Unwinding financial system support policies and rebuilding a resilient financial system

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Exiting financial system support

- Objectives – the brave new world
- Health of the financial system
- Principles guiding exit
- Transitional issues
- Cross border co-ordination
- Long-term challenges
Long Run Objectives

- Healthy, competitive, stable, financial system that supports the economy
- Facilitates efficient allocation of resources within and across time
- Supports management of financial risks
- Resilient to adverse shocks
- Can cope with failures
- Lower probability and impact of financial crises
The Financial System - Overview

- Healing is uneven and the system
  - is vulnerable to adverse developments;
  - has less capacity for maturity transformation and for providing long-term credit;
  - and faces large refinancing pressures.

- Sovereign risk crystallised in Europe
- Adverse feedback loop to financial system
- Squeeze in market liquidity and credit
- Further policy actions needed
Uneven healing, still vulnerable

Capital raising positive
But further to go

More credit losses expected
Legacy assets still a burden

Cumulative capital raising and writedowns (USD bn)

US Loan-charge-off rates (% of total loans)
Less capacity for long-term credit

Incentives for carry-seeking positions

Moribund private securitization markets

Bank term spread (10 years – 3 months) (in bps)

Global issuance of structured financial assets (USD bn)
and major refinancing pressures

Bank funding shortest for 30 years

Bunching of refinancing
Heavy competition for funds

Bank debt maturities (in years)

Banks’ syndicated debt by maturity (USD bn)
Principles guiding exit strategies

• Objectives
  – Enhance stability
  – Support market-based exit
  – Limit distortions, spillovers and arbitrage

• Desirable features
  – Pre-announced
  – Flexible
  – Transparent
  – Credible

• Need to balance these considerations
Timing of exit

• Assess both current conditions and future risks
• Early exit from most distortionary/costly (e.g., guarantees below market prices)
• Encourage timely capital repayment. But:
  – Revised prudential standards
  – Demonstrated market access
  – Avoid excess deleveraging
  – Premature exit requiring reversal has credibility costs
Objectives for exit policies

1) Address weak banks

2) Gradually remove system-wide support
Transition – system support

• Case for system-wide support measures is diminishing
• Though crystallisation of sovereign risk in Europe has required reintroduction of some support measures (liquidity, fx swaps)
• Emphasises timing challenges for policy makers
Transition – weak banks

- Treatment of weaker banks:
  - Viability of business models (resolve non-viable operations, incentivise recovery of viable business)
  - Separate/ring fence impaired assets (incentives to limit systemic spillovers from fire-sales)
  - Risks of competitive distortions affecting performance of healthy banks
Cross border co-ordination

• Optimum timing of withdrawal likely to vary
• Gains from information exchange and co-ordination:
  – Minimise cross-border distortions and arbitrage
  – Minimise collective action problems
  – Largest gains where spillover risks highest (such as deposit insurance and liability guarantees – eg Hong Kong/Singapore/Malaysia co-ordinating removal of exceptional retail deposit insurance)
• Strengthening infrastructure and framework for foreign currency liquidity (G20 group)
Addressing long run moral hazard

- Recent crisis has massively expanded moral hazard risk
- G20 charged FSB to propose measures to address ‘too big/complex/interconnected to fail’ by Oct 2010
- Possible approaches:
  - Reduce probability and impact of failure
  - Improve resolution capacity (national & cross-border)
  - Strengthen market infrastructure
- No ‘silver bullet’ likely
Transition to long run objectives

- Restore sound public finances
- Rebuild market confidence
- Exit distortionary support policies
- Strengthen financial system resilience by introducing new regulatory framework
- Solve the ‘too big to fail’ problem
- Remove perception of implicit support
“Stability” said the Controller. “stability. No civilisation without social stability. No social stability without individual stability.”

(Brave New World: Aldous Huxley Chapter 3)