HOLDERS OF CREDIT SUISSE AT1s THROWN FOR A LOOP TO THE TUNE OF $17 BILLION: ADEQUATELY FORESHADOWED OR NOT?

Who would have thought that a relatively obscure financial instrument (obscure outside the world of regulatory capital, that is, though comprising a market valued around $250 billion) would trigger headlines reporting on a wipe-out to the tune of $17 billion in the midst of the most significant event in the global financial markets since the global financial crisis (GFC) that upended the markets in 2007 and 2008. On Sunday, as part of the shotgun marriage of UBS and Credit Suisse, Credit Suisse's CHF16 billion of AT1s were rendered worthless. What enraged bondholders was that the Credit Suisse shareholders (holders of common equity in corporate finance parlance), which normally would be junior to all debt in the capital structure, will receive CHF3.25 billion. That in the normal scheme of things should not have happened, but then again the weekend rescue of Credit Suisse was anything but the normal scheme of things.

In the aftermath of the GFC, global regulators sought to shift the risk of systemic bank failures away from taxpayers and depositors to bondholders. This, in turn, would significantly limit the risk of contagion throughout the banking system and eliminate the risk of government bailouts funded by taxpayers. One instrument that emerged from these efforts was the additional tier 1, or AT1, bond. These are also known as contingent convertible securities (or CoCos). AT1s are particularly popular among European banks, but are also issued by insurance and reinsurance companies and some corporate issuers.

AT1s are part of a bank's regulatory capital, and are treated like equity. If the bank's ratio of equity capital (common shares and retained earnings, also known as Core Equity Tier 1 or CET1) to risk-weighted assets (under the Basle III framework) falls below a certain threshold, the AT1s can be converted into common equity (hence the contingent convertible in the Coco moniker), partially written down or fully written down. These outcomes constitute loss absorption. In theory, this means that if the capital ratio collapses, first the CET1 and then the AT1s absorb losses, before the senior debt (including Tier 2 (T2) bonds) is impacted.

The terms of the AT1 are set out in the terms and conditions section of the appliable prospectus or offering memorandum, which are accompanied by an extensive set of risk factors. AT1s are perpetual, which means they have no maturity date (but even in the financial world forever does not necessarily mean forever). AT1s can be called by the issuer (with the approval of the regulator, after a no-call period of five or 10 years)) and investors get the benefit of high coupons to compensate for the risk of write-down. While there is a market assumption that these bonds will be called, there is no legal requirement to do so. Coupons tend to reset around call dates. AT1s also typically have dividend stoppers/dividend pusher provisions (stopping dividend payments on the equity if a coupon payment is missed, or mandating a coupon payment if a dividend is paid).

Holders of CoCos in Banco Popular were wiped out, as was the equity, when the bank was "bailed in" 2017 at the direction of the Single Resolution Board (SRB) via a merger with Banco Santander. This was considered an isolated event.

But a funny thing happened in Switzerland. The AT1s were wiped out, but the common equity was not. Bondholders were expecting that if their AT1s were fully written down so

too would the common equity. The Swiss regulator (FINMA) instructed Credit Suisse to fully write down the AT1s on the basis of a contractual provision in the AT1s that contemplated a full write-down in the event of a "Viability Event," which includes "extraordinary government support." FINMA, in its explanation of the write-down, noted that the "extraordinary liquidity assistance loans secured by a federal default guarantee" on March 19 constituted a Viability Event, allowing FINMA to ignore the order of preference and put the common equity ahead of the AT1s. FINMA also noted that an Emergency Ordinance enacted on March 19 also served as a basis for the write-down. Subsequent statements by the head of the Swiss National Bank noted that the forced sale to UBS was the only viable option for Credit Suisse, and that resolution was out of the question, for fear it would have triggered a far larger crisis, globally.

The Swiss action in effect sidestepped the assumed order of priority. On Monday, European Central Bank (ECB) Supervision, the SRB and the European Banking Authority issued a press release confirming their view that the ECB and SRB would have followed the commonly accepted approach, namely that common equity would be the first to absorb losses, and only after the common equity had fully absorbed losses (that is wiped out) would AT1s need to be written down. Since Switzerland is not part of the European Union, this view was irrelevant to the Credit Suisse bondholders. Likewise, the Bank of England issued its own statement of creditor hierarchy, noting that in the case of the recent resolution of SVB UK, AT1s were treated as ranking ahead of the common equity (CET1) and behind T2 and, in the future, holders of such instruments should expect to absorb losses in that order.

Bondholders are reported to be considering lawsuits, although it is not clear against whom (and in what jurisdiction) the actions would be brought since the write-down was a government-directed event. Typically one would expect securityholders to sue an issuer, where the focus would be on the disclosure – both around the terms of the AT1s and the risk factors, as well as statements made by Credit Suisse management in the days and weeks leading up to the fateful weekend. Does this now become UBS's issue? Or would the suit target the Swiss government or FINMA? Reuters reported yesterday that the Credit Roundtable (a lobby group that represents 43 North American asset managers) had decided not to take legal action, based on the disclosure.

The Viability Event is embedded in the terms of the bonds, and has two alternative limbs:

- the Regulator has notified CSG that it has determined that a write-down of the Notes … is … 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
- 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.

Some commentators have referred to risk factor language (*see* the various prospectuses, available here) that states that "… in the case of any such cancellation, FINMA may not be

required to follow any order of priority," meaning that the AT1s "could be cancelled in whole or in part prior to the cancellation of any or all of [Credit Suisse's] equity capital." That language, however, appears in a paragraph describing a FINMA resolution proceeding (with a cross-reference to a separate risk factor on resolution under Swiss banking laws and regulations), in which bonds would be converted into equity or cancelled. Whatever this was, it was not resolution *per se*.

That said:

- In the first risk factor (***The likelihood of an occurrence of a Write-down is material for the purpose of assessing an investment in the Notes. The Notes may be subject to a Write-down and upon the occurrence of such an event holders will lose the entire amount of their investment in the Notes***), there is the following: "The Write-down may occur even if existing preference shares, participation certificates, if any, and ordinary shares of CSG remain outstanding."
- In the second risk factor (***The circumstances triggering a Write-down are unpredictable. Future regulatory or accounting changes to the calculation of the CET1 Amount and/or RWA Amount may negatively affect the CET1 Ratio and thus increase the risk of a Contingency Event, which will lead to a Write-down, as a result of which holders will lose the entire amount of their investment in the Notes***), there is the following: "The occurrence of a Viability Event, and a Write-down resulting therefrom, is subject to, inter alia, a subjective determination by the Regulator as more particularly described below and in Condition 7(a)(iii)… . As a result, the Regulator may require and/or the federal government may take actions contributing to the occurrence of a Write-down in circumstances that are beyond the control of CSG and with which CSG does not agree."

There seems to be a consensus that the Credit Suisse situation is distinguishable from other potential failures given the powers accorded to FINMA under the Swiss Banking Act. In the European Union, under the bail-in provisions of the Bank Recovery and Resolution Directive (Article 48), it is unlikely that the Swiss solution would have been permitted. In the meantime, the uncertainty created by the Swiss action could increase the cost of capital for European banks, or at least for Swiss banks, whose ability to meet Minimum Requirement for own funds and Eligible Liabilities (MREL) and Total Loss-Absorbing Capacity (TLAC) may be regarded differently than for banks in other European jurisdictions. Swiss financial institutions going forward will likely need to be clearer about equity conversion versus write-downs.

Concluding Thoughts

Any time that capital markets instruments achieve widespread acceptance, investors seem to pay less attention to country-specific risks. AT1s essentially are a European product, and yet there are at least three distinct regulatory regimes in Europe, the European Union/European Free Trade Area, the United Kingdom and Switzerland. While experienced securities counsel tailor risk factors, as they should, to the risks of the particular issuer and security, one can reasonably question how often those lengthy (and *seemingly* boilerplate, and I stress the *seemingly* given the variations for Swiss issuers,) provisions are read. The reality may be that

far greater attention is paid when something goes wrong than when an investment is made. That no doubt should change.

Incidentally, the rescue of Credit Suisse also calls into question the value of the comprehensive focus, since the GFC, by regulators and banks on resolution and recovery plans (*see, e.g*., ECB - recovery and resolution: banks need to be prepared and FRB - Living Wills (or Resolution Plans) – all shelved this time around in favor of ad hoc solutions. Incidentally, the FINMA Resolution Report 2022 sets out FINMA's view that both the UBS and Credit Suisse "Swiss emergency plans" are ready to implement and confirms that FINMA has again approved their group-wide recovery plans. It notes that global resolvability remains a work-in-progress, with some goals to be reached only by the end of 2022. In short, the detailed systems put in place after the GFC were not used, on the grounds, it appears, that they were insufficiently pragmatic.

The uproar over the AT1s is just one piece of a larger mosaic, namely the fragility of the banking sector following the turmoil affecting regional banks in the United States and the rescue of Credit Suisse. The question on the minds of many is where on the continuum we are in terms of the risk of contagion. Today, shares in Deutsche Bank, Germany's largest bank, tumbled (in their third days of loss) after the bank's credit default swaps (CDSs) – insurance against the likelihood of default – surged in the past few days, in a market that has seen CDSs for large European banks rise across the board and bank stocks come under increasing pressure. This is a stark reversal of the positive share performance of European bank stocks this year, driven by profit prospects around higher interest rates (a welcome development after years of negative interest rates in the eurozone).

The stress in the banking sector was an unwelcome agenda item today for EU leaders at their quarterly summit meeting in Brussels, following the expected focus on geopolitical developments yesterday. Speaking of the situation in Ukraine, there are a number of reasons why 2023 is not 2007-2008, but among them three differences stand out – the war in Ukraine and its impact on Europe, the role of social media and its potential to spark panic (*see* "'The first Twitter-fuelled bank run': how social media compounded SVB's collapse" and 'There were a couple of Tweets and then this thing went down': Citigroup's Jane Fraser says a social media bank run on SVB is a 'complete game changer'), and the continued presence of populist politicians waiting in the wings to ride to (or back to) power on the back of yet another source of grievance.

As many are asking, do the events that unfolded first in the United States on March 9 and then spread to Europe presage another global financial crisis, or can contagion be avoided because the markets believe that each of SVB, Silver gate, Signature and Credit Suisse were unique cases, whose demise should not compromise the entire system, and those sentiments prevail?

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