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Implicit Government Guarantees in Financial Institutions: new measures & issues - with Lei Zhao

Speaker : Lei Zhao at ESCP Europe, member of LABEX ReFi

The moral hazard problem caused by the implicit public subsidies extended to too-big-to-fail (TBTF) institutions has long been posing a serious threat to the stability of the financial system. Implicit government guarantees (IGG) stem from the expectation that the government will lend support to troubled financial firms deemed to be of systemic importance. To measure such guarantees, we exploit the price differential of CDS contracts written on debts with different seniorities. Our estimate of the annual implicit support enjoyed by the sample firms peaks at €175 billion in 2011. Subsidy at this level provides incentives for banks to grow larger and its variation over time deserves attention when investors make investment decisions or banks price their financial products.

In this talk, we will try to answer the following questions: (1) What is the magnitude of the implicit guarantees, both at bank level and also at aggregate level? (2) Are banks different from insurance companies in terms of the level of implicit support they obtain? (3) Does Eurozone have implications for IGG enjoyed by financial firms in the area? (4) What is the two-way feedback effect between IGG and sovereign credit risk?

Lei Zhao is an Assistant Professor in Finance at ESCP Europe and holds a PhD in Finance from the ICMA Centre, University of Reading. He is currently working in the area of bank regulation, financial stability and credit risk. His papers have been presented at leading academic conferences, such as Paris December Finance Meetings. The paper to be presented was shortlisted for the Ieke van den Burg Prize in 2015.