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MARKETSCREDIT MARKETS

Credit Suisse Write-Off Upends European Bank Capital Bonds

Holders of riskier bonds got nothing while shareholders will receive a payout in UBS shares

By Josh Mitchell Follow *and Anna Hirtenstein* Follow

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Switzerland's move to wipe out $17 billion of Credit Suisse Group AG bonds has prompted investors to reassess a market integral to the safety and resilience of Europe's banking system.

The Credit Suisse bonds that were written down as part of its takeover by UBS Group AG UBS **11.97%** ▲ were known as AT1s, or Additional Tier 1 bonds. These instruments exploded in popularity in Europe over the past decade and were seen as a way to build buffers that could protect banks in times of trouble without having to tap taxpayer funds.

The total write-off by Swiss regulators has divided opinion, with some market-watchers saying that it was justified under the terms of the bonds, while others hotly dispute that analysis.

Whatever the legal basis, investors and analysts say the deal undermined confidence in the roughly $250 billion AT1 market, threatening to drive up funding costs for European and Asian banks.

Some bondholders are thinking about challenging the wipeout. "What investors look at when they are investing is certainty of process and rule of law. That has just been swiped away in one fell swoop by Switzerland, " said Natasha Harrison, managing partner at law firm Pallas, which is assembling an investor group for potential litigation.

The write-down "could lead to contagion for wholesale funding costs across the sector," JPMorgan analysts said in a research note Tuesday. "We expect that credit investors are now likely to demand a higher risk premium across the spectrum, with cost of AT1 issuance

potentially rising into double digits," they wrote.

Over the past year, banks have typically issued such bonds paying annual percentage interest rates of mid-to-high single digits.

Market pricing initially appeared to back that position. The value of most AT1 bonds inched back up Tuesday along with global bank stocks, but most prices remained substantially below levels from before Credit Suisse's CS **2.46%** ▲ implosion.

Some fund managers said they aren't likely to invest in Swiss bank AT1s because of how bondholders were treated.

"We wouldn't be too willing to bet on those terms, there is too much uncertainty," said Artaud Caloni, a credit portfolio manager at Meeschaert Asset Management.

Banks hold capital to protect against losses. European regulators, stung by taxpayer bailouts in 2008-09 and concerned about financial stability during the region's sovereign-debt woes in the early 2010s, encouraged banks to issue AT1s as part of their capital mix, which also includes common stock and other bonds.

"Regulators wanted better-capitalized banks" after the financial crisis, said Francesco Franzoni, professor of finance at the University of Lugano and senior chair of the Swiss Finance Institute. "AT1s were created as a new avenue to increase banks' capital."

Sometimes called contingent convertible bonds, or CoCos, such securities can be written down or converted to equity in an emergency, depending on the terms of bonds issued by individual banks. They were attractive to investors because, while relatively risky, they carried high yields during a decade of low, and sometimes negative, rates.

UBS is using its own stock to pay for Credit Suisse shares.
PHOTO: STEFAN WERMUTH/BLOOMBERG NEWS

"Whenever they pay you a high return, you have to be careful about what's behind it," said Prof. Franzoni. "Investors were not discerning enough—or they trusted their bankers."

For their part, European banks liked this form of capital because their depressed share prices made issuing common shares punishing on existing investors.

U.S. regulators considered promoting them as well, but decided against it, preferring banks to hold more common equity, or shares, as well as other instruments such as preferred stock.

AT1 bonds differ from country to country and bank to bank. Some can get converted into common shares or written down partially or completely. They get triggered when a bank's overall capital ratios fall below a certain level or when a regulator determines a bank isn't viable.

The complete write-down of Credit Suisse's securities had been pushed for by UBS executives to reduce the burden the firm inherited by taking over its rival.

Some investors were caught off-guard because Credit Suisse common shares were spared, with UBS paying $3.2 billion for them via its own stock, even as the AT1s were written down.

While that upends the common order in an insolvency, there was a fierce debate over whether Credit Suisse AT1s in fact allowed such a move in their documentation.

Finma, the Swiss financial regulator, said Sunday that Credit Suisse was experiencing a crisis of confidence and risked becoming illiquid, even if it remained solvent, and required

the state-engineered deal to stay alive. The government provided a more than $9 billion backstop to UBS on potential losses.

Sowing consternation among AT1 investors: Swiss authorities hastily passed a law last week that expedited the regulators' ability to write down the riskier bonds to zero.

"It's all about credibility, and if you have laws and regulations in place you should follow them," said Patrik Kauffmann, a portfolio manager at Aquila Asset Management AG, which holds some AT1 bonds issued by Credit Suisse.

Mr. Kauffmann said these bondholders absorbing more losses than shareholders went against the letter and spirit of the law before the last-minute law change. "I don't say you need to pay 100% to AT1 holders, but they perhaps should recover a substantial amount of their investment," he said.

U.K. and European Union regulators tried to reassure AT1 bondholders, saying that in their jurisdictions, shareholders would suffer losses before bondholders in any future bank failures.

The possibility to write off Credit Suisse's riskier securities was in the bond contracts, but it required government support, said Rashid Bahar, a partner at Advestra AG, a Zurich-based law firm with a focus on capital markets and financial services.

The law change made last week effectively granted Swiss regulators "the right to make this decision and do it quickly. It is not just a matter of contract law, it is Finma's authority," Mr. Bahar said.

The prospectus of one AT1 said any write-down could happen even if ordinary Credit Suisse shares remained outstanding. A bank presentation also showed the debt ranking lower in priority than common equity.

Another test looms for the market in the coming months.

AT1s are perpetual bonds, meaning banks don't need to redeem them. But they are issued with call dates when the interest rate steps up. By tradition, banks have almost always redeemed the bonds by the call date, paying back bondholders their principal and issuing new securities to replace them.

But they can theoretically decide to leave bonds outstanding—something that has unnerved investors before, and which could be a risk, especially if the entire market has repriced.

The next important date for a European AT1 is in May, when there is a call date for a bond issued by UniCredit SpA. The Italian bank declined to comment.

—Margot Patrick and Patricia Kowsmann contributed to this article.

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