REAL EFFECTS OF GOVERNMENT GUARANTEES

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OUTLINE
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• Primer on government guarantees
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• Highlights of the three papers
  • Credit Guarantees and New Bank Relationships (Mullins and Toro)
  • Public Bank Guarantees and Allocative Efficiency (Gropp, Guettler and Saadi)
  • Equity Is Cheap for Large Financial Institutions (Gandhi, Lustig and Plazzi)
PRIMER ON GOVERNMENT GUARANTEES
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- Financial firm’s assets
  - Shareholder equity (with limited liability!)
  - Debtholders
  - Government guarantees
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- In single-period world (Merton (1977) on deposit insurance), government covers bankruptcy losses and effectively writes a put option on the assets, debt is risk-free and priced that way, shareholders are unaffected (cost of equity same).
- Lucas (2012) survey
PRIMER ON GOVERNMENT
GUARANTEES CONTINUED...
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- Cost of equity
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    • Potentially extends equity’s call option on the assets (lowers cost of equity); government in theory might impose regulatory cost (prompt corrective action, forced sale, preferred shares), e.g., F&F, AIG, Bear, Wash Mutual, etc.
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  - **Moral hazard** (Jensen & Meckling (1976), Black-Scholes-Merton)
    - With debt risk-free and no debtholder discipline (and insufficient regulatory supervision), financial firms have an incentive to take risk. This is the standard agency problem between equity and debt, but now government. Two ways: (i) riskier investments, and/or (ii) increase leverage. This increases their cost of equity though not by as much given the risk!
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    - Rather than backstopping individual firm debt, government can provide market-wide guarantees (MBSs, money market funds, TLGP, TARP, in recent financial crisis). Without quid pro quo, provide incentive for financial sector to take on more risk, but also caps tail risk for shareholders.
• **Costs: Impact on behavior**
  
  • Take on negative NPV (riskier) investments and more leverage. (e.g., Boyd & Runkle (1993), Flannery (1998), Nier and Baumann (2006), Gropp, Guettler & Grundl (2014).)
  
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• Benefits:
  - Managing systemic risk and associated negative externalities (e.g., deposit insurance and cost of bank runs, TBTF guarantees)
  - Enhance liquidity (MBS guarantees)
  - Fix market imperfections and failures (credit constraints, money market guarantee during crisis)
BANK BEHAVIOR

CREDIT GUARANTEES AND NEW BANK RELATIONSHIPS
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• Different conclusions about government guarantees
• Similarities
  • Behavior change under guarantees
    • Chile – do banks lend more to small enterprises when the loan repayment has a guarantee?
    • Germany – are savings banks more careful in who they lend to when the banks lose their guarantees?
  • Evaluate loans to small-to-medium enterprises (Chile smaller)
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Differences
- Guarantee at loan level (Chile) versus bank level (Germany)
- Greater credit constraints in Chile than Germany (?)
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PUBLIC BANK GUARANTEES AND ALLOCATIVE EFFICIENCY

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Prior to losing guarantees, savings banks dependent firms invest more, have higher sales growth, and are more unproductive. Banks continue lending to these less productive firms. This changes after guarantees are lifted.

These results are surprising. Using same data, Gropp, Gruendl and Guettler (2014) **link guarantees to greater risk-taking**. Enhance shareholder value. Costs of screening??
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Risk is changing because of leverage. Authors own theory is that it is not F-F model, but nonlinear in market (at least in left tails).

Authors do some robustness but ...

Winsorizing returns???
All financial firms? This should help identify the effect because not all financials have access to guarantees.