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How to design the unwinding of public interventions depends on the objectives governing the exit, the conditions in the financial sector, and the desired sequencing. Practical criteria for capital repayments can facilitate an orderly exit. Recent experiences contain several lessons on how to foster the restoration of private control in the financial sector.

Objectives for government interventions and exit

There are three leading objectives governing support measures and exit strategy:

1. The overriding objective is to preserve financial stability. Safeguarding the provision of credit to the economy and the robustness of the financial infrastructure should dominate other goals.
2. Distortions of market functioning should be minimized. Ensuring market discipline requires, inter alia, preserving a level playing field and providing adequate incentives for a timely exit.
3. Support measures and exit strategies should seek to minimize costs to the taxpayer.

Admittedly, in terms of exit timing, there may be a trade-off between the second and third objective.

The current setting for unwinding of public interventions

The exit from public support is currently being designed while the banking sector is still fragile. Funding profiles are short and refinancing needs over the next two years are massive, but wholesale and securitization markets have not opened up sufficiently. At the same time, central banks are expected to gradually withdraw their nonstandard liquidity support. And on the regulatory side, the Basel Committee on Banking Supervision is expected to raise the liquidity requirements for banks over the next couple of years. In all, banks face severe financing challenges over the near term.

Sequencing

The design of the exit strategy should jointly consider the various support measures, as they are to some extent substitutes and should not be seen in isolation. In any event, an exit from liquidity support should be given priority to allow a return to normal monetary policy operations and to avoid residual risks accumulating on central banks' balance sheets. Beyond this, in order to provide a back-stop, guarantee schemes could be kept open for as long as major funding vulnerabilities remain. At the same time, higher pricing of these guarantees could limit market distortions. Ideally, the schemes would temporarily continue to exist without being drawn upon. In any event, an exit from these guarantee schemes should be market driven, pre-announced, and gradual.

With regard to the unwinding of support for solvency, a flexible, tailor-made approach should be pursued according to the nature of the specific support instrument used, i.e., capital injection, asset guarantee, nationalization, or bad-bank structure. Capital injections and asset guarantees may generally be easier to exit in the short term. In contrast, unwinding a nationalization or bad-bank structure is likely to take longer, as that often requires developing and implementing a new bank business strategy. In this respect, there are several examples of supported banks in the European Union that are undergoing far-reaching structural changes in their business model, in some cases pressed by the EU competition authority.

Criteria for capital repayment

The repayment of capital injections should be assessed from both a micro- and macroprudential perspective. In the Netherlands, four explicit criteria and one implicit criterion are applied:

1. An institution's capital level must be at least equal to the supervisory target level before as well as after repayment of public funds. Stress-testing is an important instrument to establish this target level.
2. Private capital that is used to repay public support should be of at least the same quality (core Tier 1) as the capital that is replaced.
3. Third, an institution considering repayment of public funds should have demonstrated access to both equity and funding markets. This serves to limit liquidity risks after repayment. Admittedly, a clear-cut assessment of this criterion is currently hampered by the heavy reliance on central bank facilities and public funding guarantee schemes.
4. Finally, banks should not repay public support by freeing up capital through excessive deleveraging. Seen from a macroprudential angle, repayment should not exacerbate balance sheet constraints, forcing banks to cut back credit supply and thereby hampering economic recovery.

An additional, implicit criterion is that repayment of state support should not accommodate a bank that wishes to exit for the wrong reason (e.g., to circumvent restrictions on its compensation policies).

Lessons learned

Recent experience points to several lessons in the design and unwinding of public support schemes. A first lesson is that the schemes should provide incentives for a timely and automatic exit, for instance through exit premia that start low and increase over time. In practice, such premia have had a material impact on banks' enthusiasm to exit. Second, schemes should be flexible in order to allow for a tailor-made exit across support instruments, institutions, sectors, and countries. Indeed, speed of recovery and readiness to exit have been uneven across these dimensions. Third, exit programs need to be based on a thorough assessment of a bank's business model and forward-looking strategy.