

The Swiss contingent convertible

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The proposals of the Expert Commission gave a central role to an instrument that hardly existed in 2010: debt that converts into equity or is written down when the issuing bank's capital falls below a defined level. The idea was simple. A bank in difficulty would receive fresh equity automatically, by operation of the contract, without having to ask its shareholders or the state for new money at the worst possible moment. Bondholders would bear the losses before taxpayers. Academic proposals for such instruments had circulated before the crisis. Lloyds Banking Group issued enhanced capital notes with an equity conversion feature in 2009, but no regulator had yet made them a structural element of capital requirements.¹

The Swiss banks became pioneers of this market. In February 2011, before the legislation had been adopted, Credit Suisse agreed with two of its long-standing investors, Qatar Holding and the Olayan Group, on the issue of buffer capital notes that would convert into shares if the bank's common equity ratio fell below seven per cent. A few days later it placed a public issue of high-trigger contingent convertibles with institutional investors. In February 2012, UBS issued the first low-trigger instrument, a tier 2 note that would be written down permanently, without conversion into shares, if the bank's common equity ratio fell below five per cent or if FINMA declared that the bank had reached the point of non-viability.²

The choice between conversion into equity and permanent write-down was shaped by Swiss company law and tax law. A conversion requires conditional capital approved by the shareholders' meeting, which limits the amounts that can be converted and dilutes the existing shareholders. A write-down avoids these constraints. It also suited many investors, who could not hold shares under their investment mandates. For the issuing bank, the write-down produced an immediate gain that strengthened its equity. The Swiss withholding tax, which applied to interest on bonds

issued by Swiss companies, led the banks to issue their first instruments through foreign vehicles in Guernsey and Jersey. In 2012 Parliament exempted the interest on contingent convertibles and write-down bonds of Swiss banks from withholding tax for a limited period, so that the instruments could be issued from Switzerland. The exemption has since been extended.³

When the Basel III definition of capital entered into force, the Swiss instruments were adapted to the international criteria for additional tier 1 capital, which require perpetual instruments with fully discretionary coupons and a mechanism for loss absorption. The Basel Committee's definition allowed both conversion and write-down, leaving the choice to national law. Most European banks opted for conversion or for temporary write-downs that could be reversed if the bank recovered. The Swiss banks chose permanent write-downs in most of their issues, a design that placed the AT1 holders in a position different from that suggested by the ordinary hierarchy of claims. If the instrument was written down while the shares survived, the bondholders lost everything while the shareholders retained a residual value.⁴

Investors bought these instruments in large volumes, attracted by yields well above those of senior bonds. The terms and conditions of the Credit Suisse AT1 instruments described the circumstances in which a write-down would occur, including a viability event in which the Swiss authorities provided extraordinary support to prevent the bank's insolvency. For a decade, this clause was a contractual provision whose practical meaning nobody had tested. Its interpretation became the central question of the litigation after March 2023, which a later section examines.

1 Notes

1. On the early academic proposals for contingent capital (for example Mark Flannery, "No Pain, No Gain? Effecting Market Discipline via Reverse Convertible Debentures", 2005) and the Lloyds Banking Group enhanced capital notes of November 2009, see the relevant literature. To be verified. ↩
2. On the buffer capital notes agreed by Credit Suisse with Qatar Holding and the Olayan Group in February 2011, the public issue of high-trigger contingent convertibles by Credit Suisse in February 2011 and the first low-trigger loss-absorbing notes of UBS in February 2012, see the press releases of the two banks. Figures and dates to be verified. ↩

3. On the exemption from Swiss withholding tax of interest on contingent convertible bonds and write-down bonds issued under the too-big-to-fail regime (Art. 5 para. 1 lit. g Withholding Tax Act, SR 642.21), introduced with effect from 2013 for a limited period and later extended, see the Withholding Tax Act and the dispatches of the Federal Council. Status of the current deadline to be verified. ↩
4. On the Basel III criteria for additional tier 1 capital (BCBS, Basel III: A global regulatory framework for more resilient banks and banking systems, December 2010, revised June 2011, paragraph 55, and the minimum requirements to ensure loss absorbency at the point of non-viability of January 2011) and the design of Swiss AT1 instruments with permanent write-down, see the BIS publications and the prospectuses of the instruments. To be verified. ↩

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