Do Big Bank Equityholders "Pay" for Bailout Insurance Over the Economic Cycle?

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Abstract

Contrary to public perception and previous literature on public bailout subsidies, we find over the recent 43-year period equityholders in big banks paid fairly for TBTF bailout insurance in terms of equity returns. In normal (non-crisis) periods, after TBTF in 1984, big banks pay an "insurance fee" for protection against severe losses in a crisis accepting a higher net regulatory burden reflected in a -9% per annum lower equity return relative to small banks. Moreover, a measure of left-tail risk protection, conditional on a crisis, fully explains this Big−Small bank equity premium "fee" paid in normal times. During crises, big banks earn higher returns (a reversal of that observed in normal times), which on average offset the big bank equity return discount in non-crisis times. Over several economic cycles, there is no abnormal Big−Small bank equity premium and bailout insurance is fairly priced for equityholders in that there is no difference between big and small bank equity returns.

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