Tim Phillips [00:00:00]:
Today on VoxTalks Economics. One year on we revisit the shocking demise of Credit Suisse. Welcome to VoxTalks Economics from the Center for Economic Policy Research. My name's Tim Phillips. Every week we bring you the best new research in economics. So remember, follow us, wherever you get your podcasts. And look for us on instagram as well at VoxTalks Economics.

[Voiceover] [00:00:34]:
We start with the troubled global banking sector. European markets have closed down more than 3%, spooked by a major selloff of shares in the swiss banking giant Credit Suisse.

Tim Phillips [00:00:47]:
It's twelve months since the sudden downfall of Credit Suisse. What happened and what lessons can we learn? Beatrice Weder di Mauro of the Geneva Graduate Institute and INSEAD and also president of CEPR, was one of an expert team who were called in by the Swiss Department of Finance to investigate the why and the how of the crisis. And she's with me today to talk about that. Welcome back to VoxTalk's Economics, Beatrice.

Beatrice Weder di Mauro [00:01:16]:
Thank you, Tim. Good to be back.

Tim Phillips [00:01:19]:
Credit Suisse was so shocking because it was one of the global banks that was considered too big to fail. What does that mean? And why do we separate out some too big to fail banks?

Beatrice Weder di Mauro [00:01:32]:
Because, Tim, some 15 years ago, Lehman Brothers caused enormous shock to the world economy, to the world financial markets.

[Voiceover] [00:01:42]:
Lehman Brothers is going bankrupt. And financial markets from Asia to Europe are doing their utmost to prevent Monday from turning from dark to black.

Beatrice Weder di Mauro [00:01:52]:
Total cost of that disorderly cross border failure of a large bank. We're still summing it up. I was looking just now, the European Union and the OECD countries that had banking crises never really recovered from that enormous shock. So it was a shock financially, in real economic terms, and also socially and politically. We understand since then that very large banks can be dangerous. And the regulators, supervisors at the Financial Stability Board, the FSB, have been spending ten years building a new regime which is supposed to make no large bank too big to fail. No large financial institution, in fact, too large to fail. So that's the too big to fail framework and the Credit Suisse was the real first test of this regime.

Tim Phillips [00:02:48]:
I said that the downfall of Credit Suisse was sudden, but the problems at Credit Suisse were not. In the years leading up to this big event last year, what was going on at the bank?

Beatrice Weder di Mauro [00:03:01]:
Credit Suisse was quite exceptional in many ways. It had a whole series of scandals and scandal on scandal. If you look at at least the last three years before the eventual downfall, the franchise value of the business model had been increasingly questioned. And way this expresses itself is by share prices falling, price to book values falling by some 90% almost at the very end. Yes. While at the same time, other European banks weren't doing so badly. So it was really an exceptional case.

Tim Phillips [00:03:39]:
And a lot of criticism for the way it was doing its business. A lot of worry about it. But when, in 2023, did this become an existential crisis?

Beatrice Weder di Mauro [00:03:49]:
It became a very obviously existential crisis in the October of 2023. That's when the first bank run happened. And it was a bank run among the wealthy clients. It actually started in Asia, and within only a few weeks, Credit Suisse lost 80 billion in deposits from on balance sheet. And you have to add to that, when clients of that type leave, they're also pulling away other money that we're giving Credit Suisse under asset management contracts, that's not on the balance sheet, but that is a lot of income that is also falling at the same time. So at the same time, the deposits are decreasing, balance sheet is decreasing, and income possibilities of the future are decreasing.

Tim Phillips [00:04:33]:
Now, we're going to be discussing today what happened next, but how was this crisis resolved at Credit Suisse and who was responsible for resolving it?

Beatrice Weder di Mauro [00:04:43]:
In the end, it was resolved over a weekend. And I should mention, this is how the too big to fail, which is supposed to work. So the idea is that when a bank approaches the point of non viability, famous PoNV, a word that is by now quite well known in Switzerland, then, in principle, the authorities take over and they can then apply all sorts of resolution actions. Now, what happened in the case of Credit Suisse was not exactly this plan, but something similar. In the end, the authorities also did intervene. They declared that the point of non viability was close. And then they looked around, however, first for whether there was another option than resolution, and they asked UBS whether UBS would be willing and prepared to buy Credit Suisse and act as a white knight in that sense.

Tim Phillips [00:05:40]:
Now, you are one of the expert group on banking stability that was set up in May 2023. You

were tasked to investigate, and I'm reading this out here, the role of the banks and the state framework with a view to the stability of the Swiss financial center. So explain that to me. How wide was your remit? What information did you have?

Beatrice Weder di Mauro [00:06:01]:
The remit was actually quite wide, but in principle, forward looking. The task force was asked to learn the lessons from what had happened for the future, both for the Swiss regulatory framework, but also for the international one. Of course, the Swiss was the almost immediate question. But in order to be able to fulfill this task, of course, we could not just look forward. We also had to understand what happened and why it was not our mandate to investigate whose fault it was. No, seriously, that there are a lot of other commissions, in particular, parliamentary commission, which is essentially looking into much more that kind of aspect, understanding who said what to whom and what should have been done. So that was not the remit. But we had the possibility to talk to everybody we wanted to. We had very, very good access. We did 15/20 hearings with supervisors, with the people that were at the table, but also internationally and also with financial market participants, to hear their views of what were the lessons to be learned and what were the reasons that Credit Suisse failed in the way that it failed, and that this resolution was done in the way it was done.

[Voiceover] [00:07:20]:
Credit Suisse wasn't the only banking crisis in 2023. It was triggered in part by the failures of Silicon Valley bank, Signature bank, and First Republic in the US. What went wrong for them, and what can regulators, investors and customers learn? Listen to Making Banking Safe. Our episode featuring Stephen Cecchetti and Kim Schoenholtz from December 2023.

Tim Phillips [00:07:53]:
So let's look at regulation, first of all, and in the 15 years, gosh, has it been 15 years since Lehman Brothers, there have been a lot of updates to regulation from the perspective of the regulator. Immediately before it became non viable, was Credit Suisse sound?

Beatrice Weder di Mauro [00:08:13]:
Credit Suisse was fulfilling both the liquidity and the capital requirements regulations. That is a very important part of the story here. And it's not like in 2008, when also banks looked better capitalized in principle than they turned out to be in practice, because the capital was actually not fungible. It was, as it was later called, encumbered. In other words, when there was a solvency crisis during the global financial crisis, it was really a solvency crisis, because the capital that seemed to be showing on the books was actually not there to be used to absorb losses. That was not the problem of Credit Suisse. The capital was there, but the business model was no longer credible, and the trust in the company was failing. And eventually, this trust also failed among its clients and even its local retail clients in Switzerland. So the last three days, it was everybody running, including the retail clients, which had been very patient and sticky for a long time.

Tim Phillips [00:09:16]:
So tell me a little bit more about the candidate explanations for why there would be this run on a sound and what would narrowly be defined as a sound bank.

Beatrice Weder di Mauro [00:09:26]:
The main reason is that soundness and trust should not only be defined in terms of capital ratios. I mean, this is also, one of the lessons that we draw from this failure, that more generally, supervisors should be defining soundness more broadly, should be looking more broadly at indicators of financial markets, at indicators in a more forward looking way, describe the profit possibilities and the franchise value of the bank. Because if that one is gone, then of course, trust will also be gone. If nobody thinks that Credit Suisse will be able to make profits for many, many years, then shareholders will definitely not trust the bank anymore. And in fact, one of the triggers for the run was a major shareholder saying he was definitely not putting any more money into Credit Suisse. So that was definitely not helpful, not even for himself.

Tim Phillips [00:10:25]:
So are you saying here that the regulatory regime should be updated, revised, tightened? Or are you saying that the supervisors should be looking at a wider set of signals and maybe using more discretion?

Beatrice Weder di Mauro [00:10:41]:
One part of the lessons is to have more prompt corrective action type interventions, which would happen at a much earlier time, and which are looking at broader indicators than the ones that, to a certain extent, have grown out of the regulation from the global financial crisis. Because I want to repeat it, the global financial crisis was a solvency crisis. And the last ten years, the international community spent time in putting in place a regulation that has much, much higher capital cushions. And, in fact, this proved quite useful and important during the COVID crisis, when some of these capital cushions were used. So the whole thinking has been very much focused on capital and not enough on other dimensions of what can go wrong in a bank. After all, a bank is always going to be something fragile. That is, by definition, because the maturity of its assets and its liabilities are not the same. And that's part of what banks should be doing. That's part of their function. But I would also mention, Tim, one other thing that is important. This capital that has been built for G-SIBs is structured, and I think that's something that many people don't know. So at the core, you have the core equity, and there is a certain requirement for that. And then there is a second layer of equity, which is actually issued as bonds. It's called AT1 additional tier one equity. And then there is a third layer, which, together then, the three constitute the total loss absorbing capital. So total loss absorbing capital in Credit Suisse at the point of failure was almost 100 billion. So this is on a balance sheet of risk weighted 250 billions, or, if you wanted, not risk weighted 500 billion. It's a lot. Yeah, we're talking a lot of capital that potentially could be used for loss absorption. But this capital has to be a trigger for the AT1s and then the bail in capital to be triggered. And the AT1s, in the case of Switzerland, could be triggered when there is a public sector intervention. So the supervisor had. This is a dual trigger it's called, if capital fell below 7%, which it never did, or if there had

been a public sector intervention. So this is one of the lessons that is actually a positive lesson from Credit Suisse and from Switzerland that worked, triggering the AT1s and therefore using this additional capital to be able to make this sale. But it would equally have been available for another form of resolution. That part worked, but what would have been the next stage would have involved bailing in another 45 billion, and that part was not activated. That's why a lot of people then afterwards said that too big to fail regime was not really tested because it was not applied.

Tim Phillips [00:13:44]:
Yes. Let's talk about that resolution in a little bit more detail. I want to go back to the beginning of that weekend when the fate of Credit Suisse was decided. What options were on the table?

Beatrice Weder di Mauro [00:13:56]:
The options on the table were an option that was not in the too big to fail regime, Swiss. Namely, they did look into whether the state should take it over, but that was quickly discarded. The second option was a sale to UBS, and the third option was this bail in, I described before, that would have been declaring the point of nonviability and bailing in all of the AT1s and the additional bail in bonds. And in the last option, Credit Suisse would have been a very, very highly capitalized bank on Monday morning. But in the takeover option, of course, it was a highly capitalized bank, but with the backing of UBS. At the end of the day, those were the two options that the authorities had to decide about. And by the way, not only the authorities, but also the boards of the two banks had to agree.

Tim Phillips [00:14:46]:
Yes. And that resolution plan, that bail in plan, explain to me exactly why was that not followed in the end? Why was that unpalatable?

Beatrice Weder di Mauro [00:14:56]:
What we found out in the expert group is that it could have been followed. It had been thoroughly prepared, especially also at the international level. That's very, very important, because if you are bailing in and doing this for the first time for a G-SIB, you're actually applying this bail in of some 40, 45 billion, and that would have been converted to equity. It would have been very, very high loss to the bail in bond holders. That had to be prepared, and it had been prepared. So the crisis management group had been meeting for months, ever since October. And they were in fact prepared to do that with some little wrinkles that I'm happy to talk about, because there were some uncertainties. But clearly, one of the uncertainties that cannot be resolved just by technical preparation is the question, how much would clients, markets and everybody trust this newly recapitalized Credit Suisse on Monday morning? It would also have had another management, or at least another board, and possibly a different strategy. But the question would the run have stopped on Monday morning? That is a question that we will not be able to answer because we don't have the counterfactual. But we do know that in the option that they chose, the run essentially stopped immediately. So the authorities now can really claim that they did do not only Switzerland, but also probably the world a favor by stopping the contagion

almost completely. There was some surprise around the 80 ones and already caused quite a bit of uncertainty, which then died away within a few weeks.

Tim Phillips [00:16:31]:
I remember that uncertainty and that surprise. Tell me about those wrinkles, though.

Beatrice Weder di Mauro [00:16:36]:
One of the wrinkles is that when you convert bail in bonds, certain jurisdictions, in particular the US, the SEC would have to declare that this is an exemption. They would not go through the whole process of what usually a sale would entail, which can take months. So obviously you cannot bail in over months and live with the uncertainty. So the SEC is an important player that needs to play ball in the sense that it would have to immediately also declare an exemption. And there is a question whether some other jurisdictions also, there is enough legal certainty around this bail in proposition. Now, in the case of Credit Suisse, because of the crisis management group, which had included the SEC, eventually they were confident that they could do it, that the SEC would actually grant the exemption, and that enough work had been done previously. But the SEC is at the moment not prepared to do this exante. To say exante. We will look at this and give assurances that there will be an exemption. That is a problem which goes way, way beyond Switzerland. In fact, I repeat, for Credit Suisse, it probably would have worked. But all the other G-SIBs that have this bail in element as an important part of the resolution plan, this needs to be resolved at the international level. And in fact, FSB is well aware of their center and there are talks that are happening. But it is one example where it shows that the whole question of cross border is tricky, continues to be tricky. Why was the Lehman Brothers so terrible for the world? Because it was cross border. It was disorderly cross border failure, which led to rig fencing everywhere. In the last ten years, regulators have been trying to set up a framework that does not lead neither to bailouts nor to ring fencing. But one of the consequences of that framework is that there is some exante ring fencing. We need to have more work on how to think about that in order to make it more robust for the future.

Tim Phillips [00:18:42]:
Twelve months ago, many people were afraid that more banks would follow after this. The resolution happened, even if it didn't follow the plan that most people were expecting. And more banks did not fail. So can we call this a success?

Beatrice Weder di Mauro [00:18:57]:
The actual bail in was not tested, so I would call it a success in terms of stopping the contagion. And so for financial stability purposes, clearly it was a success. There are other lessons that need to urgently be learned by other countries. So, for instance, funding and resolution is not something that was available in Switzerland. That's the main reason why emergency law was needed in order to be able to do this resolution. And any kind of resolution, turns out you need a lot of liquidity to be able to conduct the resolution. And this, in the Swiss case, was put in place through a public liquidity backstop for the Swiss National bank. And this was used, this was needed. So the Swiss National bank gave up to 180 billion. Again, this is a large number

for a country that has a GDP of about 700 in the peak. But since the run stopped very quickly, both the guarantee was given back and the liquidity was returned. These are expensive things for the bank, not encouraged, at least in Switzerland, to sit on such liquidity or to sit on such guarantees. But the lesson there in particular for Europe is that funding and resolution is not solved in Europe yet. And therefore, it's rather good that no other G-SIB has failed until that piece is put in place. And we can be sure that the cross border effects and in fact, the ability to do the bailing are in place.

Tim Phillips [00:20:30]:
Either in Switzerland or beyond Switzerland. Do you think that regulators are aware of what needs to be done and there is the will to do it?

Beatrice Weder di Mauro [00:20:39]:
Yes, definitely in Basel and in the corresponding committees, there is some soul searching. And of course, a lot of people also said, well, I've always said it, we need funding and resolution. This proves it. And others are saying, I've always said it, the AT1s are problematic anyway, and we should never have gone for this kind of structured equity. There is, of course, a danger that since nothing else happened, the fears of contagion have subsided. There is a danger of complacency. I do sometimes hear, oh, well, the Swiss were just sleeping and they should have intervened much more strongly, much, much earlier, that could never happen to us, kind of thing.

Tim Phillips [00:21:36]:
Beatrice, thank you very much for talking about this from what you found out and for explaining it. And let's hope that people's memories aren't too short. Thank you for talking to me today.

Beatrice Weder di Mauro [00:21:46]:
Thank you, Tim. Great to be here.

Tim Phillips [00:21:57]:
If you want to read more about this, then the expert group on banking stability's report was called; The need for Reform after the Demise of Credit Suisse. I'm not going to list all the authors, there's many of them, but you can find it at too-big-to-fail.ch. There's also a VoxEU column called Global Lessons from the Demise of Credit Suisse, based in part on that report, and Beatrice Weder di Mauro and Yvan Lengwiler are the authors of that that came out on the 4 September 2023.

[Voiceover] [00:22:37]:
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