informations et traitement des données

This may sound trivial, but suddenly, on Sunday evening, a new Article 5.a. appeared:

> *Art. 5a* Zusätzliches Kernkapital
>
> Im Zeitpunkt der Kreditbewilligung nach Artikel 5 kann die FINMA gegenüber der Darlehensnehmerin und der Finanzgruppe anordnen, zusätzliches Kernkapital abzuschreiben.

If your German is as rusty as mine, maybe your French is better?



Dans ce contexte, la FINMA peut ordonner, dès l'approbation du crédit d'engagement, l'amortissement de fonds propres de base supplémentaires. L'ordre en question peut s'adresser à l'emprunteuse et au groupe financier. Il incombe à la FINMA de définir les destinataires de cet ordre. L'amortissement de fonds propres de base supplémentaires visé à l'art. 5*a* peut également être ordonné en vue d'un scénario de reprise ou de rachat sans lequel l'emprunteuse se serait immédiatement retrouvée en situation d'insolvabilité.

In plain English, any such emergency liquidity can lead to a full write down of AT1 bonds. And this is where we finally find the legal basis of the write-down. Not the Swiss resolution regime, not the bond documentation, but a law that was passed immediately before, just to allow it. A law is legal, usually, unless a constitutional court or an international court disagrees, but bond investors are generally not too keen on emergency laws designed to wipe them out.

At the end of this long exploration into AT1 shenanigans, I would like to stress that the most important lesson here might not be about AT1s!

For what appears to be the first time, a central bank facility has extremely harsh conditions attached. In our world of social media and digital banking, any measure that reduces the effectiveness of central bank liquidity is unlikely to set a global standard. Walter Bagehot must be turning in his grave.
