



LET'S TALK ABOUT...

FINANCIAL LEXICON EDITED BY THE SWISS ASSOCIATION OF ASSET MANAGERS

Exit Strategy

(Part One) This term happens to be widely met in the media, in connection with the recent economic and financial crisis still in progress. It comes from the strategic-military domain, and, later, the corporate business lexicon. The first meaning points to a situation where evolutions different from the expected ones, new balances of power, unforeseen outcomes, lacking political and operational motivations, all induce to disengage from a military action without destabilizing the scenario and, first of all, saving one's face. The second meaning refers to operators of direct or indirect investments in corporate activities, who do not have their objectives reached, their expected returns being not met, so aiming at limiting damages and liquidating their participations with the least negative possible outcome. For the design and implementation of exit strategies in corporate worlds specialists exist today, particularly when corporate events such as mergers, acquisitions, restructurings are underway.

But the current use of the term in today's communication is still different: it denotes the progressive reduction, up to their cancellation, of the interventions that government and central banks have operated after the dramatic financial crisis that spread from the subprime sector to the whole credit area and related securities, fueled by huge debts, excessive leverages, so taking to illiquidity and the disruption of many financial institutions. And then financial difficulties were to strongly and negatively affect the "real economy" too. Then governments and central banks put in place their massive actions and, after exhausting the range of their traditional interventions, other unconventional operations were defined and implemented, which we already mentioned in some previous articles. *(to be continued)* -
GLT

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(Part Two) Governments and central banks have carried out a wide range of both ordinary and “non conventional” actions aimed at sustaining economies and bailing out financial institutions in critical conditions, by injecting liquidity while buying various types of securities, including the “toxic assets”, that is non-negotiable and uncertainly priced securities, or simply by printing money through “quantitative easing” operations. Such topics have been already covered in this space, although shortly. Now, despite the crisis being well far from over, “exit strategies” are considered and discussed, in order to gradually scale down such supports and interventions until financial and economic systems can move normally out of their own means. However some points need consideration. First of all, a crisis which has been mainly generated and fueled by excessive debt has been – and still is – cured with new debt, moving the problems from private to public sectors (so heavily weighting on government deficits and overall debts), and posing the roots for further financial crisis. When speaking about exit strategies, the main question arising may be “exiting from where and bound for where ?” The support actions have allowed many “zombie companies” to stay alive, have frozen huge amounts of bad and toxic assets and put the public hands into many businesses, up to partly or fully nationalizing them. Thus the scenario has changed drastically and all exit strategies have to take into consideration major questions such as the following ones: what to do with “frozen” bad assets and how to price them? To place them back on the market again through some new inventions of financial engineering or not? To keep public participations in financial and industrial institutions? To promote mergers between financial institutions so to make them stronger and better suited for growth on the long run (and that may be a very topic subject for Switzerland financial industry too)? Obviously, whichever the answers and the related solutions, they will also affect the real economy in terms of labour market, households’ consumes and investments, corporate environments... So, this simple words so much used (and abused) by media and politicians, actually implies complex and articulated problems. *(to be continued) - GLT*

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(Part Three) After supplying abundant liquidity to banks and the financial system, also by acquiring risky and even toxic securities from a wide range of institutions, many more indeed than the usual central banks' counterparts, the time comes to think about some sort of exit strategy, that is the paths taking to disengagement and return to normal conditions. We already noted how the "after" of such moves is important, in order to favour a new efficient financial order and a sustainable economic growth. Apart from ideological, ethical and political considerations, which lie beyond the scope of our analysis, we just consider some more technical features, also possibly affecting the area of portfolio management. The first point is about overcoming the emergency phase, still under way in some countries, by insuring bank deposits and, although at a lower level, households' investments, as well as by supplying liquidity to banks and removing bad assets from their balance sheets, through all necessary actions, both ordinary and unconventional. We also noted how such toxic securities have actually and hugely moved from private to public hands, so pressing the public accounts of many nations. Thus, on overcoming emergency, the question arise how to deal with these instruments and how to recapitalise the financial institutions which have survived the secular perfect storm. So, what about the bad assets? Of course they should gradually move back from the public books to the private financial institutions, aimed at being placed on the market again and absorbed, through vehicles such as pensions funds, insurance companies, mutual funds, sovereign wealth funds... But in order to make this possible, they need realistic and reliable pricings, so to become tradable again, at least on a medium to long time perspective. However, evaluating toxic assets out of an exit strategy may prove no easy job at all, for many different reasons. *(to be continued) - GLT*

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(Part Four) Within the exit strategies that governments and central banks are planning, the “return” of previously absorbed toxic assets from banks is one of the main points. We previously mentioned some kinds of institutions which could be the receivers and the new holders-managers of such bad assets, also noting how their evaluation could prove particularly difficult, as they have been “out” for a long time, without any open-market pricing and marking in terms of demand and supply flows. Low visibility and transparency particularly affects the most sophisticated instruments among them, as the structured products whose underlying items often are no real assets at all, but rather nominal and already defaulted credits or even no more than paper items with no intrinsic values.

The “second” rescue of toxic assets may follow different paths, by using both mixed public-private structures and newly designed fully private ones, specifically aimed at creating new markets for them, perhaps favouring the merger of already existing institution in order to make them financially stronger and better suited for the difficult task. Of course the bad assets are to be held on a medium-to-long term perspective, gradually making them priced again and progressively absorbed by the broad market. Some of them, no longer valid and acceptable in terms of value, will be simply written-off and cancelled.

No doubt such operations require large amounts of money and the second big question then arises about the strategy of recapitalization for the banking system, via the capital markets or the prolonged public support.

Recapitalizing banks in adequate forms is not only important so to ensure durable and regular balances of the overall financial system, but also for the real economy itself. Inadequate capital could further limit the already restrained lending by banks to firms and families, so deterring consumes and investments within a scenario already dominated by high unemployment and poor, if any, growth.

Financial restoring and fixing-up bad assets (or at least a major part of them) also may concern other relevant institutions, such as the pension funds, from which the future of most families depend. Finally, all of that should be carried out within a new frame of careful risk monitoring, limitation of leverage for all financial actors and better caution in funds’ management at any levels. *(end)*

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