

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

by

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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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