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Credit Suisse's Collapse Reveals Some Ugly Truths About Switzerland for Investors

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(Bloomberg) -- For decades, Switzerland has sold itself as a haven of legal certainty for bond and equity investors. The collapse of Credit Suisse Group AG revealed some unpleasant home truths.

In the race to secure UBS Group AG's purchase of its smaller rival over the weekend, the government invoked the need for stability and emergency legislation to override two key aspects of open markets: competition law and shareholder rights. Then bondholders discovered that $17 billion worth of so-called Additional Tier 1 debt was worthless.

Aside from the sense of shame brought on by the bank's collapse, legal observers say these three surprises raise some fundamental questions about the primacy of Swiss banking law and also sows doubt with foreign investors about putting money in the country.

"Foreign investors may wonder if Switzerland is a banana republic where the rule of law doesn't apply," said Peter V. Kunz, a professor specialized in economic law at the University of Bern. The country "is not endangered, but there might be the risk of lawsuits" because authorities "intervened here on very thin ice."

Kern Alexander, a professor of law and finance at the University of Zurich, agreed, saying crisis management was carried out in a "panicked" way that "undermined the rule of law and undermined Switzerland."

In announcing the government-brokered sale of Credit Suisse to its Zurich rival on Sunday evening, the Swiss government cited an article of its constitution that allows it to issue temporary ordinances "to counter existing or imminent threats of serious disruption to public order or internal or external security." In this case, this included overriding merger laws on shareholder votes.

Then, when Finma chairwoman Marlene Amstad was asked during a press conference later that evening if the government was ignoring competition concerns in pushing the merger through, Amstad said financial stability trumped competition concerns.

"Regulatory law gives us the power to override the competitive situation in the interests of financial stability, and we have made use of that here," she said.

Together Credit Suisse and UBS would hold 333 billion Swiss francs ($360 billion) in customer deposits, 115 billion francs more than their nearest rival Raiffeisen, according to a UBS investor presentation.

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But the biggest pushback from investors over the deal so far concerns the decision by Swiss banking regulator Finma to write down to nothing the AT1 bonds issued by Credit Suisse.

AT1 bonds were introduced after the global financial crisis to ensure losses would be borne by investors not taxpayers. They are meant to act as a capital buffer in times of stress. Crucially, debt of this type at most other banks in Europe and the UK have far more protections and only AT1 bonds issued by Credit Suisse and former Swiss rival UBS have language in their terms that allows for total wipeout rather than a conversion to equity.

Even if the risks of those AT1 bonds were made clear to investors at the time they signed on to them, this stark example of Swiss exceptionalism marks a departure from the general rule that bondholders come before shareholders.

"A lot of lawsuits will be coming from this, which will highlight the erratic and selfish behavior of Swiss authorities in this saga," said Jacob Kirkegaard, senior fellow at the Peterson Institute for International Economics.

Ethos Foundation, whose 246 pension fund members represent 1.9 million people with 370 billion swiss francs in assets, has threatened as much over the issue of blocking shareholder votes.

"Faced with this unprecedented failure in the history of the Swiss financial center, Ethos will continue to defend the interests of minority shareholders, starting with the Swiss pension funds," the Geneva and Zurich-based foundation said in a statement on Monday.

"All options will be examined in the coming days, including legal ones, to determine the responsibilities of this debacle," it said.

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Meanwhile US law firm Quinn Emanuel Urquhart & Sullivan said it will host a call for bondholders on Wednesday with representatives from its offices in Zurich, New York and London to talk through the “potential avenues of redress which bondholders should be considering.”

--With assistance from Irene García Pérez.

(Updates with comment from academic in fourth paragraph)