

Why did Credit Suisse fail and what does it mean for banking regulation?

Jitters in the US banking system spilled over into Europe with the buy-out of one of Switzerland's leading banks by its traditional rival, UBS. The causes of Credit Suisse's failure are different from those of Silicon Valley Bank, but the impact on future regulation is likely to be greater.

The failure of Credit Suisse was a serious test of the reforms of banking regulation made after the global financial crisis of 2007-09. It was the first failure of a large, interconnected bank that was considered 'too big to fail'.

The bank's collapse was also a test of the Swiss authorities' ability to manage such an event. Credit Suisse's merger with UBS raises several questions about the robustness of the regulatory reforms and the structure of the Swiss banking sector going forward.

At its peak valuation in 2007, Credit Suisse was worth 100 billion Swiss francs (SFr). On 19 March, UBS agreed to buy it for just SFr3 billion. This is a remarkable fall from grace for an institution that dates back to the 1850s, and is seen as one of the foundations on which Switzerland's economy was built.

Bank failures often arise from some miscalculation of risk. For example, there might be a huge exposure to an overvalued property market or, as in the case of Silicon Valley Bank, a massive exposure to US government bonds that lost value as interest rates rose rapidly.

Credit Suisse had no such exposure. Instead, this was a bank that has been weakened by a series of scandals over the last two decades.

What were the scandals?

Many banks attract regulatory censure from time to time. But in recent years, [Credit Suisse](#) and its employees have been investigated, fined, made settlements and even been imprisoned for various money laundering, corruption, tax evasion and even corporate espionage scandals.

Credit Suisse's scandals are truly global in nature. They have ranged from money laundering for Japanese gangs and Bulgarian drugs traffickers, to kickbacks in Mozambique, tax evasion in the United States, spying on former employees in Switzerland, dealing with African dictators and jobs-for-business deals with Chinese officials in Hong Kong.

In early 2021, Credit Suisse found itself exposed to the collapses of US hedge fund Archegos Capital and UK finance firm Greensill Capital. Facing massive legal and reimbursement costs, Credit Suisse brought in former Lloyds Banking Group CEO Antonio Horta-Osorio to sort out its culture. But he resigned in January 2022 after twice breaching Covid-19 rules.

As the scandals piled up, investor confidence that Credit Suisse could reform itself evaporated. Indeed, Marlene Amstad, the chair of FINMA (the Swiss financial regulator), noted that Credit Suisse '[had a cultural problem that translated into a lack of accountability](#)'. As a result, Credit Suisse's share price has been sliding since the global financial crisis (see Figure 1).

What pushed Credit Suisse over the brink?

The scandals made Credit Suisse look increasingly risky. In October 2022, a journalist tweeted that a major investment bank was '[on the brink](#)', leading investors to assume that the bank in question was Credit Suisse. Deposit withdrawals of over SFr100 billion and a decline in share price followed.

Figure 1: Share price, Credit Suisse and UBS (closing price)

Source: Yahoo Finance

Then on 14 March, Credit Suisse announced that it had found '[material weaknesses](#)' in its financial reporting for 2021 and 2022. Another scandal looked to be on the cards.

When the chair of Saudi National Bank, Credit Suisse's largest shareholder, subsequently ruled out further investment, deposits flowed out and the share price collapsed.

What happened next?

On 15 March, the Swiss National Bank provided Credit Suisse with SFr50 billion as a 'liquidity backstop' that Credit Suisse could draw down (against collateral) if needed.

The hope was to reassure investors that their money was safe. But this did not succeed. As speculation grew, it became clear that an announcement would be made about Credit Suisse's future by the end of the weekend (19 March).

In the case of a failing bank, four broad options are available.

The first is to declare insolvency and allow the bank to be wound up through regular company law. This is not an option for large, interconnected banks, as it takes too long and generates too much uncertainty.

To deal quickly with a failing bank, the second option is resolution. Broadly speaking, the regulator steps in, bails-in various creditors and restructures the bank overnight or over a weekend. This is a complicated process because the regulator also needs to ensure continuity in retail banking and other key services to avoid panic in the wider financial system.

As part of reforms after the global financial crisis, regulators and large banks such as Credit Suisse are supposed to have plans in place before a crisis is reached so that they can be resolved smoothly. But the plans for resolving Credit Suisse were [still incomplete](#) despite years of preparation.

Further, FINMA chief executive [Urban Angehrn stated](#) that implementing them would have had a 'disastrous impact' on Switzerland's financial industry, adding that 'many other Swiss banks would probably have faced a run on deposits'.

This is an unnerving failure of the post-global financial crisis reforms, and one that should make regulators look again at the current framework.

A third option is to nationalise the bank. In this case the state takes over the bank, including its financial obligations.

Ironically, it seems that this option was ruled out in part because UBS was rescued with public money during the global financial crisis. Although this was ultimately profitable for the Swiss authorities, public outrage at the time seems to have reduced the political appetite for this option with Credit Suisse.

The fourth option – a merger with UBS – was therefore selected.

FINMA chair Amstad has said that several options were considered, noting, for example, that [resolution documents](#) were ready to be signed on Sunday 19 March. But this does not mean that they were under serious consideration.

[The Financial Times reported](#) that at the same meeting that Credit Suisse was informed about the SFr50 billion liquidity backstop, it was also told that it would have to merge with UBS. This suggests that the Swiss authorities had committed to the buy-out as early as 15 March.

With a hard deadline on the evening of Sunday 19 March, UBS could negotiate a favourable deal. Credit Suisse shareholders were given SFr3 billion in UBS stock. This looks cheap – based on its final share price, [Credit Suisse was valued](#) at about SFr7.4 billion. A year ago, its value stood at around SFr20 billion.

UBS also extracted financial guarantees from the government. As part of the deal, UBS has access to a further SFr100 billion from the Swiss National Bank. The Swiss government has also guaranteed losses of up to SFr9 billion (after UBS absorbs the first SFr5 billion). So even though the Swiss finance minister has asserted that this was a '[commercial solution](#)', taxpayers' money is still at risk.

A last key point of the deal was that the Swiss authorities wiped out 17 billion of Credit Suisse's so-called 'alternative tier 1' (AT1) bonds, strengthening the capital position of UBS. This bail-in has proved controversial and we will return to it below.

Conclusions from the events can be drawn both for Switzerland as a financial centre and for financial regulation generally.

What does this mean for Switzerland?

Following the buy-out, UBS accounts for about 200% of Swiss GDP. To put this in context, it is comparable to the amount of bank liabilities guaranteed by the Irish government at the start of the global financial crisis (also around 200% of GDP). That ultimately forced the Irish state into a bail-out.

What could Switzerland do if UBS fails in the future?

Given its size, the Swiss state could find it difficult to cover all of UBS's potential losses if it were to fail. Further, there would be no bank in Switzerland big enough to buy it out. This leaves resolution. But since the Swiss authorities believe that resolving Credit Suisse could have brought down the Swiss economy, presumably resolving UBS would have the same implications. After all, FINMA believes that the UBS resolution plans are as about [as incomplete as those of Credit Suisse](#).

Both UBS and Credit Suisse are considered 'global systemically important' banks. This means that they are required to hold additional capital against losses. The Swiss authorities say that they will increase the amount of capital that UBS is required to hold to reflect its greater size. But this offers little comfort when we consider that Credit Suisse's capital buffers were insufficient to prevent its failure.

Overall, the main concern is that by facilitating this merger, the Swiss authorities have created an institution that is not just 'too big to fail', but 'too big to save'.

What does the collapse of Credit Suisse mean for financial regulation?

First, the reforms, put in place following the global financial crisis, to supervise large, interconnected banks have not operated as planned. These reforms are intended to ensure that Credit Suisse could be resolved. But the Swiss authorities believed that the plans to do so were incomplete and would have made the situation worse. Perhaps this is an idiosyncratic Swiss issue, but perhaps it is not – in which case, we should worry.

The Swiss authorities have noted that the reforms requiring larger capital buffers enabled Credit Suisse to withstand the run in October 2022. But the extra time it gained did not enable the authorities to prepare a less chaotic end for Credit Suisse. The benefits of larger buffers in this case are thus disputable.

Second, funding costs for banks may increase due to the bail-in of the Credit Suisse AT1 bonds. They were designed to provide additional loss-absorbing capacity by being written down to zero in stress events. But it appears that investors had not expected a write-down to occur before shareholders were completely wiped out.

Immediately after the announcement, investors dramatically increased the yield they required to hold AT1 bonds, prompting regulators in the euro area and the UK to state that they would not bail in bondholders before shareholders.

More recently, many AT1 yields have declined. Whether there will be a longer-term effect on bank funding costs in Switzerland, or more broadly, remains to be seen.

All in all, the collapse of Credit Suisse was not a pretty sight and will have far-reaching effects for both Switzerland and global financial regulation.

Where can I find out more?

- [How the Swiss 'trinity' forced UBS to save Credit Suisse](#): *Financial Times* on how the buy-out came about.
- [Four ways to fix the bank problem](#): Martin Wolf on how to make the banking system more resilient.
- [Switzerland's new megabank is bad news for Swiss bankers](#): *The Economist* on the aftermath of the deal.
- [Credit Suisse began with a successful bet, and ended with one that failed](#): *Neue Zürcher Zeitung* with a history of Credit Suisse.