Nigel Jenkinson
Financial Stability Board

My comments focus entirely on financial system support measures while recognizing that there are clear links between exceptional policies to support the financial system and extraordinary measures to bolster the macroeconomy. I will cover four areas: (1) the principles guiding exit, (2) transitional issues, (3) cross-border coordination, and (4) some long-term implications and objectives.[1]

Principles guiding exit

There are a number of unexceptionable high-level objectives and desirable features that can be set out as guides to decisions on exit. In practice, however, tensions may exist between them (or even within them), and the challenge is judging how to balance the respective objectives and the associated risks. For example, all would agree that decisions on exit should be taken to support financial stability. But a balance still has to be struck between decisions to keep policies in place as a temporary backstop and the risk that such a backstop, if not very well designed, could lead to continued support for unsustainable business models, potentially sowing the seeds for future problems.

Less difficult is the principle that decisions should support market-based exit, for example by setting pricing incentives that lower the usage of support measures as markets normalize; and the principle that exit decisions should limit market distortions, spillovers, and arbitrage across borders. But there are potential tensions between the goal that exit strategies should be transparent and preannounced to give market participants time to prepare and the goal that they should be flexible to give the authorities the capability to respond to changes in market conditions. Again, in practice, a balance needs to be struck: to gain flexibility, announcements in some cases could be state-contingent—providing market participants with the information that will condition the policy decision—while still recognizing that decisions with preannounced timetables could sometimes yield benefits given that they are likely to be easier to understand and thus to implement.

---

[1] My remarks draw extensively on the note prepared by the Financial Stability Board for the recent G-20 Finance and Governors meeting at St. Andrews: “Exit from Extraordinary Financial Sector Support Measures,” Financial Stability Board, November 7, 2009.

Timing and transitional issues

Decisions on the timing of withdrawal of support also require the weighing of uncertain costs and benefits. For example, timely repayment of public capital is desirable both to reduce financial market distortions and to lower fiscal risks. But prudential supervisors need to be confident that a bank repaying such support has a sustainable capital position, taking into account the higher standards that will be required in the future, and that the capital planning of the banking system collectively does not compromise aggregate credit provision. Moreover, the incentives of the individual banks may not be fully aligned with those of the authorities. For example, a bank may be particularly keen to exit the support arrangements to demonstrate renewed strength. But it may also be more prepared to take the risk that such an exit may be premature, relying on a too-big-to-fail backstop from the public authorities if it gets into trouble again. The moral hazard this engenders, and indeed the crystallization of renewed failure, are clearly outcomes the authorities wish to avoid.

As the financial system gradually heals, stronger banks will regain normal market access, while weaker banks may not. In its note for the November 2009 G-20 meeting, the Financial Stability Board judged that the case for systemwide support measures is diminishing given the improvements in recent months. In dealing with weaker banks, authorities face challenges in judging which are potentially viable as a whole or in part and ensuring that nonviable operations are resolved and wound down. There is a good case for separating the impaired assets from the healthy part of the bank to provide incentives both to manage the healthy business effectively and to seek maximum value from working out the impaired assets over time. There are, of course, risks that managing such assets down too quickly could lead to fire-sale externalities on the rest of the system; that needs to be reflected in the mandate of the management of the workout.

Cross-border coordination

Recognizing the differences in the strength of national financial systems, the optimum timing of withdrawal from support is likely to vary across countries. Nonetheless, there are gains from coordination, given that support measures and uneven exit decisions distort the allocation of capital across borders. Clear gains are to be had from information exchange and stronger forms of coordination regarding programs whose adverse spillover risks are highest, such as funding guarantees and exceptional retail deposit insurance measures. The agreement between Hong Kong SAR, Singapore, and Malaysia to set up a joint group to coordinate the exit from the exceptional retail deposit guarantees that expire at the end of 2010 is a good, practical example. Such coordination helps to resolve the potential collective action problem, in which countries may wish to end support but may be individually cautious about doing so unilaterally because of a fear of leakage of funding to other countries. Without coordination, the distortionary policies may remain in place, when in practice bringing the countries together and implementing a common decision would achieve the first-best outcome of collective exit.

Longer-term considerations

Finally, it is important to recognize that besides judging how and when to exit, authorities need to address the issue that such policies have substantially magnified the moral hazard distortions arising from institutions that are too big, complex, or interconnected to fail. Indeed, until this issue is addressed, financial institutions may well act as if they have an implicit backstop, even though the support measures have been formally withdrawn. The G-20 leaders have consequently charged the Financial Stability Board to work with member national authorities, international institutions, and standard setters to identify proposals, by October 2010, to address the moral hazard risks. That work is progressing on three broad fronts: policies to reduce the probability and impact of failure; policies to strengthen national and international contingency planning and crisis resolution tools; and measures to strengthen market infrastructure to withstand failure. There is unlikely to be a single "silver bullet" to lower the moral hazard risks associated with systemically significant institutions. But it is vital that we keep this key issue very much in mind in reviewing exit policies and the redesign of the regulatory system.