Government Absorption of Financial Risk: Discussion of "How much do Guarantees and Bailouts Cost the Government?"

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May 2024

Important Paper!

- What are the costs to taxpayers of **Bailouts** and **Guarantees**?

- Paper applies ‘tools’ of financial valuation:
  - Expected payouts
  - Time value of money
  - Risk

- Why this paper matters:
  - **Important to inform voters about choices made by their agents (politicians)!**

Comments

- How can we think about guarantees v. bailouts?

- What are some costs which go beyond those incorporated here?

- Some thoughts on the current moment in banking

Bailouts v. Guarantees (1)

- Guarantees (Ex ante) v. Bailouts (Ex post)

- Guarantees are well-defined by law
  - Valuation is therefore straightforward
  - Cost is not too high
    - Expected cash flow is low ('tail' events)
    - Discount rates are high (due to risk)

Bailouts v. Guarantees (2)

- But bailouts are arguably much more important
  – Most Crisis-related actions were bailouts (ex post)
    - Extension of deposit insurance
    - TARP
    - GSE Conservatorship
    - MMMF protection & other Fed Facilities
    - PPP Program & Extended unemployment insurance
    - Fed's Corporate Bond Fed Facility
- **We can't value these ex ante, since we don't know what they will be**

Bailouts v. Guarantees (3)

- What else in financial markets is (implicitly) guaranteed (i.e., would get bailed out)?
  - Paypal/Venmo?
  - Tether?
  - Mortgage companies (recent FSOC declaration)
- Even scarier:
  - Who gets bailed out when 'the big one' hits the West Coast?
- **There is no way to measure cost of 'unknown unknowns'**

Additional costs of B&Gs (1)

- Cheap debt / over levered financial system
- Larger & more interconnected FIs (TBTF, a la Stern & Feldman)
- Investment misallocation (too much risk in non-financial sector)
- Competitive inequities

And:

- Too little investment in risk management
- Weak market discipline

Additional costs of B&Gs (2)

- New evidence on Risk Management (Schneider, Strahan, Yang, 2024)
  - Largest banks demand less RM human capital than small
  - Largest banks *do not* respond to risk in RM hiring
    - Unlike smaller banks
  - Largest banks invest more in RM when they have ‘skin in the game’ (i.e., capital)
- **Our conclusion: Incentives distorted/weakened by expectations of government support…**

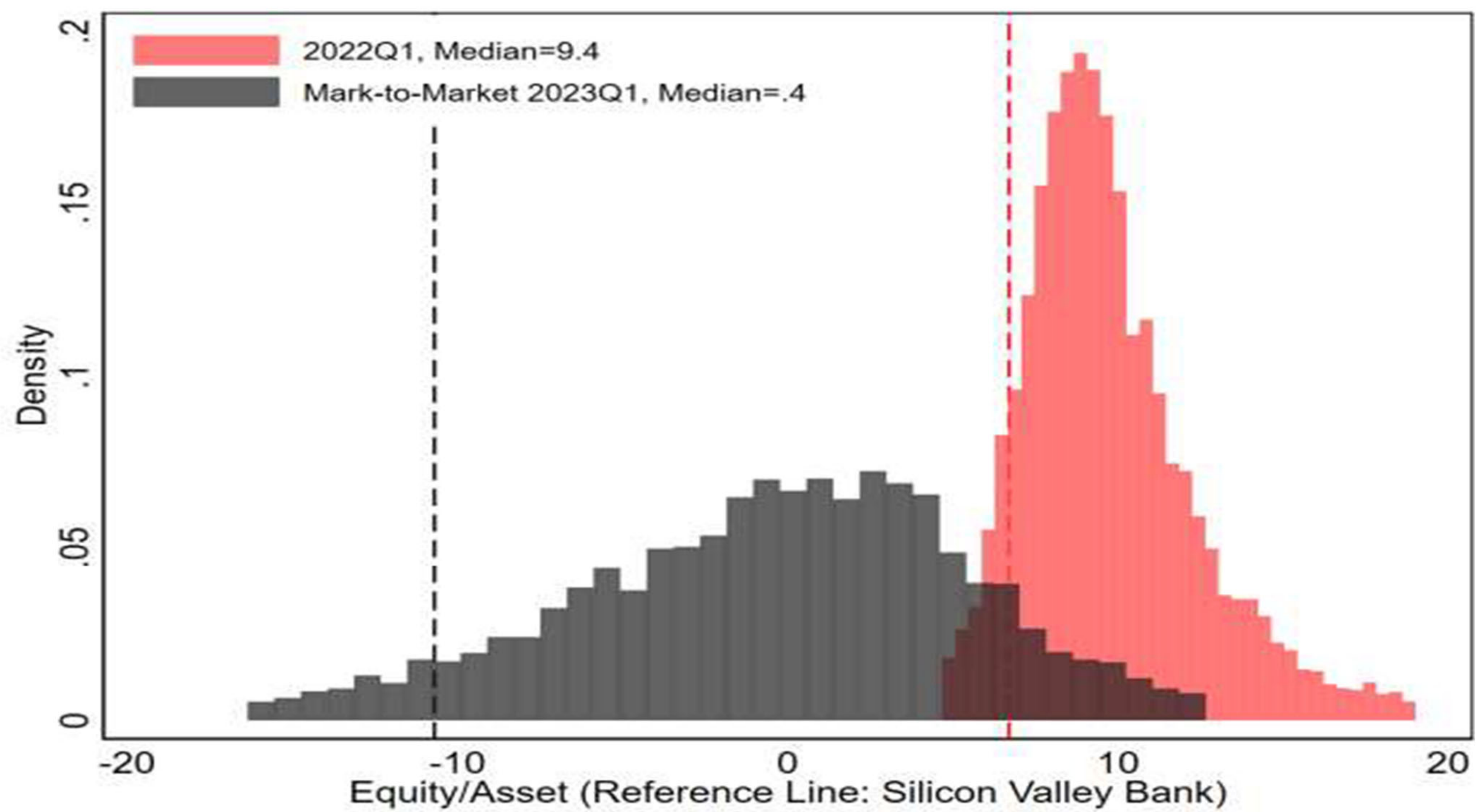
Additional costs of B&Gs (3)

- Market discipline (e.g., depositor 'walks' or 'runs') are **essential to force regulatory intervention**
  - Continental Illinois; GFC; SVB crisis
- Why is regulatory forbearance bad?
  - Because 'zombies' are bad… they eat the brains of the living (Romero, 1968).

The current moment (1)

- SVB crisis ‘ended’
  - Only 6 banks have failed…
  - And the runs stopped (deposits up in Q4, 2023)
- But what about bank losses?
  - 50% of assets in bonds or real estate
    - Duration = 7 years
    - Interest rate increase = 2.5%
    - Loss rate = 7 x 2.5% = 15%, or 7.5% of assets
  - **If capital was 10% in 2022, it’s 2.5% now…**

From Jiang et al.
(ignores deposit franchise value)



The current moment (2)

- This is the S&L crisis, redux
- What happened then (and now?):
  - Large jump in interest rates
  - Large unrealized losses
  - Slow action of regulators (creating zombies)
  - S&Ls doubled-down on risk…
- FDIC Improvement Act of 1991
  - What happened to Prompt Corrective Action?!

Assessment

- Paper makes important quantitative calculations on direct costs of B&G
  - Very hard problem, since no one knows the scope of future bailouts
- Additional indirect **Costs** and **Benefits** are both large and uncertain
  - Hard to move people off their ‘priors’!
- Plea to regulators: Don’t repeat the mistakes from the 1980s