Bank Bailout Menus[1]

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Abstract

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Bailing out banks requires overcoming debt overhang as well as dealing with adverse selection with respect to the quality of banks' balance sheets, in terms of heterogeneity in both the likelihood and extent of their potential shortfalls, of future asset values vis-a-vis contractual debt obligations. We examine bailouts that eliminate debt overhang, while attempting to minimize subsidies to banks' equityholders. When banks do not differ with respect to the extent of debt overhang, it can be fully overcome with the minimal amount of subsidies, providing each bank's equity holders no more than their pre-bailout values, with a partial new equity injection, or an asset buyout. When levels of debt overhang co-vary with underlying probabilities of default, we characterize the conditions for attaining a similar minimal subsidy outcome, with a Menu of either equity injection or asset buyout plans, satisfying suitable self-selection constraints among bank types. These involve global rather than local conditions, with multiple intersections of indifference curves among types, and imply strictly greater funds injections than those needed to make existing debt default-free. We also explore the role of coupling asset purchases with providing the bailout agency Options to buy bank equity, to enhance its capture of rents arising from new investments by banks, and compare its performance with equity injections on this dimension, as well as others such as post-bailout stakes held by prior inside equity holders, and the resulting incentives for efficient performance.