Discussion of
“Pricing of Implicit Guarantees for Financial Institutions”

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Praise

- The topic studied in the paper is timely and important.
- Banks are building blocks of our financial system, and health of the banking industry directly affects the efficiency of the financial system.
- This is not only of interests to academic researchers but also highly relevant to banking regulators.
Literature review

- Even though the topic is timely, the current paper is only one of quite a number of similar studies in this area.

- Bond data: Acharya, Anginer, and Warburton (2015), Schweikhard, Tsesmelidakis, and Merton (2015). Using bond transaction data, they study the notion of “too big to fail” and quantify the value of implicit guarantee;

- CDS data: Zhao (2015) uses CDS data to measure the implicit government guarantees enjoyed by European financial institutions;
Literature review (cont.)

- Equity data: Lai and Ye (2015) develop a enhanced equity pricing model with a built-in stochastic policy parameter and empirically study the market value of the time-varying regulatory forbearance policy.

- Therefore a more comprehensive literature review section is definitely necessary. It would also significantly improve paper if the results in the empirical analysis could be related to those in the existing literature.
The payoff of the equity and debt

- The payoff of the debt in the paper:
  \[ D_T = k + (V_T - k)^+ 1_{\min_{t_0 < t < T} V_t < k} - (k - V_T)^+ + G_T \]

- A more sensible and sustainable payoff of the debt:
  \[ D_T = k + [V_T - (k - G')]^+ 1_{\min_{t_0 < t < T} V_t < (k - G')} - [(k - G') - V_T]^+ \]

- The payoff of the equity:
  \[ E_T = [V_T - (k - G')] 1_{\min_{t_0 < t < T} V_t < (k - G')} \]
Time varying $\kappa$

- In the paper $\kappa$ is bank-specific. This is good.
- However, for each bank $\kappa$ is constant overtime.
- Of course, the implicit guarantee is time-varying and depends on bank characteristics as well as macro economic conditions.
- Two ways to improve the paper in this direction: a) explicitly model $\kappa$ as a stochastic variable in the model and calibrate the model to study the time-varying nature (this is feasible but requires much more modeling techniques); b) keep $\kappa$ as constant in the model, but calibrate the model to different sample periods.