Doing ‘whatever it takes’

Description

Maria Demertzis*

The early March failure of Silicon Valley Bank (SVB) in the United States, and the sale of Credit Suisse to UBS in Switzerland are reminders of an era of financial troubles that we would rather not revisit.

Just over 10 years ago, and in the middle of the global financial crisis, the then-president of the European Central Bank Mario Draghi’s statement, on 26 July 2012, that *“…within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough.”* On that occasion, when the banking crisis threatened the integrity of the euro area, just the commitment to doing something proved enough to calm the markets, not just locally, but worldwide.

However, one can promise to do ‘whatever it takes’ and then get away with not having to do it only once. The next time a need arises, one must follow through. Whatever action is taken must then necessarily be big, probably unprecedented and will likely create a lot of problems. This is exactly what happened in the wake of SVB and Credit Suisse. Faced with turbulence in financial markets again, the response of policymakers was bound to be erring on the side of doing too much.

In both the US and Switzerland, regulators worried about the effects one bank’s problems might have on the whole system. They opted to stretch, if not bend, the rules in an effort to do whatever was needed to stabilise the system. While they were still legally within their rights, the actions taken were unexpected and will possibly have long-lasting effects.

In the case of SVB, the issue was deposits. The deposit-guarantee scheme that was designed after the financial crisis covered only the first $250,000 in each account. But as most of the bank's customers used the bank for day-to-day cash management, like paying salaries, implementing this scheme would have wiped out the cashflows of many companies, which would then have been unable to pay their staff. The knock-on effect was unclear and not something policymakers were willing to contemplate. The memory of a tiny segment of a national market, the subprime market in the US, starting a financial crisis, is still very vivid in their memories. Unwilling to take that risk, they guaranteed all deposits, not just the first $250,000.

Now the question is what happens next? Are all bank deposits now guaranteed everywhere and all the time? Who pays for these guarantees? Are the funds that banks put aside for such cases still sufficient? Is the taxpayer again going to bear the burden? The move to guarantee all deposits potentially changes the face of retail banking. Is this what policymakers wanted to achieve?

The challenges faced by Credit Suisse a few days after the SVB failure were different, but in departing from the rules, the response of policymakers was similar.

Faced with the need to write down the value of assets in order for Credit Suisse to be bought by UBS, the authorities bypassed the order in which this is done for the different types of assets. Usually, the holdings of shareholders are wiped out first before other asset holders. But the Swiss authorities opted to preserve some value for shareholders and completely wipe out the value of AT1 bondholders instead.

Credit Suisse AT1 bondholders were appalled and will go to court. But the ramifications of such a reversal in how value is diluted in distress situations go beyond Switzerland. Worldwide AT1 bondholders worry they are now first in the line of fire in any situation in which value needs to be written down, though the contracts they originally signed were different. European Union financial authorities rushed to issue reassurances that such a thing would not happen in their jurisdiction. But how could they possibly be credible in arguing this, when in the space of a few days, there have been two examples of authorities opting to do 'whatever it takes' to protect their domestic markets?

There are no longer local markets, just local interests. Particularly for the banking sector, which is so globally connected and in which information travels instantly, one area's problems are everyone's problems. As crises accumulate, the weapons to fight them get bigger and bigger. No doubt once the dust settles rules will adjust to widen the set of contingencies they deal with. But is this really the problem? Maybe it is not the rules that need a rethink this time, but the system, which is having its limits tested.

On the other hand, the system appears to converge on one rule: and that is, we will do whatever it takes.

***Maria Demertzis is a Senior fellow at Bruegel and part-time Professor of Economic Policy at the School of Transnational Governance at the European University Institute in Florence. The article is published by Bruegel and is also posted on the blog of the Cyprus Economic Society.*