

Discussion of 'Bank bailouts and market discipline: How bailouts expectations changed during the financial crisis'
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Introduction

Following the Lehman collapse, public authorities responded to the ensuing financial panic by generalized and institution-specific rescue packages

- The generalized rescue operations addressed mainly funding needs of banks. These included increases in deposit insurance limits and official guarantees of newly issued bank debt
- By contrast, bank recapitalizations and asset purchases were in most cases tailored and available to specific institutions only, and they addressed solvency problems

Table 1

Bank rescue packages.

	AT	AU	BE	CA	CH	DE	ES	FR	IT	JP	NL	SE	UK	US
Deposit insurance														
Capital injections	✓		✓		✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Debt guarantees ¹	✓	✓+	✓			✓	✓	✓			✓	✓	✓	✓
Asset support ²		(✓)	✓	(✓)	✓	✓	(✓)	✓-		(✓)	✓-		✓-	✓+

Note: Shaded areas represent generalised bank rescue packages (or expanded deposit insurance schemes, respectively). Ticks indicate actual usage, i.e. specific actions taken either under the programme or as standalone actions. Example: the recapitalisation of UBS is shown as a tick in an unshaded area in the column CH, since it was a standalone action (there was no generalised recapitalisation programme). AT = Austria; AU = Australia; BE = Belgium; CA = Canada; CH = Switzerland; DE = Germany; ES = Spain; FR = France; IT = Italy; JP = Japan; NL = Netherlands; SE = Sweden; UK = United Kingdom; and US = United States.

¹✓ = Guarantee on new issuance and ✓+ = guarantee also covers outstanding stock of debt.

²✓ = Actual asset purchases or insurance; ✓- = asset insurance only; ✓+ = actual purchases and insurance; and (✓) = asset purchases conducted as part of a programme for supporting key credit markets (rather than specific banks).

Sources: Central banks; government sources; press reports.

Brei, Gambacorta and von Peter (2013)

Consequences of bank rescues

- The rescue operations appear to have been successful when assessed by their primary objective - the mitigation of a financial panic and the collapse of the banking system
- Rescue operations can have important negative consequences, notably they can become very costly - if not properly employed - and be associated with unproductive support costs
- Another negative, but more indirect consequence is the danger that bank behavior becomes distorted by government rescues. The expectation of state support, system-wide or bank-specific, may give rise to moral hazard and/or erode market discipline

⇒ The present paper focuses on these indirect costs associated with distortions that might be created by market participants' perceptions that governments are unwilling to let banks fail

Brief summary

- The authors investigate whether bank spreads - measured by changes in CDS spreads - remained sensitive to firm-specific risk characteristics in response to the bank rescues in the US and the failure of Lehman Brothers
- Any insensitivity of bank spreads to observable risk characteristics is then interpreted as an erosion of market discipline
- This is a valuable question since a similar reaction of market participants has been observed in the aftermath of the rescue of Continental Illinois in 1984 (Flannery and Sorescu, 1996)
- To derive the econometric model, the authors use the framework on the structural firm value introduced by Merton in 1974 which uses insights from option pricing theory
- The results show that the sensitivity of bank spreads to risk characteristics declined following the rescue of Bear Stearns, especially after the Lehman collapse and TARP program. The effects are more pronounced for large financial institutions and investment banks. There is no comparable effect for non-financial firms

Comments

- The paper is a valuable and interesting contribution. It combines theory and econometrics, using complex financial data. It is very well written
- In the introduction, there is a literature review on market discipline. However, since the paper is to a large extent on bank rescues, one could also add a short paragraph on the literature on bank rescues
- Was not one objective of the rescue packages to make bank spreads less sensitive to risks? For instance, debt guarantees of newly issued bank debt are intended to keep bank spreads at normal levels. Thus, it appears that one should distinguish two periods after the Lehman collapse: one during which debt guarantees have been in place and one thereafter
- It would be interesting to see if there is a differential impact across banks that received TARP funds and those that did not

- The reduced sensitivity of CDS spreads to bank risks might in part be due to the fact that this sensitivity depends on the level of risks. One could take this non-linearity into account by including in addition the square of the risk proxies or by interacting them with a dummy for low vs high risk banks (measured by the same risk proxies used)
- Did the authors take into account that creditors might have responded by shortening the maturity of debt rather than its price? Market discipline might manifest itself by the threat of providing funding that can be not renewed on short notice
- The discussion of the results comes a bit short compared to the theoretical part. It would be helpful to explain the magnitude of a coefficient