

Credit Suisse takeover: protecting Japanese investments under the Japan-Switzerland EPA

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1. Introduction

On 18 March 2023, the sale of struggling Credit Suisse to its rival, UBS, was announced. The transaction took the form of a merger² of the two banks supported by the Swiss Government, with UBS to be the only surviving entity upon the closing of the merger transaction ("**Transaction**"). In an unprecedented turn of events, Government measures taken to support the transaction triggered a complete write-down of the nominal value of all Credit Suisse Additional Tier 1 ("**AT1**") bonds in an amount of around 16 billion Swiss Francs, while the takeover preserved some value for Credit Suisse's shareholders.

This newsletter addresses the situation Japanese investors in Credit Suisse AT1 bonds are currently facing as a result of the Swiss Government measures taken to support the takeover. It also will analyze potential remedies Japanese investors have at their disposal under the international investment protection mechanism in place between Japan and Switzerland.

2. Measures taken by the Swiss Government to support the takeover

On 16 March, the Swiss Federal Council published the emergency *Ordinance on Additional Liquidity Assistance Loans and the Granting of Federal Default Guarantees for Liquidity Assistance Loans from the Swiss National Bank to Systemically Important Banks*,³ which it then amended on 19 March⁴ ("**Ordinance**").

The Ordinance provides, among others, that (i) the Transaction will not be subject to shareholders' approval, (ii) the Swiss National Bank will grant Credit Suisse and UBS a liquidity assistance loan facility of up to 100 billion Swiss Francs, and further liquidity assistance loan facility to Credit Suisse of up to 100 billion Swiss

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² <https://www.credit-suisse.com/about-us-news/en/articles/media-releases/credit-suisse-and-ubs-to-merge-202303.html>

³ The Swiss Federal Council's Ordinance of 16 March 2023 on additional liquidity assistance loans and the granting of federal default guarantees for liquidity assistance loans from the Swiss National Bank, accessible at: <https://www.news.admin.ch/newsd/message/attachments/76289.pdf>

⁴ The Swiss Federal Council's Ordinance of 19 March 2023 on additional liquidity assistance loans and the granting of federal default guarantees for liquidity assistance loans from the Swiss National Bank, amending the Swiss Federal Ordinance of 16 March 2023 on additional liquidity assistance loans and the granting of federal default guarantees for liquidity assistance loans from the Swiss National Bank, accessible at: <https://www.news.admin.ch/newsd/message/attachments/76290.pdf>

Francs, with privileged creditor status of the Swiss National Bank in a potential bankruptcy, (iii) the Swiss Government will provide a 9 billion Swiss Francs guarantee to UBS against losses which it may incur during the takeover, and most importantly, (iv) 16 billion Swiss Francs worth of AT1 of Credit Suisse may be written down by the Swiss Financial Market Supervisory Authority ("**FINMA**"). On 19 March 2023, FINMA confirmed the write-down of AT1 bonds⁵ and on 23 March 2023, FINMA announces it had instructed Credit Suisse to write-down the AT1 bonds.⁶

3. Characteristics of AT1 bonds

After the 2008 financial crisis showed vulnerabilities in the banking sector, the third Basel Accord ("**Basel III**") was introduced and implemented in various European jurisdictions, including Switzerland. It is a framework intended to increase minimum capital requirements and capital ratio, i.e. the percentage of a bank's capital to its risk-weighted assets.

AT1 bonds yield higher interest to bondholders than other types of bonds. They are considered to be riskier since they are designed to absorb losses. Indeed, in case a bank's capital ratio falls below a certain threshold, a bank may either (i) convert the bonds to shares or (ii) reduce or nullify their value. Both will lead to lowering the bank's level of debt, reestablishing the bank's capital ratio to levels acceptable under the Basel III requirements.

4. A criticized approach to debt repayment

Notwithstanding AT1 bonds' high risk profile,⁷ customarily, when a financial institution fails, the hierarchy of claims dictates an order which the reimbursement of debt must follow. Ordinary bonds are typically paid back before AT1 bonds are, but AT1 bondholders, in turn, are paid out before shareholders. In other words, common equity instrument holders are customarily subordinated to bondholders in the creditor hierarchy.

The regulatory framework in place under Swiss law at the time when the AT1 bondholders purchased their bonds from Credit Suisse also establish a clear hierarchy of losses upon resolution, stating that losses are borne by shareholders first, before being absorbed by AT1 bondholders.⁸ This principle was reaffirmed by FINMA,⁹ and recognized by Credit Suisse in a statement to shareholders made on 14 March 2023.¹⁰

⁵ FINMA announcement of 19 March 2023, accessible at: <https://www.finma.ch/en/news/2023/03/20230319-mm-cs-ubs/>

⁶ FINMA announcement of 23 March 2023, accessible at: <https://www.finma.ch/en/news/2023/03/20230323-mm-at1-kapitalinstrumente/>

⁷ "The AT1 instruments issued by Credit Suisse contractually provide that they will be completely written down in a "Viability Event", in particular if extraordinary government support is granted.", FINMA announcement of 23 March 2023, accessible at: <https://www.finma.ch/en/news/2023/03/20230323-mm-at1-kapitalinstrumente/>

⁸ See article 19 of the Capital Adequacy Ordinance, accessible at: <https://www.news.admin.ch/news/message/attachments/76290.pdf>

⁹ FINMA factsheet dated 1 December 2014, "The Swiss "too big to fail" regime", accessible at: https://www.finma.ch/en/~media/finma/dokumente/dokumentencenter/myfinma/faktenblaetter/faktenblatt-schweizer-too-big-to-fail-regime-tbtf.pdf?sc_lang=en&hash=E92CB30F47DE68554D046FF8596155BE

¹⁰ Credit Suisse's annual report for 2022, 14 March 2023, accessible at: <https://www.credit-suisse.com/about-us/en/events/annual-general-meeting.html>

Here, the Ordinance led to AT1 bonds being entirely written down in an effort to lower the bank's level of debt, in order to reestablish the bank's capital ratio to compliant levels. However, and surprisingly for some, the takeover enabled shareholders to retain some value. Shareholders will be able to receive about 3 billion Swiss Francs' worth of UBS shares. By favoring shareholders over bondholders, the Swiss Government diverted from what has been common practice. While there has been a prior incidence of AT1 bonds being written down when Spanish Banco Popular collapsed in 2017, this followed the customary hierarchy of claims and the bank's shareholders also lost the entirety of their investment.¹¹

On 20 March, the ECB Banking Supervision, the Single Resolution Board and the European Banking Authority issued a press release noting that the order according to which shareholders and creditors of a troubled bank should bear losses has been implemented consistently since the 2008 financial crisis. It noted that "*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*", and that this principle had been consistently applied in past cases and would "*continue to guide the actions of the SRB and ECB banking supervision in crisis interventions.*"

The Monetary Authority of Singapore,¹² the Hong Kong Monetary Authority¹³ and the Bank of England¹⁴ made similar statements which can be considered as veiled criticism of the "Swiss approach".

5. Investment protection under the Japan-Switzerland EPA

In 2009, an Agreement on Free Trade and Economic Partnership was entered into by Japan and Switzerland ("**Japan-Switzerland EPA**" or "**EPA**").¹⁵ It is a legal instrument intended to facilitate trade and investment between the two economies. To achieve the latter objective, the EPA contains provisions meant to ensure that investments made by investors of one party into the jurisdiction of the other party are afforded certain protections.

Investments which are covered by the EPA include, among others, "*bonds, debentures, loans and other forms of debt, including rights derived therefrom*",¹⁶ which means that Japanese¹⁷ direct or indirect¹⁸ holders of AT1 bonds issued by a Swiss financial institution are covered by the guarantees included in the EPA.

Japanese investors in Credit Suisse AT1 bonds might be protected by provisions in the EPA which prohibit expropriation of their investments by Switzerland, or measures tantamount to expropriation unless the measure is taken (i) in the public interest, (ii) in a non-discriminatory manner, (iii) in accordance with due

¹¹ [https://www.europarl.europa.eu/RegData/etudes/BRIE/2017/602093/IPOL_BRI\(2017\)602093_EN.pdf](https://www.europarl.europa.eu/RegData/etudes/BRIE/2017/602093/IPOL_BRI(2017)602093_EN.pdf)

¹² <https://www.mas.gov.sg/news/media-releases/2023/mas-statement-on-additional-tier-1-instruments-issued-by-singapore-banks>

¹³ <https://www.hkma.gov.hk/eng/news-and-media/press-releases/2023/03/20230322-3/>

¹⁴ <https://www.bankofengland.co.uk/news/2023/march/boe-statement-uk-creditor-hierarchy>

¹⁵ Agreement On Free Trade and Economic Partnership Between Japan and the Swiss Confederation signed on 19 February 2009, accessible at: <https://www.mofa.go.jp/region/europe/switzerland/epa0902/agreement.pdf>

¹⁶ Article 85(c)(iii) of the Japan-Switzerland EPA.

¹⁷ As per Articles 85(g)(i)(A) and 85(g)(iii), "*a national of Japan*" or "*an enterprise constituted or organised under the applicable law of [Japan] and carrying out substantial business activities in [Japan]*"

¹⁸ Article 85(f) of the Japan-Switzerland EPA.

process of law, and (iv) against prompt, adequate and effective compensation equivalent to the fair market value of the expropriated investment at the time when the expropriation was publicly announced.¹⁹ At least at first sight, one might argue that the Ordinance leading to the writing off of the value of AT1 bonds, and giving priority to reimbursing shareholders over AT1 bondholders, led to AT1 bondholders' investments being deprived of their value in a discriminatory manner, without receiving adequate compensation in return.

The EPA also protects Japanese investors by providing that each party shall accord to investments of investors of the other Party fair and equitable treatment ("**FET**") and full protection and security.²⁰ The FET standard typically protects investors against (i) unreasonable, arbitrary and discriminatory treatment; (ii) failure to offer a stable and predictable legal framework; (iii) lack of transparency and denial of due process and justice; and (iv) frustration of an investor's legitimate expectations.

Viewed against this standard, one may question Switzerland's decision to nullify the value of AT1 bonds and not to follow the hierarchy of claims which exists in the Swiss regulatory framework and has been recognized by FINMA. In addition, one might argue that by stating that Credit Suisse's capital requirements were met, and that its liquidity would be guaranteed,²¹ days before the write-down of the AT1 bonds, the Swiss authorities failed to act in a transparent manner.²²

The EPA provides that Japanese investors who deem that Switzerland has breached its obligations under the EPA may initiate arbitral proceedings against Switzerland to recover their damages. This is conditional upon entering into amicable consultations, which must begin at least six months prior to the initiation of arbitral proceedings,²³ and such proceedings must be initiated within five years from the date of the write-down.²⁴ Japanese investors have the option to initiate arbitration under the ICSID Convention or under the UNCITRAL Arbitration Rules.²⁵ While individual bondholders might be reluctant to individually pursue their losses, experience shows that bondholder claims can be bundled into a collective action,²⁶ thus reducing the litigation risk for the individual bondholder.

6. Conclusion

Existing investment protection provisions between Japan and Switzerland provide safeguards for Japanese institutional or retail investors who have invested in AT1 bonds issued by Credit Suisse. They may have a

¹⁹ Article 91 of the Japan-Switzerland EPA.

²⁰ Article 86 of the Japan-Switzerland EPA.

²¹ <https://www.finma.ch/en/news/2023/03/20230315-mm-statement/>

²² Per Article 98 of the Japan-Switzerland EPA in connection with Annex VI, Article VI(1), Switzerland is not prevented from adopting or maintaining measures for prudential reasons, including for ensuring the integrity and stability of its financial system. However, where such measures do not conform with the provisions regarding expropriation and FET pointed out above, Switzerland may not use them as a means of avoiding its obligations under the Japan-Switzerland EPA.

²³ Article 94(3) of the Japan-Switzerland EPA.

²⁴ Article 94(5) of the Japan-Switzerland EPA.

²⁵ Article 94(3)(a) and (c) of the Japan-Switzerland EPA.

²⁶ See *Abaclat and Others v. Argentine Republic*, Decision on Jurisdiction and Admissibility (4 August 2011), ICSID Case No. ARB/07/5, a case which discussed the concept of mass claims proceedings in investment treaty arbitration. The arbitral tribunal in this case found that it had jurisdiction to hear claims of 60,000 claimants contesting aspects of Argentina's sovereign bond restructuring program.

claim for compensation by virtue of the investment arbitration mechanism provided for by the Japan-Switzerland EPA. For further assistance and an introduction to the practice of investment arbitration, please feel free to contact us or to watch an exclusive N&A webinar on investment-arbitration (in Japanese).²⁷

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²⁷ N&A Legal Forum Online, Investment Arbitration Webinar Series, accessible at: <https://www.nishimura.com/ja/knowledge/seminars/20220330-75911>