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# Credit Suisse CoCos: Why the Write-Down Makes Sense

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On March 19th, UBS Group AG agreed to buy Credit Suisse for around 3bn CHF. The deal was facilitated by FINMA, the Swiss supervisory authority for banks and financial markets. This was necessary to avoid the collapse of Credit Suisse and, consequently, the possible national and international contagion.

The most contentious point of this construction lies in the fact that the holders of Contingent Convertible bonds (CoCos) were wiped-out even though shareholders retained a minimal claim on the bank.

This piece will defend the decision of the Swiss authority from a functional perspective, arguing that the flawed design of CoCos regulation largely explains the contentious course of action taken by FINMA. In so doing, we will address the main critiques voiced by the popular press; other regulators and former investors. Before delving into the matter, it is useful to summarize the facts that led to the sale of Credit Suisse.

Rumours around Credit Suisse's precarious position were openly discussed at least since 2021. The tensions generated by the collapse of SVB immediately put Credit Suisse under the spotlight once again, worsening considerably its credibility.

On Wednesday 15th, the Swiss National Bank (SNB) and FINMA issued a joint statement declaring that Credit Suisse met the regulatory capital and liquidity requirements and pledging to provide liquidity assistance, if needed. The statement aimed to decrease market uncertainty but, in hindsight, represents the basis for the course of action leading to the write-down of the CoCos. On March 16th, the Swiss legislator approved a decree legitimizing the liquidity assistance to Credit Suisse. On March 19th, the day of the sale, the decree was amended adding a new article 5a. The new provision empowered FINMA to also write down Cocos in the scenario of a sale. Accordingly, FINMA wiped out CoCos for around 17bn CHF.

Three lines of criticism were raised against the CoCos wipe-out. First, from a corporate finance perspective, CoCos are debt instruments and investors should be able to price them relying on equity suffering losses first. Second, from a legal perspective, FINMA subverted the traditional hierarchy between claims. Finally, from a prudential perspective, FINMA's decision would generate market distrust and foster further turmoil. We address these criticisms below.

Contingent Convertible bonds were proposed before the Global Financial Crisis (Flannery, 2003) and were introduced in Basel III as a form of pre-issued capital increase, should book equity fall below a contractually agreed threshold. If the contractually agreed threshold is equal to or greater than 5.125% of CET1 ratio, these instruments will count as Additional Tier 1 (AT1) instruments. Consequently, the design of CoCos itself requires them to absorb losses ahead of insolvency. In the case of Credit Suisse, the AT1 instruments had a threshold set at 7% of CET1 ratio as the Swiss implementation of Basel imposed stricter rules, whereby only CoCos with a higher threshold could count as core capital.

From a prudential perspective, if CoCos do not absorb losses on a going concern basis, they are simply useless and cannot be told apart from traditional subordinated bonds, making CoCos just another layer of debt. The distinction is not trivial, as AT1 instruments give banks the ability to comply with leverage ratio requirements through instruments other than common equity.

The prudential nature of CoCos as pre-issued equity smoothens the legal concerns surrounding the wipe-out, ie the violation of the hierarchy of claims. First, Credit Suisse was not insolvent at the time of the sale, as declared by FINMA and SNB a few days before. Second, the prospectuses of the various AT1 instruments that were wiped out deviated from the strict adherence to creditors' priority out of bankruptcy. The CoCos issued by Credit Suisse were of the 'principal write-down' type rather than the more common 'conversion to equity' type. This means that investors contractually agreed to absorb losses through the cancellation of their entitlements, even in cases where the common shareholders are not wiped out. The prospectuses invariantly stated that the loss absorption mechanisms could be triggered by a 'contingency event' (ie the CET1 ratio falling below 7%) or by a 'viability event'. The definition of a 'viability event' in the prospectuses is complex but, in general terms, covers situations where extraordinary government support is provided to improve the capital adequacy of Credit Suisse. FINMA stated that its decision to wipe out the Cocos was based on the existence of a viability event. Its decision was also based on the powers provided by Article 5a of the decree of the Swiss legislator, which was considered necessary to reduce the legal uncertainty of whether the trigger was met. Unsurprisingly, several investors are reportedly considering challenging the wipe-out of the CoCos in court.

Despite the legal issues, wiping out the CoCos also makes sense from a corporate finance perspective. CoCos are hybrid instruments that can absorb losses ahead of insolvency; hence, investors should price in this risk and banks should incorporate it in their funding structure decisions (Myers & Majluf, 1984). Moreover, the CoCos wipe-out eased the debt overhang problem Credit Suisse ran into, making the transfer to UBS possible (Myers, 1977; Perotti, 2023).

Despite the legal and financial reasons for imposing losses on CoCos, a special law empowering FINMA to wipe out CoCos ahead of the sale was considered to be necessary to actually impose those losses. Beyond making the whole construction prone to massive lawsuits, resorting to ad hoc legislation increases legal uncertainty for investors investing in CoCos.

Until Credit Suisse, CoCos had never been wiped out to absorb losses on a going concern basis because of a wide-spread fear of market panic. This practice reinforced AT1 CoCos holders' expectations of not suffering losses outside of insolvency, generating a vicious circle that the FINMA decision has (hopefully) severed.

Such a vicious circle was boosted by the relatively low triggers of these instruments and the possibility to 'play' with the book value of equity. CoCo conversion or write-down relates to accounting measures of book equity so that the bank has incentives to inflate the book equity and the supervisor may forebear to delay interventions. Moreover, the contingency event for conversion (7% of CET1) and insolvency (4.5% of CET1, plus prudential add-ons) are tremendously close and easily overlapping. The early proponents of CoCos argued for automatic triggers based on market value of equity. Such triggers would counter the incentives to delay but were never adopted given the risk of market manipulation they would entail.

FINMA and SNB declared Credits Suisse perfectly solvent to calm down the markets a few days ahead of the sale. It would have made little sense to adjust accounting numbers and declare the bank almost insolvent a few days after to convert the CoCos, leading to the paradoxical situation of a 'Schrödinger's bank', at once perfectly solvent and yet almost insolvent.

These complexities highlight the flawed regulatory construction regarding how CoCos absorb losses outside insolvency and leave a challenge for the future. Contingent Convertibles can play an important role if their regulatory and contractual structure is redesigned to rule out doubts about their loss-absorbing capacity even before equity is wiped out, thus making ad hoc legislation unnecessary. If this redesign is not possible, CoCos should not count as AT1 instruments and the common equity requirement should be increased accordingly.

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