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Aviram Levy

Sebastian Schich

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The Design of Government Guarantees for Bank Bonds: Lessons from the Recent Financial Crisis

by

Aviram Levy and Sebastian Schich*

In 2010 authorities have taken the first steps to end some of the public support measures put in place in response to the financial crisis, starting with government guarantees for bond issues. Financial institutions have made extensive use of this tool, which has been effective in avoiding a further tightening of funding conditions, but this type of public support has, nonetheless, raised some concerns. First, the cost of issuing guaranteed bonds has mainly reflected the characteristics of the sovereign guarantor rather than those of the issuer, thus favouring "weak" borrowers with a "strong" sovereign backing. This situation has the potential to distort competition and create incentives for excessive risk taking. Such effects could have been reduced by the choice of a different fee determination mechanism. Second, the continued availability in 2010 of guarantee schemes, despite a declining overall usage, may be alleviating the pressure on some weak financial institutions to address their weaknesses: the average creditworthiness of banks issuing after mid-2009, when market conditions became more favourable, has sharply declined.

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* Aviram Levy is Head of the Financial Analysis Division in the Economic Research Area of Banca d'Italia; Sebastian Schich is Principal Administrator in the Financial Affairs Division of the OECD's Directorate for Financial and Enterprise Affairs. The authors gratefully acknowledge the excellent statistical assistance provided by Andrea Cardillo (Banca d'Italia) and Pierre Ruether (PhD student and part-time trainee at the OECD) and editorial assistance provided by Laura McMahon (OECD). This article was written following a recommendation by the Committee on Financial Markets (CMF) to further develop work on government-provided bond guarantee arrangements in the context of its Strategic Response to the Financial Crisis. An earlier version was discussed at the April 2010 CMF meeting, and the present article takes into account these discussions as well as any written comments received subsequently. All remaining errors are those of the authors.