Public Guarantees on Bank Bonds: Effectiveness and Costs

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OECD Banking Law Symposium 2011 - Paris, 3-4 October 2011

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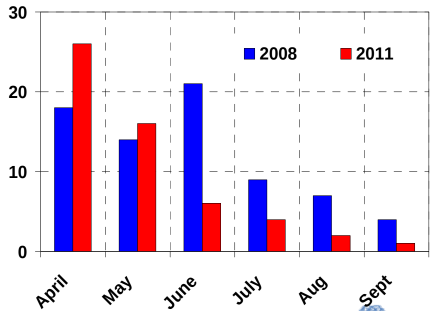
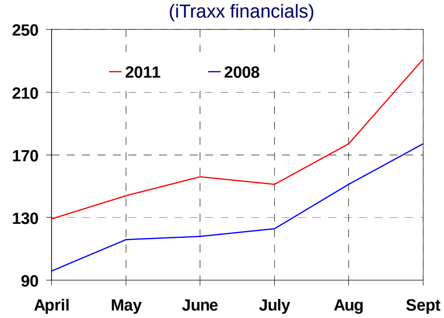
- 2008/09: governments issued guarantees to contain deterioration of fin'l conditions. They were subsequently discontinued…
- …but EA mkt conditions are worse today than in 2008!

Bond issues by EA banks: 2011 vs. 2008
(billion €)



CDS on EA banks: 2001 vs. 2008
(iTraxx financials)



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Outline of the presentation

1. Guaranteed bank bonds (GBBs) in the context of rescue measures
2. GBBs: were they effective?
3. Can we do the trick again?
    - Medium-term costs (distortions, moral hazard)
    - Are sovereign guarantees still valuable?
4. Conclusions

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The rescue measures: some background

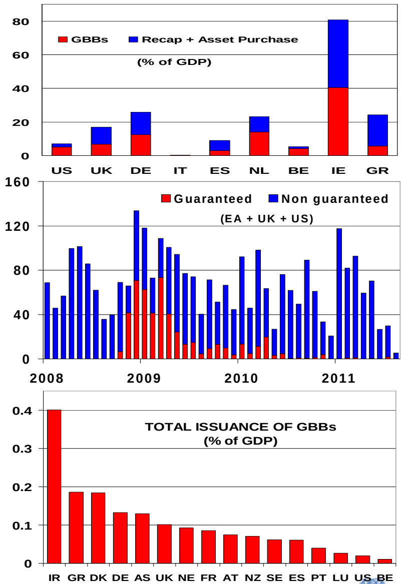
- Oct. 2008: Gvts adopt measures to support banks
    - Guarantees on new debt;
    - Capital injections;
    - Asset purchases/asset guarantees
- These measures had two main objectives:
    - Support funding, in order to avoid liquidity crises and bankruptcies
    - Support lending, in order to reduce the likelihood of credit crunch

Focus on GBBs

- Did GBBs achieve the two objectives?
- Caveat: assessing effectiveness is a challenging task
    - *Counterfactual* is unknown (eg, what would have happened in the absence of intervention?)
    - Difficult to *separate* effects of GBBs from those of other rescue measures

1. GBBs in the context of rescue measures

Some facts: banks used GBBs extensively



- GBBs were the most heavily used tool, partly because they do not affect budget deficits
- GBBs represented a large % of total issuance of bank bonds, especially until mid 2009
- GBBs were used extensively in countries hit hard by the crisis, especially by banks that had lost mkt access

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2. GBBs: were they effective?

Obj. 1: Avoid widespread bankruptcies

- Three indicators of the impact on banks' default risk:
  - o The CDS spread of the banks that issued GBBs decreased **(Chart)**
  - o The cost of non-guaranteed bond funding decreased significantly **(Chart)**
  - o No. of guarantee calls: despite large volumes of GBBs and bank vulnerability, guarantee calls have been rare

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Obj. 2: Support credit supply (1)

- Assessing the effect on financial intermediation is even more difficult, due to several factors that may generate confounding effects on credit supply:
  - o Banks' strategies: banks may have chosen to use funds to strengthen balance sheets rather than to increase lending
  - o Macro conditions: credit supply was likely affected by strongly expansionary monetary policies, economic recovery
  - o Micro factors: lending standards likely influenced by bank-specific characteristics which are hard to measure and may emerge slowly (eg losses)

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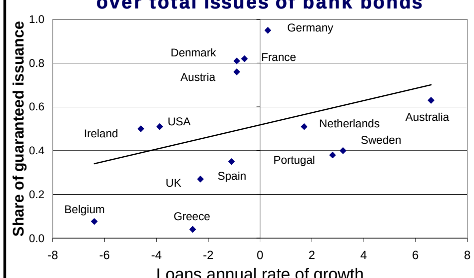
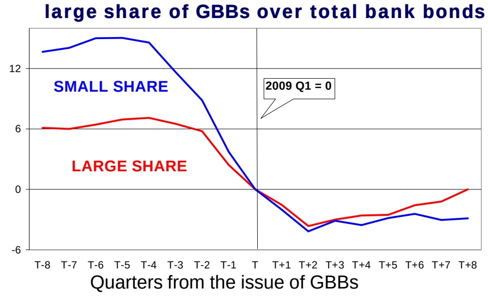
Obj. 2: Support credit supply (2)

➢ Systematic analyses of the effect of guarantees on bank lending are not available

Growth of bank loans vs % of GBBs over total issues of bank bonds



Loans growth for countries with small and large share of GBBs over total bank bonds



o These (very) preliminary analyses point to a positive relation between lending growth and the intensity of recourse to GBBs

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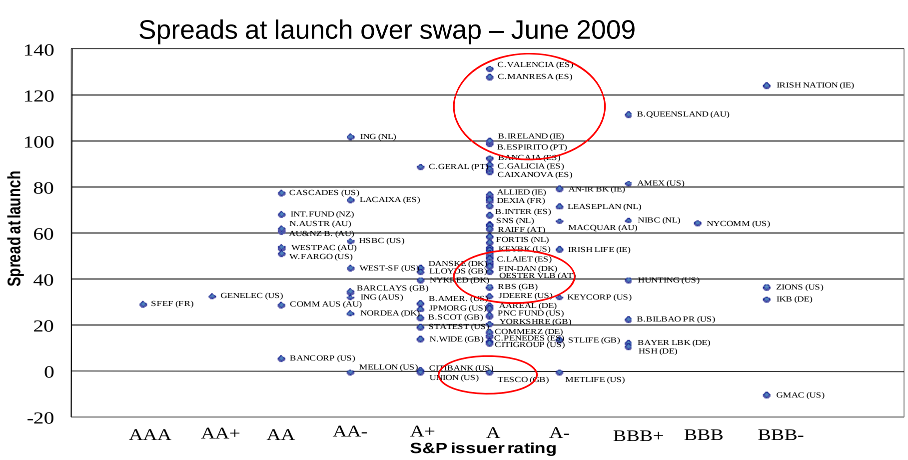
Can we use GBBs again?

- All in all, guarantees seem to have contributed to the smooth functioning of the financial system
- Can we use them again? At which conditions?
  - o Distortions to functioning of banking markets
  - o Deteriorating sovereign risk

Cost Distortions (1)

Cost of GBBS differs sharply even for equally rated banks



Cost Distortions (2)

- Empirically, during the crisis 65% of the spread of GBBs reflected the risk of the sovereign, NOT the risk of the bank (fig. 1). In **normal times** country-specific factors have **negligible** effects (fig. 2)

Fig. 1 - **Crisis period** (Oct. 08-Oct. 09)

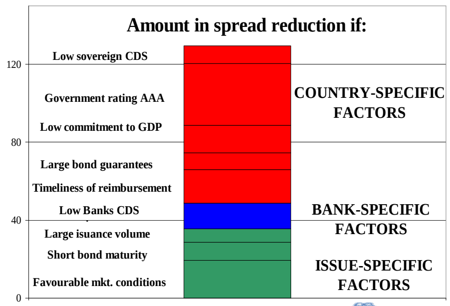
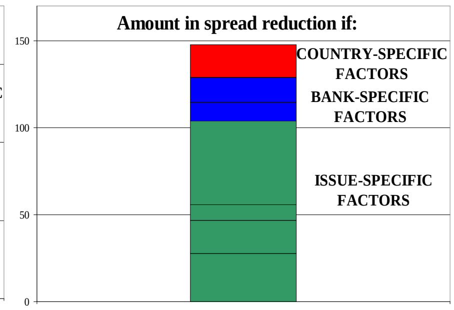


Fig. 2 - **Pre-crisis period** (2006)



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3. Can we do the trick again?

Cost Distortions (2)

- Empirically, during the crisis 65% of the spread of GBBs reflected the risk of the sovereign, NOT the risk of the bank (fig. 1). In **normal times** country-specific factors have **negligible** effects (fig. 2)
- Hence the adoption of GBBs implied that weak banks from strong countries got cheaper funds than strong banks from weak countries

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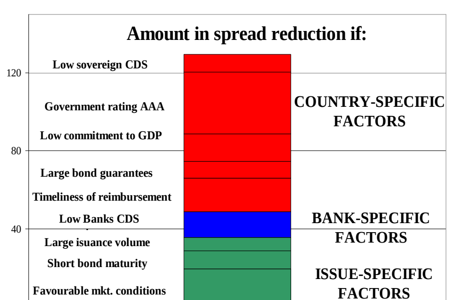
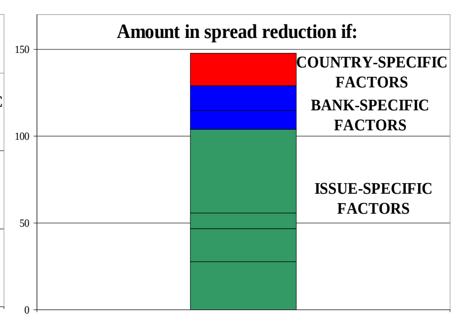


Fig. 2 - **Pre-crisis period** (2006)



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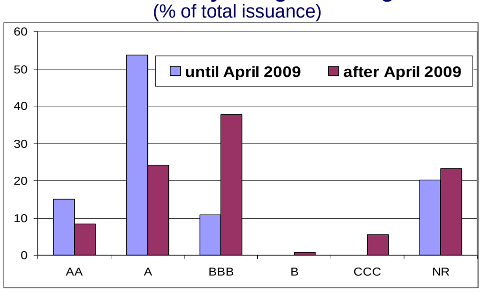
Implications of cost distortions

- Absence of level playing field harms competition…
- … and leads to misallocation of resources and lower banking system productivity

Issuance of GBBs by rating of issuing banks
(% of total issuance)



- Moreover, guarantees may distort banks' strategies and create MH (excessive risk-taking). Credit quality of issuers worsened over time: issues declined (increased) for banks with high (low) rating

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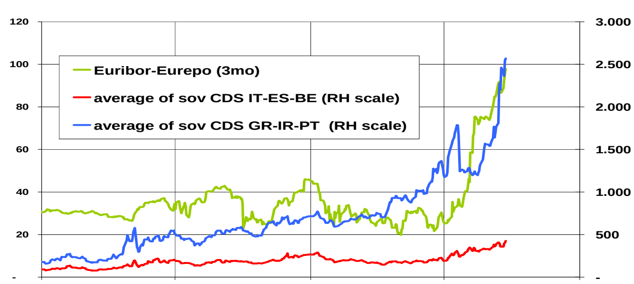
The European crisis: sovereign risk higher, value of guarantees lower

- Since end-2009, the sovereign debt crisis has reduced significantly the value of guarantees, especially those by weaker EA countries
- Extension of public guarantees by weak countries may not improve funding conditions of banks. It may even worsen the conditions of the sovereign



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Conclusions

- Bond guarantees proved to be an effective policy tool
  - o Issuance was sizable, and has likely contributed to lower funding costs and to prevent a credit crunch
- They contributed to avoiding worst case scenarios, reducing the likelihood of widespread bankruptcies
- Can we use them again? Maybe, but probably not in the same form. Two issues need to be addressed
  - o Distortions due to differences in the value of guarantees (sovereign-based pricing of the guarantees?)
  - o Weaknesses of domestic sovereign in some countries (International guarantees? In which form?)

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Conclusions

Thank you for your attention

Sources:

Panetta F. et al. (2009), "*An assessment of financial sector rescue programmes*", BIS Papers, No.48.

Panetta F. et al. (2011), "*The Impact of Sovereign Credit Risk on Bank Funding Conditions*", CGFS Paper No.43.

Levy A. and S. Schich (2009), "*The design of government guarantees for bank bonds: lessons from the recent financial crisis*", OECD Journal: Financial Market Trends, Vol. 2010, No.1.

Levy A. and A. Zaghini (2011), "*The pricing of Government-Guaranteed Bank Bonds*", Banks and Bank Systems, Vol.6, No.3, pp.35-43.

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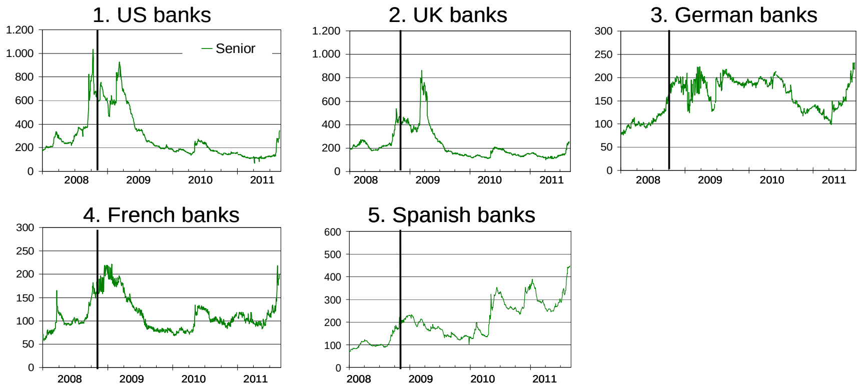
2. GBBs: were they effective?

Cost of bond issues decreased significantly

Yield on non-guaranteed bank bonds

(the vertical line indicates the approval of the GBB program; basis points)



➢ In 2008-09 the recourse to GBBs was associated to a large reduction of the cost of senior non-guaranteed bank debt

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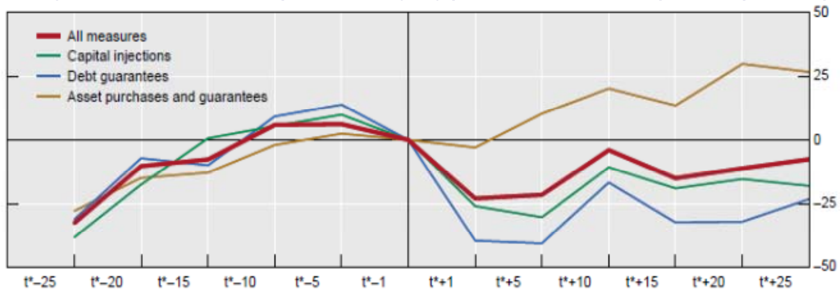
BACK

2. GBBs: were they effective?

GBBs issuance was associated to lower CDS spreads

Event-study on the announcement of rescue measures: changes in bank CDS premia by type of measure (basis points)



Source: Panetta et al. (2009)

➢Issuance of GBBs was associated to a persistent decline in CDS premia by <u>about 40 basis points from peak to trough</u>

➢ Recapitalizations have also had significant announcement effects

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BACK

Distortions (2)

- In order to disentangle the contribution of each characteristic of guaranteed issuance (issuer, sovereign, bond, mkt conditions) a cross-section regression was run on a sample of guaranteed bonds issued in 13 countries between Oct. 2008 and Oct. 2009. The regression was replicated for non-guaranteed bonds before the crisis

$$(1)\ spread = \alpha_0 + \sum \alpha_j D_j^{BANK} + \sum \alpha_k D_k^{ISSUE} + \sum \alpha_i D_i^{GOV} + \sum \alpha_z D_z^{MKT.COND.} + \varepsilon$$

Table 4: Breakdown of exogenous variables

Variable	Dummies	Breakdown
Issuance volume	3	Low, medium, high
Maturity	3	Low, medium, high
Currency of denomination	3	Euro, US dollar, other currencies
Rating of bond issue	2	AAA, not AAA
Issuer rating	4	BBB, A, AA, AAA
Issuer sector	2	Bank, non-bank financial institution
Issuer CDS spread	3	Low, medium, high
Bond issuer frequency	2	Once, more than once
Sovereign CDS	3	Low, medium, high
Sovereign rating	2	AAA, not AAA
Size of bond guarantees pledged by government	2	Low, high
Total resources committed by government (% to GDP)	3	Low, medium, high
Promptness of payments in case of default	3	Fast, medium, slow
Market conditions	4	2008Q4; 2009Q1; 2009Q2; 2009Q3