**Why government guarantees are a double-edged sword**

**By Viral V Acharya and Julian Franks**

As the search goes on for culprits and remedies in the global financial crisis, not enough attention has focused on the role played by governments in explicitly or implicitly guaranteeing the banking system.

The massive bank bailouts now being undertaken across the industrial world make the point: governments can not allow banks to fail for fear that the collapse of one will provoke a systemic crisis. By extension, we would contend that government guarantees played a central role in creating the mess in the first place, and that reforming them will be key to preventing a recurrence.

Consider the role played by guarantees in encouraging banks to operate with such astonishingly high levels of leverage prior to the crisis. The market believed that their liabilities— not just customer deposits but also their uninsured public debt - were in effect guaranteed by government regulators. This kept the price of their borrowing artificially low: banks with leverage to assets ratios of 80 or even per cent were able to borrow in the good times at just 20 basis points above government bonds.

The presence of guarantees means that as bank leverage and default risk increase, the true cost to the provider of the guarantee (i.e., the government) rises, but the cost to the bank does not. Hence, banks have a free option to increase leverage to extraordinarily high levels. This would of course not be such a problem if government ‘marked to market’ the price of guarantees, effectively getting banks to pay a fair price commensurate with their risk taking – but that is not how the system works. Compounding the problem, the high leverage that guarantees encourage inevitably leads banks to gamble on expansionary monetary policy by going ‘down the quality curve’.

Of course at some point the low quality loans default, banks make losses and lose a part of their capital. Bank share prices fall reflecting their high leverage ratio and vulnerability to small changes in the value of assets. In turn, uninsured depositors and wholesale creditors start to worry about the likelihood of the government extending guarantees, and the market cost of bank debt spirals upwards.

A case in point here was the bank run at Northern Rock, and the fact that its problems caused a contagion primarily for those banks (Alliance and Leicester, Bradford and Bingley, and HBOS) that had greater reliance on uninsured commercial paper. These banks were accorded higher valuation multiples by markets in good times, but once risks rose, the conditions were reversed. Banks like HSBC that had greater reliance on deposits have been much less affected, and have not even felt the need to participate in the UK government bailout.

Might it be that bankers, by taking on such high leverage, were simply maximizing shareholder value, given there are mispriced government guarantees, and that they simply got unlucky? We do not think so. Instead, we believe that capital budgeting at banks is in fact broken.

First, the relatively flat cost of debt in good times gives bankers the illusion that their cost of capital in bad times will also be low, or in other words, that their funding costs will not rise even with extreme leverage and high business risks.

Second, the extremes of leverage encourage bankers to place little weight on the cost of equity. When leverage is as high as 95% or more and its cost relatively flat, the cost of equity hardly matters. But this is true only until banks find themselves in a crisis and must issue equity at punitive dilution costs.

Third, there is excessive risk-taking at banks also induced by myopic compensation packages tied to the past year’s accounting profits rather than long-term return on assets. No bank
board wants to deviate from such packages as it fears losing employees to competitors. It is essentially a “race to the bottom” in the governance of a highly competitive sector.

In absence of guarantees, banks taking on excessive leverage and risks would face steep costs of funding, be it debt or equity. Creditors, for instance, would monitor and discipline bank management in good times rather than leaving that task to regulatory supervision.

Alas, such monitoring largely disappears when so much of bank debt is explicitly or implicitly guaranteed. In the absence of market discipline, deposit insurance and coarsely-designed capital requirements are a most imperfect proxy. The former tend to be mispriced; the latter can easily be gamed.

It is thus ironic that the very guarantees that induced banks to take on excessive leverage and risk, and endanger our jobs and savings, must be sharply increased to get us out of the current mess.

Regulators ought to remind themselves that guarantees are a double-edged sword. They are inevitable in systemic crises, for political reasons as well as for efficiency. But somewhat unfortunately, they linger even after crises abate and their pernicious effects on bankers' incentives remain unchecked.

The task of fixing capital budgeting at banks is not just for bankers. Only if regulators charge suitably for the guarantees will banks price them in to their loans and leverage decisions. Resolution of the most severe financial crisis of our lifetimes may otherwise soon turn out to be a Pyrrhic victory.

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