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The Credit Suisse collapse and international financial law

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ABSTRACT
The 2023 banking turmoil showed that there is still work to do on banking reforms. This is particularly true when it comes to bank resolution. This note examines the resolution of Credit Suisse and focuses specifically on its international dimension. Two issues deserve particular attention. First, the peculiar resolution action by the Swiss authorities confirms that despite a standardised global blueprint for bank resolution, banks are still 'global in life but national in death'. Second, the litigation strategies of AT1 investors present some interesting developments, notably the use of investor-state dispute settlement.

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A. Introduction

One of the positive regulatory outcomes of the 2008–2012 financial turmoil is the increased attention to the complex international dimension of banking. The Financial Stability Board and the Basel Committee on Banking Supervision unleashed a series of policy proposals to strengthen cross-border bank resolution and harmonise the policy armoury supervisors can rely on to monitor an international bank.[1] In Europe, policy-makers revived their aspirations for more integration by creating a Euro-wide bank supervisory and resolution framework that gave Frankfurt and Brussels the competence to deal with European banks.[2] Yet, the 2023 banking turmoil, and especially the collapse of Credit Suisse in Switzerland, showed that some of the perennial problems affecting cross-border banking resolution are still present. This note briefly offers some thoughts on what the Credit Suisse resolution means for international finance.

On the 19th of March 2023, the Swiss Financial Market Supervisory Authority (FINMA) finally decided to pull the plug on Credit Suisse by orchestrating its takeover by the larger Swiss bank UBS. The resolution procedure, which would technically qualify as a 'sale of asset', was reinforced by liquidity supply by the Swiss National Bank and extensive guarantees to UBS by the Swiss Confederation for potential losses of certain assets.[3] As a

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[1]For an overview, see M Haentjens and B Wessels (eds), *Research Handbook on Cross-Border Bank Resolution* (Routledge 2019).
[2]See D Busch and G Ferrarini, *The European Banking Union* (OUP 2020).
[3]FINMA, 'FINMA approves merger of UBS and Credit Suisse' (19 March 2023) available at https://www.finma.ch/en/news/2023/03/20230319-mm-cs-ubs/.

critical part of the resolution procedure, FINMA ordered the complete write-down of Credit Suisse's Alternative Tier 1 (AT1) securities for a total value of CHF 16 billion. Crucially, FINMA decided to leave Common Equity Tier 1 (CET1) securities largely untouched, thus preserving existing shareholders.[4]

Given the highly interconnected nature of Credit Suisse, the Swiss Financial Market Supervisory Authority's (FINMA's) resolution action presents profound international implications from a regulatory and contractual viewpoint. Two in particular deserve attention. First, the Swiss authorities' unorthodox approach to resolution (and the similarly surprising approach by the US authorities in the Silicon Valley Bank crisis) showed that the old Mervin King's adage 'banks are global in life and national in death' still applies. In both cases, regulators deviated from the regulatory template on bank resolution and bailouts, thus throwing doubts about the strength of the soft law guidelines agreed upon in Basel a decade ago.

Second is the avalanche of international litigations that investors have launched through different avenues to challenge the Swiss regulator's decisions. This suggests that banks with a substantial cross-border presence still struggle to be resolved efficiently. More worryingly, the increased use of international investment arbitration to challenge regulatory actions presents a worrying trend as the legal framework of international investment law is unsuited to regulate supervisory actions, thus posing an undue constraint on an already fragile regulatory and supervisory framework.[5]

In the following, I will discuss these two aspects and offer some reflections.

B. Credit Suisse's AT1 write-down from a global regulatory perspective

The first point for reflection stems from the unorthodox approach FINMA took to resolve Credit Suisse. The decision to write down AT1 securities, mostly contingent convertible bonds (CoCos) and preserve CET1 was probably motivated by broader strategic geoeconomic and political considerations. On the one hand, the Swiss authorities needed to preserve the existing shareholder cohort, which had substantial investments in other major Swiss corporations. On the other hand, CoCo holders were better placed to absorb losses as they were primarily non-European retail investors.[6] Yet, bypassing standard priority rules created some friction with overseas regulators. Ultimately, it shows that despite the fanfare for a more standardised global resolution framework, national authorities will always adopt the solution that is most aligned with their national interests.

I. The key attributes

To understand the backlash against FINMA's AT1 write-down, we need to take a step back to the aftermath of the global financial crisis when bank resolution reforms became one of

[4]There is a growing literature on the Credit Suisse collapse. For a quick overview, see P Bolton, W Jiang and A Kartasheva, 'The Credit Suisse CoCo Wipeout: Facts, Misperceptions, and Lessons for Financial Regulation' (2023) Swiss Finance Institute Research Paper No 23–32; K Mero, 'Shall We Reconsider Banking Regulations? Some Lessons Drawn from the Failure of Silicon Valley Bank and Credit Suisse' (2023) Economy and Finance 101.

[5]O Walker, K Wiggins and M Ruehl, 'How UBS's $3.3bn Credit Suisse deal spawned $9bn of legal claims' (*Financial Times*, 10 October 2023).

[6]A Choi and J Zhang, 'Creditors, Shareholders, and Losers In Between: A Failed Regulatory Experiment' (2024) ECGI Working Paper No. 753/2024, at 33.

the key topics in financial regulatory circles. The nightmare defaults of Lehman Brothers, Fortis Bank, and the numerous bank bailouts in between had alerted bank regulators to the need to establish a proper regime for failing banks. Banking regulators responded by unleashing several reforms. In 2011, the Financial Stability Board published the *Key Attributes of Effective Resolution Regime for Financial Institutions* (the Key Attributes).[7] The document sets out the core elements of bank resolution regimes – 12 key pillars – and provides a template that national resolution authorities ought to follow when designing their own resolution framework. The objective was to set a minimum global regulatory standard that would guarantee a certain degree of uniformity in the way bank resolution is implemented in all jurisdictions.

A clear creditor hierarchy during resolution and the loss-absorbing capacity of bank instruments were among the main elements of the new resolution standard. Key Attribute 5.1 states:

> Resolution powers should be exercised in a way that respects the hierarchy of claims while providing flexibility to depart from the general principle of equal (pari passu) treatment of creditors of the same class, with transparency about the reasons for such departures, if necessary to contain the potential systemic impact of a firm's failure or to maximise the value for the benefit of all creditors as a whole. In particular, equity should absorb losses first, and no loss should be imposed on senior debt holders until subordinated debt (including all regulatory capital instruments) has been written-off entirely (whether or not that loss-absorption through write-down is accompanied by conversion to equity).

The idea behind this approach is to transfer the burden of bank failures from the public sector to bank shareholders and, subordinately, more senior bank creditors. Within the complex bank creditor hierarchy, shareholders ought to play a fundamental role as they are the first buffer against the bank's collapse. This does not necessarily come as a surprise, as the very philosophy behind capital regulation in use since the early 1980s was to use shareholders as a key tool to enhance banks' corporate governance. As a result, in most bank crises, shareholder value is typically wiped out or at least severely reduced before any intervention by the regulator.

More importantly, the Key Attributes make clear that within the creditor structure, capital comes first in attributing losses and, only later, more complex instruments such as hybrid capital, junior debt and senior debt. If this creditor hierarchy had not been adopted, the entire edifice of capital regulation would have collapsed. Basel III is based on the idea that those who have the legal power to influence bank management and, therefore, risk are best placed to assume the costs of bank actions. Non-equity instruments are unable to perform this task as they do not entail voting rights. In addition, Key Attribute 5.2 sets out the critical principle that.

> [c]reditors should have a right to compensation where they do not receive at a minimum what they would have received in a liquidation.

This means that in the event of a resolution, bank creditors should expect to be treated no worse than in a normal bank insolvency. In practice, losses should be attributed to creditors in a proportional manner depending on their seniority and according to the usual bankruptcy rules, starting with shareholders up to senior creditors.

[7]Financial Stability Board, 'Key Attributes of Effective Resolution Regimes for Financial Institutions' (2011).

II. The Swiss position

FINMA's intervention dumbfounded markets and regulators around the world, as it seemed to contradict the two cardinal principles of bank resolution discussed before. Fearing that Credit Suisse could signal a backtrack from the agreed regulatory status quo and lead to a collapse of the global AT1 securities market, foreign regulators immediately responded by issuing statements clarifying that they would not take a similar approach to resolution. Exemplary is the joint communique by the three European banking authorities – ECB, the Single Resolution Board, and the European Banking Authority – which reaffirmed the usual creditors hierarchy during resolution:

> The resolution framework implementing in the European Union the reforms recommended by the Financial Stability Board after the Great Financial Crisis has established, among others, the order according to which shareholders and creditors of a troubled bank should bear losses. 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.[8]

Almost immediately, legal analysts started to publish analyses on the legality of the measure.[9] It is not the point of this contribution to investigate further the complex legal aspects of the UBS-Credit Suisse merger. However, it is important to say that prima facie, the AT1 write-down is permitted under Swiss law. Indeed, Swiss legislation in force prior to the resolution clarified that AT1 debt securities are senior to CET1 during bank resolution and insolvency and that the usual creditor hierarchy is respected.[10] However, the same legislation allowed Swiss authorities flexibility to bypass the usual hierarchy under certain contractual and regulatory conditions.[11]

The contracts governing Credit Suisse's AT1 debt were peculiar insofar as they deviated from the Basel standards. Under Basel III, all AT1 instruments must be converted if the consolidated CET1 ratio falls below 5.125%.[12] In Credit Suisse AT1's prospectus, it was clear that the instrument be written down if: (i) FINMA decides that a write-down is necessary to prevent the bank from becoming insolvent; (ii) and if the bank receives extraordinary support from the resolution and supervisory authorities. Indeed, the terms of the AT1 stipulate that a write-down event can occur if either the CET1 ratio falls below 7% or if Credit Suisse receives an irrevocable commitment of extraordinary support from the authorities.[13] This is exactly what happened when Swiss authorities passed an Emergency Ordinance dealing with emergency liquidity assistance to systemic banks.[14] The new law, issued on 19 March allowed FINMA to bypass the general meetings and the write-down of core capital during resolution.[15]

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[8]European Central Bank, 'ECB Banking Supervision, SRB and EBA statement on the announcement on 19 March 2023 by Swiss authorities' (20 March 2023).
[9]See J Legras, 'Who Killed Credit Suisse?' (*Financial Times* ,21 March 2023).
[10]The two decrees are the Banking Insolvency Ordinance and the Swiss Banking Act.
[11]See Legras (n 9).
[12]Although other jurisdictions, including the UK, set the trigger at a higher level.
[13]H Eidenmüller and J Paz Valbuena, 'Bailout Blues: The Write-Down of the AT1 Bonds in the Credit Suisse Bailout' (*Oxford Business Law Blog* ,24 April 2023).
[14]The decree is a temporary emergency measure based on Article 184(3) and Article 185(3) of the Swiss Federal Constitution that must be replaced by ordinary law.
[15]Verordnung über zusätzliche Liquiditätshilfe-Darlehen und die Gewährung von Ausfallgarantien des Bundes für Liquiditätshilfe-Darlehen der Schweizerischen Nationalbank an systemrelevante Banken (19 March), Article 5(a).

III. Lessons

The Credit Suisse resolution did not create the negative cross-border spillovers seen with other major cross-banking crises. Admittedly, the timely intervention by the Swiss authorities prevented market chaos and was relatively smooth, given the size of the bank. Yet, the unorthodox AT1 write-down raises concerns about the efficacy of the global bank resolution reforms agreed in Basel a decade ago and, unfortunately, confirms the theory that bank resolution has national interests as the main guiding principle.

The Swiss authorities were not alone in being criticised for their supervisory approach. In the United States, supervisory authorities and regulators were similarly criticised for their approach in the resolution of Silicon Valley Bank. When the FDCI failed to auction the bank, US Treasury Secretary Janet Yellen pledged to protect all deposits, including those above the US$ 250,000 insured threshold.[16] The decision was justified under the 'systemic risk exception', although doubts were raised about the applicability of the rule.[17] Even in this case, European regulators were furious at the US authorities for their pledges to extend blank government support to failing banks.[18] The US regulators' stance was admittedly perceived as a backtrack from the regulatory consensus achieved after the global financial crisis to end bailouts and limit government interventions during banking crises.

To conclude, the handling of the two banking crises indicated that soft law and international financial standards matter very little. If anything, the 2023 spring bank turmoil has confirmed that cooperation and regulatory alignment in resolution are complicated to achieve as national regulators tend to prioritise their national interests over regulatory convergence.

C. International litigation on the Swiss resolution action

Another interesting aspect of the 2023 banking turmoil is the avalanche of litigations initiated by Credit Suisse's AT1 investors. Admittedly, this was something that ought to have been expected, given the legal risks associated with subordinated debt instruments and the lack of a proper cross-border framework for bank resolution. The international litigations on Credit Suisse can be divided into two very different legal strategies, both of which I discuss below.

I. Contract-based litigation

Private litigation in domestic courts is usually the main legal strategy for disgruntled investors. Inevitably, the collapse of Credit Suisse was followed by several lawsuits in Switzerland, London, and New York courts against the Swiss regulator.[19] It is too early for us to comment in detail about the legal strategies of the parties and the points of law raised in court. However, it will be interesting to see how these cases develop. Indeed, they will test

[16] Joint Statement by the Department of the Treasury, Federal Reserve, and FDIC (12 March 2023) – https://www.fdic.gov/news/press-releases/2023/pr23017.html.
[17] L Noonan, 'European regulators criticise US 'incompetence' over Silicon Valley Bank collapse' (Financial Times ,16 March 2023).
[18] ibid.
[19] Walker, Wiggins and Ruehl (n 5).

the strength of cross-border bank bail-ins against some of the potential legal issues raised in the literature.[20]

When the Financial Stability Board first recommended using bail-in as a tool to resolve banks, questions were immediately raised about the legal and practical complexities of resolving a bank with a substantial cross-border presence.[21] The use of hybrid instruments, CoCos and the adoption of bail-in legal powers by national resolution authorities have inevitably complicated cross-border bank resolutions.[22] Without analysing the corporate structure implications of international bail-ins, which did not matter given Credit Suisse was acquired by UBS, for the sake of this paper, the main difficulty is to address the contractual issues that might arise when debt securities are written down.[23]

The most complicated scenario is when the securities subject to bail-in or write-down are governed by a local law other than the law of the resolution authority. Imagine a bank headquartered in Country A that sold Alternative Tier 1 capital instruments in Country B and whose contractual terms are governed by Country B's applicable law. In simple terms, the question is to what extent Country A's resolution authority in charge of resolving the bank can change the contractual terms of those securities as part of the resolution action. Since AT1 instruments are subjected to foreign law and traded internationally, the power of the national resolution authority to act extraterritorially would be put into question. In many jurisdictions, for instance, in England and Wales, foreign statutes cannot change a local contract. Creditors who saw their contracts changed could sue the resolution authorities in foreign courts and would probably win since foreign resolution powers would not be recognised.[24] From what we know so far, most of the notes were subject to Swiss law, which reduced sensibly the risk of litigation. However, legal risks would remain if any of those notes were subject to foreign law.

The most likely legal issue raised in the Credit Suisse litigation is the potential contractual misrepresentation with regard to the resolution powers of the Swiss authorities and the trigger mechanism applicable to the securities. Even if securities were governed by Swiss laws, they were probably issued in foreign jurisdictions, most likely in the New York and London markets. In this case, they must comply with the foreign disclosure and listing requirements. In the event of an 'unusual' resolution action by resolution authorities, meaning an action that does not fit with past resolution actions for similar events, or is based on a controversial interpretation of the contract and statutory powers, or is blatantly in violation of the contractual documentation, a question might arise as to whether there might be a potential misrepresentation and violation of local securities law.[25] Investors might claim that there was a legitimate expectation that the usual priority rules would be respected in the event of resolution.

[20]F Lupo-Pasini, *The Logic of Financial Nationalism: The Challenges of Cooperation and the Role of International Law* (CUP 2017); D Schoenmaker, *Governance of international banking: the financial trilemma* (OUP 2013).

[21]S Gleeson, 'Legal aspects of bank bail-ins' (2012) Special paper 205, LSE Financial Market Group Paper Series.

[22]F Lupo-Pasini and RP Buckley, 'International Coordination in Cross-Border Bank Bailins: Problems and Prospects' (2015) Eur Bus Org Law Rev 203.

[23]Here, the main debate is between a Single-Point-of-Entry resolution versus Multiple-Point-of-Entry. See Clifford Chance, 'Bank resolution and bail-ins in the context of bank groups' (2011).

[24]The legal problem is not insurmountable, but it needs a lot of legal coordination between the two countries, a high degree of legal harmonisation and careful contract drafting. In the EU, the Bank Recovery and Resolution Directive obviates this issue by giving EU resolution authorities the power to intervene, thus forcing national EU courts to recognise the resolution action. However, outside of the EU, harmonisation is less effective. It just needs loopholes in contract drafting and a more challenging conflict of law rule in order to trigger potential litigations.

[25]In this case, the issue is whether FINMA's resolution action fits with AT1 securities' Information Memoranda.

II. International investment arbitration

The most exciting aspect of the Credit Suisse litigation is the use of international investment arbitration. Financial investors usually prefer standard private commercial litigation or arbitration as the primary dispute settlement mechanism.[26] Yet, in recent years, especially after the global financial crisis, we have witnessed increased use of investor-state dispute settlements in various financial services.[27]

Investor-state arbitration allows private investors to sue sovereigns for the host state's violation of specific standards of treatment set to protect the investment. To do so, investors rely on the international investment agreement (IIA) between their state of origin and the host state where the investments are located. The IIA entitles investors to rely on the legal protection of the treaty. At present, there are more than 2600 similar international instruments in force, covering bilateral investment relations from virtually all countries.[28] In the Credit Suisse case, investors from various Asian and Middle Eastern countries immediately grouped to sue the Swiss government based on the applicable bilateral investment treaties between Switzerland and their states. Major international law firms, including Quinn Emanuel and Clyde & Co, are reported to be assisting investors in those litigations.[29]

Unlike standard commercial litigation, the legal dispute is not adjudicated according to the law applicable to the contract of investment but rather according to the specific standard of treatment set in the applicable IIA and the principles forming the body of international investment law. This legal framework, detached from the classical contractual law principles that govern the private aspects of the transaction, is still much more closely related to public international law. Without entering into details, three standards of treatment are particularly relevant when it comes to bank resolution actions.[30]

As the name suggests, the principle of non-discrimination prevents the host state from subjecting foreign investors to a legal, economic or regulatory treatment worse than that according to investors from other countries or their own. This standard is particularly relevant to challenges of bail-outs, which typically tend to favour local banks against foreign-owned ones. Most IIAs also include the Fair and Equitable Treatment standard, which broadly protects against violations of basic rules of law, transparency and due process. Sometimes, the FET standard has also been used against the host state's failure to protect investors' legitimate expectations and to offer a stable regulatory framework. Finally, portfolio investors can rely on the expropriation standard, which prevents sovereigns from expropriating foreign investors' assets without adequate compensation. Unlawful expropriations have historically taken the form of a direct acquisition of assets. However, a growing jurisprudence extends the concept to indirect expropriations

[26]WW Park, 'Arbitration in Banking and Finance Arbitration in Banking and Finance (1998) 17 Ann Rev Banking L 213; ICC, 'Financial Institutions and International Arbitration – ICC Arbitration & ADR Commission Report' (2016) <https://cdn.iccwbo.org/content/uploads/sites/3/2016/11/icc-financial-institutions-and-international-arbitration-icc-arbitration-adr-commissionreport.pdf>.

[27]F Lupo-Pasini, 'Financial Disputes in International Courts' (2018) 21 JIEL 1; K Apostolova and G Dawson, 'Banks as Claimants in Investment Arbitration' (2020) 16 Asian Int'l Arb J 93; J Chaisse and K Olaoye, 'International banking and finance use of the investment treaty regime: Hong Kong as a case study' (2023) Capital Markets Law Journal 44.

[28]See, UNCTAD, International Investment Agreement Navigator, available at https://investmentpolicy.unctad.org/international-investment-agreements.

[29]T Jones, 'Clyde & Co prepares treaty claims over Credit Suisse' (*Global Arbitration Review*, 26 March 2024) https://globalarbitrationreview.com/article/clyde-co-prepares-treaty-claims-over-credit-suisse.

[30]On this see J Stewart and others, 'Credit Suisse, AT1 bonds and taking the BIT between the teeth' (2023) JIBFL 293.

whereby regulatory changes de facto deprive investors of the benefit of their investments. This latter aspect is one of the most contentious as it forces arbitration courts to juggle the sovereign right of a state to regulate, including the right to change legislation in a way unfavourable to investors, with investors' legitimate expectations that the regulatory and legal framework on which they base their commercial actions be changed in a way that makes their investment unprofitable.

It is too early to say which legal strategy and claims investors will rely on in their litigation. For now, the main conclusion is that the high-profile investment arbitrations originating from the collapse of Credit Suisse will further increase the visibility and, perhaps, the appeal of this litigation method to financial investors. In my opinion, this is not entirely a welcomed development for financial services. In other studies, I have argued that the principles of international investment law are useful only to protect financial investors against arbitrary and protectionist actions from the host state or to counter very lax and inefficient supervisory actions.[31] However, I doubt that they would improve regulatory actions or maintain financial stability. The most likely outcome is more regulatory uncertainty among regulators in less structured jurisdictions, which might fear the threat of litigation and, therefore, favour the interest of international investors over other essential considerations such as the protection of financial stability or regulatory innovation.

First, non-discrimination should not be a factor in a bank resolution or supervisory action. When supervisors are confronted between maintaining financial stability (even if this means favouring local creditors, whether shareholders or depositors) and protecting foreign investors, they should always favour the former over the latter objective. Second, the unclear contours of the indirect expropriation principles might expose regulators to excessive scrutiny and deter regulatory innovations. A small financial system with a predominance of foreign-owned banks will be put under a lot of pressure if regulators decide to change regulatory requirements to increase operating costs or reduce bank profitability.

Yet, most international investment agreements, especially the most recent ones, contain prudential carve-outs that exclude regulatory actions from treaty-based claims. Thus, the bar for investors to demonstrate the unlawfulness of the measure will be very high as they need to demonstrate the violation of a standard of treatment and that such a measure was not taken for a financial stability objective. Given that the protection of financial stability is the main statutory mandate for supervisory authorities in virtually all countries, investors would need to demonstrate that regulators have acted ultra vires.

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[31]F Lupo-Pasini, 'Financial Disputes in International Courts' (2018) JIEL 1.