TOO-SYSTEMIC-TO-FAIL:
WHAT OPTION MARKETS IMPLY ABOUT SECTOR-WIDE GOVERNMENT GUARANTEES

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ABSTRACT

Investors in option markets price in a substantial collective government bailout guarantee in the financial sector, which puts a floor on the equity value of the financial sector as a whole, but not on the value of the individual firms. The guarantee makes put options on the financial sector index cheap relative to put options on its member banks. The basket-index put spread rises fourfold from 0.8 cents per dollar insured before the financial crisis to 3.8 cents during the crisis for deep out-of-the-money options. The spread peaks at 12.5 cents per dollar, or 70% of the value of the index put. The rise in the put spread cannot be attributed to an increase in idiosyncratic risk because the correlation of stock returns increased during the crisis. Sector-wide tail risk, partially absorbed by the government's collective guarantee for the financial sector, lowers the index put prices but not the individual put prices, and hence can explain the basket-index spread. A structural model with financial disasters quantitatively matches these facts and attributes as much as half of the value of the financial sector to the bailout guarantee during the crisis. The model solves the problem of how to measure systemic risk in a world where the government distorts market prices.

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An online appendix is available at:
http://www.nber.org/data-appendix/w17149
1 Introduction

We argue that options markets are uniquely suited to gauge the market’s perception of too-systemic-to-fail government guarantees. Since guarantees only kick in during a financial crisis, their effect should be most visible in asset prices that reflect tail risk, like put options. We find that investors price in substantial government bailout guarantees.

During the financial crisis, there was markedly less aggregate tail risk priced in put options on the financial sector index than in the individual put option prices on the stocks that make up the index. This leakage of aggregate tail risk at the sector level is consistent with investors’ perception of a strong collective bailout guarantee for the financial sector. By putting a floor under the equity value of the financial sector, the government eliminates part of the sector-wide tail risk, but it does not eliminate idiosyncratic tail risk. This explains why out-of-the-money (OTM) index put options were cheap during the crisis relative to the basket of individual put options. We use the difference between the cost of a basket of options and an index option to estimate the size of the guarantee extended to the financial sector during the crisis. Figure 1 plots the dollar difference in the cost of insuring the downside risk of all firms in the financial sector and the cost of only insuring against the sector-wide downside risk. It also displays the market capitalization of the financial sector itself. The cost differential peaks at $139 billion on October 13, 2008, or 10.5% of the financial index’s market value. Using a structural model, we find that the collective bailout guarantee accounts for as much as half of the market value of the financial sector over our 2003-2009 sample.

Absent government guarantees, the high basket-index spread in the financial sector is puzzling. Standard option pricing logic suggests that the dramatic increase in the correlation of stock returns during the crisis should raise the price of the OTM index options relative to the price of a basket of individual options with the same moneyness. This is exactly what we find for call options in all sectors of the economy. In contrast, the cost of the basket of individual stock puts soars relative to the cost of the index puts for the financial sector. This increase in the basket-index put spread is much larger for the financial sector than for any other sector. The basket-index spread for OTM
put options on the financial sector index reaches a maximum of 12 cents per dollar insured in March 2009, or 70% of the cost of the index put. To generate the increase in the basket-index spread for OTM put options, the standard option model would have to assume a large increase in idiosyncratic risk relative to aggregate risk. But this would counter-factually imply a sharp decrease in stock return correlations.

A collective government guarantee for the financial sector can explain the puzzle. Intuitively, the government’s collective bailout guarantee truncates the distribution of the total equity value of the financial sector, but not that of the individual stocks in the sector. Consider two OTM put options with the same strike price below the index bound, one on sector index and one on a representative individual stock. An increase in the volatility of aggregate shocks will increase the correlation among stock returns, it will increase the put prices of individual stocks, but it does not affect the index put price. We generalize this intuition to our structural model and show that only a calibration with a bailout guarantee can simultaneously generate a high put spread and an increase in correlation between stocks.

Furthermore, a careful study of the evolution of the put spread for the financial index lends direct support to our government guarantee hypothesis. The spread increases by on average 1.61 cents (27%) in the first five days after government announcements that increase the probability of a bailout, while it decreases on average 0.85 cents (13%) after announcements that have the opposite effect. The largest increase in the spread (60%) was registered in the first five days after the U.S. Congress approved the TARP bailout.

We use a calibrated dynamic asset pricing model with crash risk to study the impact of sector-wide bailout guarantees on individual and index option prices. In particular, we use a version of the Barro-Rietz asset pricing model with a time-varying probability of rare disasters. It features both Gaussian and financial disaster risk. In the model, the collective government guarantee bounds the aggregate equity loss rate for the financial sector in a disaster, but not for individual firms in the sector. We model the financial crisis as an increased probability of a financial disaster. First, we show that this (state-of-the-art) structural model without bailout guarantees cannot explain the
joint stock and option moments for the financial sector, discussed above. It has the same problem as a much simpler Gaussian model sketched above, in that it predicts a decrease in the correlation between stock returns for those parameters that generate an increasing put spread. Second, we show that a model with a bailout guarantee can account for the facts. We estimate a reduction in the average loss rate for shareholders during financial disasters from 55.7 to 37.2 percent of equity. Third, we use the structural parameters of the model to infer the effect of the bailout option on financial firms’ cost of capital. The downside protection lowers the equity risk premium in the financial sector by 50 percent. The collective bailout guarantee accounts for half of the value of the financial sector according to our model estimates. Fourth, we show robust results with respect to various aspects of the model.

We investigate and rule out three other potential alternative explanations for the sharp rise in the basket-index spread during the crisis. We consider mispricing due to capital constraints, counter-party risk, and short sale restrictions. Taking advantage of the basket-index spread does not tie up capital and occurs through exchanges with a AAA-rated clearing house in the middle. The short-sale ban was in place only for a very short time, applied equally to individual and index options, and market makers were exempted from it. We study liquidity differences among different types of options (index versus individual, puts versus calls, or financial firms versus non-financials), and argue that several of the facts are inconsistent with a liquidity explanation. Third, we consider and rule out a decline (in absolute value) in the price of correlation risk.

Our paper contributes to the growing literature on tail risk measurement and how this risk is priced. In recent work, Kelly (2011) uses the cross-section of stock returns to construct a measure of tail risk. Backus, Chernov, and Martin (2011) use option prices to make inference about the size and frequency of consumption disasters. Drechsler and Yaron (2011) study stock returns and option prices in a long-run risk model with jumps. Our work uses the relative valuation of sector and stock-specific option prices to distinguish between firm-specific and aggregate tail risk. We find that there was less aggregate tail risk priced in index option markets during the crisis than there would have been absent a bailout option.
Our paper contributes to the options literature that studies the relationship between individual and index options. Driessen, Maenhout, and Vilkov (2009) argue that index options provide a hedge against increases in correlations, which constitute a deterioration in the investment opportunity set, because their prices rise when correlations increase. Individual options do not have this feature. That is what makes index options typically expensive. We argue that index put options in the financial sector are relatively cheap during the crisis because they are essentially subsidized through the government guarantee. Carr and Wu (2009) and Schurhoff and Ziegler (2011) also study the price of index versus individual options. In earlier work, Bates (1991) uses OTM put and call index option prices to study the market’s expectations about the 1987 stock market crash.

Our work contributes to the important task of measuring systemic risk in the financial sector. See Acharya, Pedersen, Philippon, and Richardson (2010); Adrian and Brunnermeier (2010); Huang, Zhou, and Zhu (2011) for novel ways of measuring systemic risk. Our results highlight the difficulties of systemic risk measurement when governments distort market prices by providing bailout guarantees. All else equal, the basket-index spread for OTM put options would be natural measure of systemic risk: the smaller the basket-index spread in a sector, the larger the amount of systemic risk in that sector. However, in sectors that benefit from a collective bailout guarantee, an increase in the basket-index spread occurs when systemic risk peaks and the collective bailout guarantee kicks in. This is what we observed in the financial sector and, to a lesser extent, in the broader economy during the 2007-2009 crisis. A structural model like ours is needed to undo the effect of the government’s distortions on measures of systemic risk. Ranciere and Tornell (2011) discuss how to design regulation in the context of government bailout guarantees.

Other studies have measured the size of guarantees on the cost of bank credit. Giglio (2010) and Longstaff, Arora, and Gandhi (2009) infer joint default probabilities for banks from the pricing of counter-party risk in credit default swap markets. Recently, Coval, Jurek, and Stafford (2009) and Collin-Dufresne, Goldstein, and Yang (2010) compare the prices of index options and CDX tranches prior and during the financial crisis. Veronesi and Zingales (2010) study the value of

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1Kacperczyk and Schnabl (2011) study money market mutual funds’ risk exposure and relate them to (internal) guarantees provided by a parent company.
government bailouts to bondholders and stockholders of the largest financial firms during the crisis. We focus exclusively on the equity side, and we find evidence of a large collective equity bailout guarantee in the financial sector. From our model, we conclude that option prices tell us that the bailout option substantially reduces the cost of capital for systemically risky financial firms. Consistent with this result, Gandhi and Lustig (2010) quantify the effect of too-big-to-fail on the cost of equity capital of large banks by analyzing stock returns on size-sorted bank portfolios. They find that large banks have risk-adjusted returns that are 5% per annum lower than those of the smallest banks, and they attribute this difference to the implicit guarantee for large banks.

In a seminal paper on this topic, O’Hara and Shaw (1990) document large positive wealth effects for shareholders of banks who were declared too-big-to-fail by the Comptroller of the Currency in 1984, and negative wealth effects for those banks that were not included. Since we find strong evidence of ex-ante subsidies to shareholders, this implies that there are even larger subsidies to other creditors of large banks.

The rest of the paper is organized as follows. After defining index and basket put and call spreads and their relationship in Section 2, we document their empirical behavior in the financial sector and in all other non-financial sectors in Section 3. Section 4 finds supporting evidence for our collective bailout hypothesis in the events of the 2007-2009 crisis. Section 5 develops a structural asset pricing model which features a time-varying probability of financial disasters. A technical contribution of the paper is to derive option prices in the presence of a bailout option essentially in closed-form. Section 6 calibrates the model and shows that it is able to account for the observed option and return data, but only when a bailout guarantee is present. Section 7 studies and rules out three potential alternative explanations: mispricing, liquidity, and fluctuations in the price of correlation risk. The last section concludes. Technical details are relegated to a separate appendix.

2 Cost of Basket of Options and Index Option Prices

We focus on a traded sector index $i$ comprised of different stocks $j$. $\text{Index}$ denotes the share price level of the index, which is a constant fraction, $1/scale$, of the total market value of its constituent
stocks. The dollar cost of the index, i.e., the total market cap of all the firms in the index, is given by $\text{Index}^\$ = \sum_{j=1}^{N_i} s_j S_j$, where $N_i$ is the number of different stocks that constitute index $i$, while $S_j$ and $s_j$ are the price per share and number of shares outstanding, respectively, for stock $j$ in index $i$. This defines $\text{scale} = \frac{\text{Index}^\$}{\text{Index}}$. We use $P_{\text{basket}_i}$ to denote the price of a basket of put options on all stocks: $P_{\text{basket}_i} = \sum_{j=1}^{N_i} s_j P_{t_j}$. We use $P_{\text{index}_i}$ to denote the price of a put option on the sector index. Similarly, we use $C_{\text{basket}_i}$ to denote the price of a basket of call options on all stocks in the sector index and $C_{\text{index}_i}$ to denote the price of a call option on the index. We study two different ways of comparing basket and index options.

**\(\Delta\)-Matched Basket** The first approach ensures that the index and the individual options have the same option $\Delta$.\(^2\) First, we choose strike prices $K_{j}, j = 1, 2, \ldots, N_i$ for individual stocks to match the targeted $\Delta$ level. Second, we choose the strike price $K$ for the index to match that same $\Delta$. Third, we choose the number of index options with strike $K$ such that the total dollar amount insured by the index (denoted $K^{\text{index}, \$}$) is equal to the dollar amount insured by the basket:

$$K^{\text{index}, \$} = \sum_{j=1}^{N_i} s_j K_j.$$

The advantage of this approach is that both the index and individual options in the basket have the same moneyness. However, no-arbitrage does not bound the basket-index spread at zero from below.

**Strike-Matched Basket** The second approach ensures that the strike price on the index matches the share-weighted strike of the basket. First, we choose all the strike prices $K_{j}, j = 1, 2, \ldots, N_i$ for individual stocks that are part of the index to match a certain $\Delta$. Second, we choose the strike price of the index options $K^{\text{index}, \$}$ (in billions) such that the strike price of the index (in dollars)

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\(^2\)The $\Delta$ of an option is the derivative of the option price with respect to the underlying asset price. While put options have negative $\Delta$, we use the convention of taking the absolute value, so that all $\Delta$s are positive. $\Delta$ measures the moneyness of an option, with low values such as 20 indicating OTM options and high values such as 80 indicating in-the-money (ITM) options. At the money options have a $\Delta$ of 50.
equals the share-weighted sum of the individual strike prices:

\[ K_{\text{index},\$} = \sum_{j=1}^{N_i} s_j K_j. \]

Third, we choose a strike price for the index \( K \) such that the total dollar cost of insurance equals \( K_{\text{index},\$} \):

\[ K_{\text{index},\$} = K \times \text{scale}. \]

The advantage of this approach is that the cost of the basket has to exceed the cost of the index option by no arbitrage, which bounds the basket-index spread below from zero. The disadvantages are that the moneyness and \( \Delta \) of the index option can differ from the moneyness of the option basket and that this approach is computationally more involved.\(^3\)

**No-Arbitrage Basket-Index Relationship** We compare the cost of the index option and the basket of options under the second approach. At expiration \( T \), the payoff of the basket of options is: \( P_{\text{basket}}^{t,i} = \sum_{j=1}^{N_i} s_j \max(K_j - S_{T,j}, 0) \). We can compare this payoff to the payoff from the index put option: \( \text{scale} \times P_{\text{index}}^{t,i} = \max(K_{\text{index},\$} - \sum_{j=1}^{N_i} s_j S_{T,j}, 0) \), where the strike price of the index in dollars is the weighted strike price of the underlying stocks in the basket \( K_{\text{index},\$} = \sum_{j=1}^{N_i} s_j K_j \).

**Proposition 1.** The cost of the basket of put options has to exceed the cost of the index put option:

\[ P_{\text{basket}}^{t,i} \geq \text{scale} \times P_{\text{index}}^{t,i}, \forall t \leq T. \] \( (1) \)

**Proof.** The payoffs at maturity satisfy the following inequality: \( \sum_{j=1}^{N_i} s_j \max(K_j - S_{T,j}, 0) \geq \max(K_{\text{index},\$} - \sum_{j=1}^{N_i} s_j S_{T,j}, 0) \). First note that, for each \( j \), \( s_j \max(K_j - S_{T,j}, 0) \geq s_j(K_j - S_{T,j}) \). This implies that \( \sum_{j=1}^{N_i} s_j \max(K_j - S_{T,j}, 0) \geq K_{\text{index},\$} - \sum_{j=1}^{N_i} s_j S_{T,j} \). However, this also means that \( \sum_{j=1}^{N_i} s_j \max(K_j - S_{T,j}, 0) \geq \max(K_{\text{index},\$} - \sum_{j=1}^{N_i} s_j S_{T,j}, 0) \), because the left hand side is non-negative. Since the payoff from the option basket exceeds that of the index option, its cost must

\(^3\)Since data are on a discrete grid of \( \Delta \)s, different option \( \Delta \)s can satisfy this condition on consecutive days. To avoid oscillation in the basket price, we set a given sector’s basket \( \Delta \) equal to the mode of the day-by-day best \( \Delta \) match for that sector.
be weakly higher as well.

Intuitively, the basket of put options provides insurance against states of the world in which there are large declines in the price of any individual stock, including declines that affect many stocks simultaneously. The index put option only provides insurance in those states of the world that prompt common declines in stock prices. The difference $P_{b_{T,i}} - P_{i_{T,i}}$ between these two put prices is the cost of insurance against large declines in individual stock prices but not in the overall index. Hence, the basket-index spread is non-negative. The same inequality applies to the basket of calls and the call on the index.\footnote{This property is unique to equity options. In the case of credit default swaps, the cost of a basket of credit default swaps has to be equal to the CDX index to rule out arbitrage opportunities.}

**Cost Per Dollar Insured** To be able to compare prices across time, sectors, and between puts and calls, we define the cost per dollar insured ($cdi$) as the ratio of the price of the basket/index option divided by its strike price: $P_{b_{cdi,i}} = \frac{P_{b_{T,i}}}{\sum_{j=1}^{N_i}s_j K_j}$ and $P_{i_{cdi,i}} = \frac{scale \times P_{i_{T,i}}}{\sum_{j=1}^{N_i}s_j K_j}$. From equation (1), we know that the cost of basket insurance exceeds the cost of index insurance, $P_{b_{cdi,i}} \geq P_{i_{cdi,i}}$, if we construct the index strike to match the share-weighted strike price. We define the basket-index put spread per dollar insured as: $P_{i}^{spread} = P_{b_{cdi,i}} - P_{i_{cdi,i}}$. $C_{b_{cdi,i}}^{basket}$ and $C_{i_{cdi,i}}^{spread}$ are defined analogously.

## 3 The Basket-Index Spread in the Data

This section documents our main stylized facts.

### 3.1 Data

We use daily option data from January 1 2003 until June 30, 2009. Index option prices are on the nine iShares sector exchange-traded funds (ETF) and on the S&P500 ETF, traded on the CBOE. As ETFs trade like stock, options on these products are similar to options on individual stock. Options on ETFs are physically settled and have an American-style exercise feature.
nine sector ETFs have the nice feature that they have no overlap and collectively cover the entire S&P500. Appendix A contains more details and lists the top 40 holdings in the financial sector ETF.\(^5\) We also use individual option data for all 500 stocks in the S&P500. The OptionMetrics Volatility Surface provides daily European put and call option prices that have been interpolated over a grid of time-to-maturity (TTM) and option $\Delta$, and that perform a standard adjustment to account for the American option feature of the raw option data. The European style of the resulting prices allows us to compare them to the European-style options we compute in our structural model later. Interpolated prices allow us to hold maturity and moneyness constant over time and across underlyings. The constant maturity options are available at various intervals between 30 and 730 days and at grid points for (absolute) $\Delta$ ranging from 20 to 80. We focus primarily on options with 365 days to maturity and on $\Delta$ of 20. We obtain implied volatility data from the interpolated implied volatility surface of OptionMetrics. We use CRSP for returns, market capitalization, and number of outstanding shares for sector ETFs and the individual stocks. Our database changes as the index composition of the S&P500 changes. We calculate realized volatility of index and individual stock returns, as well as correlations between individual stock returns from CRSP return data. Whenever a firms gets added or deleted from the S&P500 and hence form its sector ETFs, we also drop it from the individual option data base so as to maintain consistency between the composition of the option basket and the index option.\(^6\)

### 3.2 $\Delta$-Matched Basket

This section describes the moments in the data for the basket-index option spread. We find that OTM put options on the index were cheap during the financial crisis relative to the individual stock options, while OTM index calls were relatively expensive. This pattern is much more pronounced for the financial sector than for other non-financial sectors.

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\(^5\)Our sample length is constrained by the availability of ETF option data. For the financial sector (but not for all non-financial sectors), we are able to go back to January 1999. The properties of our main object of interest, the basket-index put spread for financials, do not materially change if we start in 1999.

\(^6\)Our results remain unchanged when we redo them for the list of firms that remain in the financial sector index throughout our sample.
Panel I in Table I provides summary statistics for the basket-index spread per dollar insured for the Δ-matched approach using index and individual options with Δ = 20. Columns (1)-(2) report results for the financial sector. Columns (3)-(4) report results for a value-weighted average of the eight non-financial sectors. Columns (5)-(6) report the differences in the spread between the financial and non-financial sectors. All spreads are reported in cents per dollar insured. An increase in the spread between the basket and the index means index options are cheaper relative to the individual options. We report statistics for three samples: the entire sample (top panel, January 2003 until June 2009), the pre-crisis sample (middle panel, January 2003 until July 2007), and the crisis sample (bottom panel, August 2007 until June 2009).

Over the full sample, the mean spread for OTM puts is 1.69 cents per dollar in the financial sector and 1.11 cents in the non-financial sector. The basket-index spread for OTM calls are an order of magnitude smaller: 0.24 cents for financials and 0.21 cents for non-financials. The standard deviation of the basket-index spread over time is 1.89 cents for puts compared to only 0.16 cents for calls in the financial sector. Hence, put spreads are more volatile. The largest basket-index put spread for financials is 12.45 cents per dollar, recorded on March 6, 2009. It represents 70% of the cost of the index option on that day. On that same day, the difference between the spread for financials and non-financials peaks at 9.07 cents per dollar insured. The largest put-based basket-index spread for non-financials is 4.1 cents per dollar, recorded on November 21, 2008. In contrast, the largest basket-index call spread is only 0.49 cents for financials and 0.36 cents for non-financials.

The bottom half of Panel I focusses on the crisis subsample. The mean spread backed out from OTM puts is 3.79 cents per dollar for financials and 1.57 for non-financials. While there is an across-the-board increase in the put spread from pre-crisis to crisis, the increase is much more pronounced for financials (4.7 times versus 1.7 times). Put spread volatility increases in the crisis, especially for financials, whose standard deviation rises from 0.20 pre-crisis to 2.39 during the crisis. Non-financials put spread volatilities increase from 0.44 to only 0.90. A very different pattern emerges for OTM call spreads. They are substantially lower in the crisis than in the pre-
crisis period. The crisis call spread is 0.06 cents for financials and 0.11 cents for non-financials. The volatility increases only modestly from 0.06 to 0.17 (0.05 to 0.10) for financials (non-financials).

Figure 2 plots the cost of the basket of put options per dollar insured (full line), the cost of the financial sector put index (dashed line), and the basket-index spread (dotted line) for the entire sample. Before the crisis, the basket-index spread is essentially constant and very small, less than 1 cent per dollar. During the crisis, the put spread increases as the index option gradually becomes cheaper relative to the basket of put options. The cost of the basket occasionally exceeds 30 cents while the cost of the index put rarely rises above 20 cents per dollar. At the start of 2009, the difference exceeds 12 cents per dollar of insurance. The basket index spread also becomes more volatile. By fixing ∆ as the crisis unfolds, we are looking at put contracts with lower strike prices during the crisis, and hence at options with lower prices. This tends to lower the basket-index spreads. None of the eight non-financial sectors has anywhere close to such a large put spread increase during the crisis.

Figure 2 plots the cost per dollar insured of basket and index call options, as well as the call spread. During the crisis, index options become more expensive relative to the basket of call options. In addition, the volatility of the basket-index spread decreases. At some point, the call spread becomes negative (-0.44 cents at the lowest point).\footnote{Recall that the zero lower bound for the spread only holds for strike-matched and not ∆-matched options, so that this negative number does not present a puzzle.} We find essentially the same results for call spreads in all other sectors.

Figure 3 compares the put spread of financials and non-financials over time (the dotted lines from the previous two figures). For non-financials (solid line), the basket-index spread remains very low until the Fall of 2008. For financials (dashed line) on the other hand, the put spread starts to widen in the summer of 2007 (the asset-backed commercial paper crisis), spikes in March 2008 (the collapse of Bear Stearns), and then spikes further after the Freddie Mac and Fannie Mae bailouts and the Lehman Brothers bankruptcy in September 2008. After a decline in November and December of 2008, the basket-index spread peaks at 12 cents per dollar in March 2009. The dotted line plots the difference in put spread between the financial sector and non-financial sectors.
This difference is positive throughout the crisis, except for a few days in November of 2008. It increases from the summer of 2007 to October 2008, falls until the end of 2008, and increases dramatically from January to March 2009. Section 4 provides a detailed interpretation of this pattern based on crisis-related government announcements.

### 3.3 Strike-Matched Baskets

Panel II in Table I reports results for our second approach to compare basket-index spreads: the index strike matches the share-weighted strike price of the basket. In this case, no-arbitrage implies that the basket-index spreads are non-negative. Essentially, we see the same pattern as with the \( \Delta \)-matching approach. The correlation between these two measures is 0.995. However, the basket-index spreads are larger when we match the share-weighted strike price. The reason is that the higher volatility of individual stock returns leads to a lower (higher) strike price for OTM put (call) options when we match \( \Delta \)s. Put differently, individual options in the second approach have higher \( \Delta \)s than index options, which increases spreads.

The average put spread during the crisis is 5.85 cents per dollar for financials (compared to 3.79 cents in Panel I), and the volatility is 3.01 (compared to 2.39). The maximum spread is now 15.87 cents per dollar insured (compared to 12.46). This number represents 89% of the cost of the index put on March 6, 2009 (compared to 70%). On that same day, the difference between the put spread for financials and non-financials peaks at 10.17 cents per dollar. The maximum spread for calls is only 1.27 cents per dollar. The minimums reported are all positive, which means the no-arbitrage constraint is satisfied. Since our results do not seem sensitive to how we perform the basket-index comparison, we report only the \( \Delta \)-matched basket-index spread results in the remainder of the paper.

### 3.4 The Effect of Time To Maturity

Panel III of table I studies the cost of insurance when the TTM is 30 days instead of 365 days. As we show later, these shorter maturity option contracts are more liquid. Naturally, all basket-index
spreads are smaller for shorter-dated options, because the cost per dollar insured increases with the TTM. Yet, we observe the same patterns as in Panel I. We limit our discussion to Panel III; the strike-matched results in Panel IV are very similar.

Starting with the basket-index spread for puts on financials, we find an average of 0.62 cents per dollar in the crisis, up from 0.17 cents pre-crisis. This represents an increase by a factor of 3.7, only slightly lower than the 4.7 factor with \( TTM = 365 \). Per unit of time (that is, relative to the ratio of the square root of maturities), the put spread increase during the crisis is larger for \( TTM = 30 \) options than for \( TTM = 365 \) options. The 30 day spread reaches a maximum of 2.45 cents per dollar or 52\% of the cost of the index option on that day. The call spread for financials decreases from an average of 0.16 cents pre-crisis to an average of 0.10 cents during the crisis, a slower rate than for longer-dated options. For non-financials, there is an increase in the put spread by a factor of 1.8 (from 0.13 before the crisis to 0.23 cents during the crisis). This is similar to the increase in long-dated puts of 1.8 times, and larger when taking into account the shorter time interval. The call spread for non-financials increases slightly during the crisis (from 0.11 to 0.14 cents), while it falls for longer-dated options (from 0.25 to 0.11 cents). This is the only qualitative (but quantitatively small) difference with longer-dated options.

### 3.5 The Effect of Moneyness

Table II reports the cost of insurance for basket versus the index as a function of moneyness (\( \Delta \)). It follows the format of Table I, and their Panel I is identical. While option prices are naturally higher when options are closer to being in the money (ITM), it turns out that spreads also increase in size. However, the proportional increase in the basket-index spread from pre-crisis to crisis is much larger for OTM put options than for at-the-money (ATM) puts.

Starting with financials, options with the lowest moneyness (\( \Delta = 20 \)) see the largest proportional increase in put spread from pre-crisis to crisis. That factor is 4.7 for \( \Delta = 20 \), 3.5 for \( \Delta = 30 \), 3.0 for \( \Delta = 40 \), and 2.5 for ATM options (\( \Delta = 50 \)). Similarly, the proportional decrease in call spreads is larger for OTM than for ATM options. For non-financials, the put spread increase during
the crisis is much smaller and decreases in moneyness. The difference in the put spread between financials and non-financials (reported in column 5) increases only marginally during the crisis, from 2.22 cents at $\Delta = 20$ to 2.37 cents per dollar at $\Delta = 50$. Since ATM option prices are obviously higher for high-$\Delta$ options, the financials minus non-financials put spreads are much larger in percentage terms for OTM options. To illuminate this point, Table III reports the percentage spread, measured as the basket-index spread divided by the cost of the index option. For put options on financials, the percentage spread during the crisis is 37% for $\Delta = 20$ but only by 26% for $\Delta = 50$. Similarly, the maximum percentage put spread falls from 81% to 52% as moneyness increases. For call options on financials, the largest percentage spreads are in the pre-crisis sample. Finally, we only see large increases in the average percentage spreads for OTM put options with $\Delta = 20$ on financials.

### 3.6 Correlation and Volatility

The crisis was characterized by a substantial increase in the correlation of individual stock returns. Panel I of Tables V and VII reports the average pairwise correlations for financials and non-financials stocks, respectively, computed from daily return data. Correlation among stocks in the financial sector index is 51.3% on average over the entire sample. This number increased from 45.8% pre-crisis to 57.6% during the crisis. For non-financials, the correlations are lower. The average correlation is 45.2%. This number increased from 33.7% pre-crisis to 56.8% in the crisis. Figure 4 plots correlations for financials and non-financials. The correlations for financials are invariably higher. We argue below that the increase in correlations during the crisis is evidence that points towards the collective bailout hypothesis.

Panel I of Tables V and VII also reports realized volatility of individual stock and index returns for financials and non-financials. Panel I of Tables IV and VI reports option-implied volatilities in financials and non-financials. Over the entire sample, the implied volatility is 2.9 percentage points higher than the realized volatility for financials. In the pre-crisis sample, this difference is 9.8 percentage points (21.7% versus 11.9%). However, in the crisis-sample, this difference shrinks
to 4.7 percentage points (48.5% versus 43.8%). The ratio of the two falls from 1.8 to 1.1. In the options literature, the difference between implied volatility and the expectation of realized volatility is called the volatility risk premium. To the extent that the sample realized volatility is a good proxy of the conditional expectation of realized volatility, this is evidence that the volatility risk premium in financials decreases during the crisis.\footnote{It is yet another important indication that index put options on the financial sector are cheap during the crisis. For non-financials, in contrast, the volatility risk premium barely decreases during the crisis. The difference between implied volatility and average realized volatility is 9.5 percentage points in the pre-crisis sample compared to 9.1 percentage points during the crisis. Similarly to puts, call options on financials indicate a large decrease in the volatility risk premium from 3.0 percentage points to -6.0 percentage points in the crisis. The decrease is again smaller for non-financials.} It is yet another important indication that index put options on the financial sector are cheap during the crisis. For non-financials, in contrast, the volatility risk premium barely decreases during the crisis. The difference between implied volatility and average realized volatility is 9.5 percentage points in the pre-crisis sample compared to 9.1 percentage points during the crisis. Similarly to puts, call options on financials indicate a large decrease in the volatility risk premium from 3.0 percentage points to -6.0 percentage points in the crisis. The decrease is again smaller for non-financials.

\section{The Basket-Index Spread and the Government}

In this section, we provide direct evidence that the dynamics of the basket-index spread during the crisis are closely tied to government announcements that relate directly to the collective bailout hypothesis. In a financial disaster, the banking sector is insolvent because the sector’s asset value drops below the value of all debt issued. Under the collective bailout hypothesis, the government bounds the value of total losses to equity holders in a financial disaster. In principle, bailouts of bondholders and other creditors do not imply that the value of equity is protected. However, in practice, given the uncertainty about the resolution regime, especially for large financial institutions, the collective bailout ensures a positive value of equity in the financial sector. In the presence of a collective bailout guarantee, an increase in the probability of a financial disaster increases the put basket-index spread because the cost of downside insurance for the entire sector, which is supported by the government, increases by less than the cost of downside insurance for all the stocks in the basket. If the guarantee is specific to the financial sector, we do not expect to see the same pattern in other sectors.

\footnote{In any GARCH model, lagged volatility is the key predictor of future volatility.}
Broadly speaking, we distinguish between four different regimes during the crisis shown in Figure 5. In Regime I, stretching from the start of the crisis in August 2007 to mid-October 2008, the market gradually increased its assessment of the probability of a collective bailout for banks’ shareholders. This regime is characterized by gradually increasing put spreads in the financial sector (dashed line in Figure 5), and a much smaller increase in the non-financials put spread (solid line). Regime II ranges from mid-October 2008 to early January 2009: the shift in TARP policy, away from buying troubled assets, increased uncertainty about the size and the effectiveness of the bailout. This policy change started by the Treasury’s announcement of the $250bn capital injection program. This regime is characterized by a steep decline in the put spread for financials but not for non-financials. Their difference (the dotted line) reaches zero in early November 2008. The start of Regime III coincides with the announcement of the financial support for Bank of America in mid-January and the subsequent commitment to buy troubled assets on a large scale. During this regime, the market readjusts its assessment of the collective bailout probability upwards. The financial put spread reaches a peak of 12 cents per dollar. The non-financial put spread declines during much of this period. In regime IV, starting in mid-March 2009, the market lowers its assessment of the probability of financial firms failing, and the put spread starts a gradual decline. This decrease continues until the end of our sample.

To link the put spread directly to (the market’s perceptions of) the government’s bailout actions, we study government announcements during the financial crisis of 2007-2009. We focus on significant announcements for which we can determine ex-ante the sign of the effect on the likelihood and size of a collective bailout.

**Announcement Effects** We identify five events that increase the probability and the size of a government bailout for shareholders of the financial sector: (i) October 3, 2008: Revised bailout plan (TARP) passes the U.S. House of Representatives, (ii) October 6, 2008: The Term Auction Facility is increased to $900bn, (iii) November 25, 2008: The Term Asset-Backed Securities Loan Facility (TALF) is announced, (iv) January 16, 2009: Treasury, Federal Reserve, and the FDIC Provide assistance to Bank of America, (v) February 2, 2009: The Federal Reserve announces it
is prepared to increase TALF to $1trn. We refer to these as positive announcement dates. These announcement dates are indicated in the top panel of Figure 6, which plots the basket-index spread.

We also identify six negative announcements that (we expect ex-ante to) decrease the probability of a bailout for shareholders: (i) March 3, 2008: Bear Stearns is bought for $2 per share, (ii) September 15, 2008: Lehman Brothers files for bankruptcy, (iii) September 29, 2008: House votes no on the bailout plan, (iv) October 14, 2008: Treasury announces $250bn capital injections, (v) November 7, 2008: President Bush warns against too much government intervention in the financial sector, and (vi) November 13, 2008: Paulson indicates that TARP will not used for buying troubled assets from banks. These announcement dates are depicted against the basket-index spread in the bottom panel of Figure 6.

Figure 7 plots the basket-index put spread for financials around the announcement dates. The panel on the left shows the five positive announcements (dashed lines), while the panel on the right shows the six negative announcements (dashed lines). The solid line depicts the average effect across events. We find that the basket-index spread increases 1.61 cents (27%) in the first 5 days following a positive announcement, while it decreases 0.85 cent (13%) in the first 5 days following a negative announcement, on average across announcements. The pre-announcement movements suggest that some are anticipated by the market. We obtain similar average responses when we examine the financial minus the non-financial basket-index spread around announcement dates instead. After the positive announcement dates, the response is somewhat smaller but after negative announcement dates the response is larger. Hence, these announcement dates mainly affect the financial spread not the non-financial spread.

The largest positive effect occurs after the House approves the Emergency Economic Stabilization Act of 2008 (Public Law 110-343) on October 3, which establishes the $700 billion Troubled Asset Relief Program (TARP). The spread increases 3 cents or 60% in the first five days after the announcement. Furthermore, the approval of TARP started a sustained increase in the basket-index spread in the ensuing period.

Both the failure of Bear Stearns and Lehman Brothers initially reduce the basket-index put
spread. In the case of the Lehman failure, the spread goes back up in the following days. Possibly, the government underestimated the consequences of the failure and markets subsequently increased the perceived probability of a bailout. The largest negative effect was registered on October 14, when the U.S. Treasury announced the TARP would be used as a facility to purchase up to $250bn in preferred stock of U.S. financial institutions. The Treasury essentially shifted TARP’s focus from purchasing toxic assets to recapitalizing banks, following similar initiatives in the U.K. and Continental Europe. Nine large financial organizations announced their intention (reportedly under pressure from the Federal Reserve and the Treasury) to subscribe to the facility in an aggregate amount of $125 billion, with many more smaller banks to follow later. Because the government participations were mostly in the form of preferred equity, they diluted existing shareholders. The shift in TARP’s focus was clearly bad news for existing shareholders. In response, the put spread declined about 2.5 cents per dollar insured (about 35%) in the first five days after the announcement. This announcement started a major decline in the spread that was reinforced by speeches delivered by president Bush and Secretary Paulson in early November. Clearly, there was a fear that bank shareholders would not receive the government bailout they had hoped for.

This decline in the spread was reversed only in early January when the FDIC, the Fed and the Treasury provided assistance to Bank of America, without diluting existing shareholders. The put spread started its largest increase in the beginning of February 2009 and peaked in the beginning of March. On February 10, 2010, Treasury Secretary Geithner announced a Financial Stability Plan involving Treasury purchases of convertible preferred stock in eligible banks, the creation of a Public-Private Investment Fund to acquire troubled loans and other assets from financial institutions, expansion of the Federal Reserve’s Term Asset-Backed Securities Loan Facility (TALF), and new initiatives to stem residential mortgage foreclosures and to support small business lending. The Federal Reserve Board announced that it was prepared to expand TALF to as much as $1trn and to broaden eligible collateral to include AAA-rated commercial mortgage-backed securities, private-label residential mortgage-backed securities, and other asset-backed securities. The expansion of TALF would be supported by $100bn from TARP. In the last week of February there was
discussion of assurances to prop up the banking system, including Fannie Mae and Freddie Mac.

As a result, markets were gradually reassured that the government was indeed committed to bailing out the financial sector without wiping out equity holders. Our measure of the value of the bailout guarantee suggests that the market was not initially reassured by the TARP program and its implementation, which consisted mostly of cash infusions from sales of preferred shares. Only when the Treasury and the Federal Reserve explicitly announce programs to purchase toxic assets such as mortgage-backed securities does the collective bailout guarantee become valuable.

**Non-financials**  During the financial crisis, as market-wide volatility increased, even the index put options on the non-financials became *cheaper* relative to the individual stock options. The put spread, the dotted line in Figure 6, hovers around 1 cent until Lehman Brothers fails in September 2008. After that, it increases to 3.9 cents on October 10, and it reaches a maximum of 4.1 cents on November 21. This suggests that, for a brief period, the market was expecting bailouts in certain non-financial sectors as well. For example, on November 18, the CEOs of General Motors, Chrysler, and Ford testify before Congress and request access to TARP for federal loans. This access is granted on December 19, 2008. Nevertheless, the magnitude of the put spread in non-financials is much smaller than in financials.

### 5 Model with Financial Disaster Risk

The critical difference between banks and other non-financial corporations is their heightened exposure to bank runs during financial crises. Historically, runs have been made by depositors, but in the modern financial system they are made by other creditors such as investors in asset-backed commercial paper, repos, and money market mutual funds (see Gorton and Metrick, 2009). This leads us to consider banking panics or financial disasters as a source of aggregate risk. To model the asset pricing impact of financial disasters, we use a version of the Barro (2006); Rietz (1988); Longstaff and Piazzesi (2004) asset pricing model with a time-varying probability of disasters, as developed by Gabaix (2008); Wachter (2008); Gourio (2008). We believe such a model is
appropriate to capture the momentous financial crisis that took place over our sample period. The model features two sources of priced risk: Gaussian risk and financial disaster (tail) risk. While non-financial corporations are also subject to these rare events, their exposure is more limited and they do not (or at least much less) enjoy the collective bailout guarantee that supports the financial sector. The model allows us to interpret the financial crisis as an elevated probability of a financial disaster (for pricing purposes), and also as a realization of a financial disaster itself. A technical contribution of the paper is to derive analytical option pricing expressions in such a setting with bailout guarantees.

5.1 Environment

Preferences We consider a representative agent with Epstein and Zin (1989) preferences over non-durable consumption flows. For any asset return $R_{i,t+1}$, this agent faces the standard Euler equation:

$$1 = E_t[M_{t+1}R_{i,t+1}],$$
$$M_{t+1} = \beta^{\alpha}\left(\frac{C_{t+1}}{C_t}\right)^{-\frac{\psi}{\alpha}}R_{a,t+1}^{\alpha-1},$$

where $\alpha \equiv \frac{1-\gamma}{1-\psi}$, $\gamma$ measures risk aversion, and $\psi$ is the elasticity of inter-temporal substitution (EIS). The log of the stochastic discount factor (SDF) $m = \log(M)$ is given by:

$$m_{t+1} = \alpha \log \beta - \frac{\alpha}{\psi} \Delta c_{t+1} + (\alpha - 1)r_{a,t+1}.$$

All lowercase letters denote logs. We note and use later that $\frac{\alpha}{\psi} + 1 - \alpha = \gamma$.

Uncertainty There is a time-varying probability of disaster, $p_t$. This probability follows an $I$-state Markov chain. Let $\Pi$ be the $1 \times I$ steady-state distribution of the Markov chain and $P$ the $I \times 1$ grid with probability states. The mean disaster probability is $\Pi P$. The Markov chain is uncorrelated with all other consumption and dividend growth shocks introduced below. However,
the volatility of Gaussian consumption and dividend growth risk potentially varies with the Markov state. This allows us to capture higher Gaussian risk in bad states associated with high disaster probabilities.

In state \( i \in \{1, 2, \ldots, I\} \), the consumption process \( (\Delta c_{t+1}) \) is given by a standard Gaussian component and a disaster risk component:

\[
\begin{align*}
\Delta c_{t+1} &= \mu_c + \sigma_{ci} \eta_{t+1}, \quad \text{if no disaster} \\
\Delta c_{t+1} &= \mu_c + \sigma_{ci} \eta_{t+1} - J_{t+1}^c, \quad \text{if disaster},
\end{align*}
\]

where \( \eta \) is a standard normal random variable and \( J^c \) is a Poisson mixture of normals governing the size of the consumption drop (jump) in the disaster state. We adopt the Backus, Chernov, and Martin (2011) model of consumption disasters. The random variable \( J^c \) is a Poisson mixture of normal random variable. The number of jumps is \( n \) with probability \( e^{-\omega \frac{\omega}{n!}} \). Conditional on \( n \), \( J^c \) is normal with mean \( (n \theta_c) \) and variance \( n \delta_c^2 \). Thus, the parameter \( \omega \) (jump intensity) reflects the average number of jumps, \( \theta_c \) the mean jump size, and \( \delta_c \) the dispersion in jump size.\(^9\) Finally, we allow for heteroscedasticity in the Gaussian component of consumption growth: \( \sigma_{ci} \) depends on the Markov state \( i \).

**Individual Dividends in Financial Sector** In state \( i \in \{1, 2, \ldots, I\} \), the dividend process of an individual bank is given by:

\[
\begin{align*}
\Delta d_{t+1} &= \mu_d + \phi_d \sigma_{ci} \eta_{t+1} + \sigma_{di} \epsilon_{t+1}, \quad \text{if no disaster} \\
\Delta d_{t+1} &= \mu_d + \phi_d \sigma_{ci} \eta_{t+1} + \sigma_{di} \epsilon_{t+1} - J_{t+1}^d - \lambda_d J_{t+1}^a, \quad \text{if disaster}
\end{align*}
\]

where \( \epsilon_{t+1} \) is standard normal and i.i.d. across time. It is the sum of an idiosyncratic and an aggregate component, which we introduce in the calibration below. The term \( \exp (-J_{t+1}^d - \lambda_d J_{t+1}^a) \)

---

\(^9\)Note that when \( J^c \) is activated, we have already conditioned on a disaster occurring. Therefore, the parameter \( \omega \) is not the disaster frequency but rather the mean of the number of jumps, conditional on a disaster. There is a non-zero probability \( e^{-\omega} \) of zero jumps in the disaster state. In what follows we normalize \( \omega \) to 1.
can be thought of as the recovery rate corresponding to a disaster event. The loss rate varies across banks. It has an idiosyncratic component $J^d$ and a common component $\lambda_d J^a$. The idiosyncratic jump component is a Poisson mixture of normals that are i.i.d. across time and banks, but with common parameters $(\omega, \theta_d, \delta_d)$. We set $\theta_d = 0$, which implies that the idiosyncratic jump is truly idiosyncratic; during a disaster the average jump in any stock’s log dividend growth is equal to the common component $-\lambda_d E[J^a]$.

**Collective Bailout Option** The key feature of the model is the presence of the collective bailout option which puts a floor $\underline{J}$ on the losses of the banking sector. The aggregate component of the loss rate is the minimum of the maximum industry-wide loss rate $\underline{J}$ and the actual realized aggregate loss rate $J^r$:

$$J^a_{t+1} = \min(J^r_{t+1}, \underline{J})$$

We model $J^r$ as a Poisson mixture of normals with parameters $(\omega, \theta_r, \delta_r)$. For simplicity, we assume that the jump intensity is perfectly correlated among the three jump processes ($J^c, J^i, J^r$), but the jump size distributions are independent. We can think of the no-bailout case as $\underline{J} \rightarrow +\infty$, so that $J^a = J^r$.

5.2 Valuing Stocks

**Valuing the Consumption Claim** We start by valuing the consumption claim. Consider the investor’s Euler equation for the consumption claim $E_t[M_{t+1}N^{R^a}_{t+1}] = 1$. This can be decomposed as:

$$1 = (1 - p_t)E_t[\exp(\alpha \log \beta - \frac{\alpha}{\psi} \Delta c^{ND}_{t+1} + \alpha r^{ND}_{t+1})] + p_t E_t[\exp(\alpha \log \beta - \frac{\alpha}{\psi} \Delta c^D_{t+1} + \alpha r^D_{t+1})],$$

where $ND (D)$ denotes the Gaussian (disaster) component of consumption growth, dividend growth or returns. We define “resilience” for the consumption claim as:

$$H^c_t = 1 + p_t \left( E_t \left[ \exp \left\{ (\gamma - 1) J^c_{t+1} \right\} \right] - 1 \right).$$
In section B.1 of the separate appendix, we derive a system of equations that can be solved for the equilibrium log wealth-consumption ratios.

**Valuing the Dividend Claim**  The investor’s Euler equation for the stock is $E_t[M_{t+1}R^d_{t+1}] = 1$, which can be decomposed as:

\[
1 = (1 - p_t)E_t \left[ \exp(\alpha \log \beta - \frac{\alpha}{\psi} \Delta c_{t+1}^{ND} + (\alpha - 1)r_{a,t+1}^{ND} + r_{d,t+1}^{ND}) \right] \\
+ p_tE_t \left[ \exp(\alpha \log \beta - \frac{\alpha}{\psi} \Delta c_{t+1}^{D} + (\alpha - 1)r_{a,t+1}^{D} + r_{d,t+1}^{D}) \right]
\]

If we define “resilience” for the dividend claim as:

\[
H^d_t = 1 + p_t (E_t \left[ \exp \left\{ \gamma J^c_{t+1} - J^d_{t+1} - \lambda_d J^a_{t+1} \right\} \right] - 1),
\]

then the Euler equation simplifies to:

\[
1 = H^d_t E_t \left[ \exp \left\{ \alpha \log \beta - \frac{\alpha}{\psi} \Delta c_{t+1}^{ND} + (\alpha - 1)r_{a,t+1}^{ND} + r_{d,t+1}^{ND} \right\} \right].
\]

In section B.2 of the separate appendix, we derive a system of equations that can be solved for the equilibrium price-dividend ratios.

**Equity Risk Premium**  An important object is the equity risk premium, which is the expected excess log stock return adjusted for a Jensen inequality term:

\[
-Cov(m, r) = \gamma_d \sigma^2_a + \zeta_{m,i} + \gamma Cov(J^d 1_D, J^c 1_D) + \gamma \lambda_d Cov(J^a 1_D, J^c 1_D),
\]

where $1_D$ is an indicator variable that is activated by the occurrence of a disaster. Appendix B.3 derives the right-hand-side terms as a function of the structural parameters. The first term represents the standard Gaussian equity risk premium, the second term reflects compensation for the risk that emanates from the Markov switches, while the last two terms are the pure compensation
for disaster risk. Since we will normalize $\theta_d$ to zero, the second term is zero and the third term represents the entire disaster risk premium. It depends on the risk aversion coefficient, the probability of a disaster, and the extent to which aggregate consumption and financial stocks’ dividends fall in a disaster. The latter depends on $\theta_r$ and $\lambda_d$ as well as on the bailout guarantee, $J$. Absent the bailout guarantee, the disaster risk premium would be $\gamma \lambda_d p_i (2 - p_i) \theta_c \theta_r$, which is always higher than the equity premium in the presence of a guarantee.

### 5.3 Valuing Options

The main technical contribution of the paper is to price options in the presence of a bailout guarantee.

**Options on Individual Banks** We are interested in the price per dollar invested in a put option (cost per dollar insured) on a bank stock. For simplicity, we assume that the option has a one-period maturity and is of the European type. We denote the put price by $Put$:

$$Put_t = E_t \left[ M_{t+1} (K - R_{t+1})^+ \right] = (1 - p_t) Put_{i}^{ND} + p_t Put_{i}^{D},$$

where the strike price $K$ is expressed as a fraction of a dollar (that is, $K = 1$ is the ATM option). The put price is the sum of a disaster component and a non-disaster component. We derive both components next. The no-disaster option price in state $i$:

$$Put_{i}^{ND} = \sum_{j=1}^{I} \pi_{i,j} Put_{ij}^{ND},$$

where $Put_{ij}^{ND}$, the option price conditional on a transition from $i$ to $j$, has the familiar Black-Scholes form.

Similarly, the disaster option price in state $i$:

$$Put_{i}^{D} = \sum_{j=1}^{I} \pi_{i,j} \sum_{n=1}^{\infty} \frac{e^{-\omega \omega_n}}{n!} Put_{ijn}^{D}. \quad (2)$$
where $Put_{ijn}^D$ is the option price, conditional on a transition from $i$ to $j$ and $n$ jumps. Because of the truncation of payoffs by the bailout, the valuation of these disaster options is non-standard. The closed-form expressions for option prices are provided in section B.4 of the separate appendix.

We verify that the above put price collapses to the simpler case of no bailout options, that is $J^a = J^r$. This is the case as $J \to +\infty$.

**Options on the Financial Sector** To aggregate from the individual firms to the index, we use a generic set of index weights $w_j, j = 1, \ldots, N_i$ for the sector $i$’s constituents, where $\sum_{j=1}^J w_j = 1$. We assume that all individual firms in an index face the same dividend growth parameters (ex-ante identical except for size $w_j$). Assuming in the model that all stocks initially trade at $1$, the one-period dividend growth rate of the index in the model is given by:

$$\Delta d^{index} \approx \sum_{j=1}^J w_j \Delta d^j.$$  

The weights allow us to take into account a finite number of index constituents as well as sector concentration, as measured by $\sqrt{\left(\sum w_i^2\right)}$. The Gaussian dividend growth shock $\epsilon$, which is not priced, has standard deviation $\sigma_{d_i}$. We assume that a fraction $\xi_d$ of its variance is aggregate, with the remainder being idiosyncratic. It follows that the Gaussian variance of the index is given by

$$\sigma_{d_i}^{index} = \sigma_{d_i} \sqrt{\left(\xi_d + \sum_{j=1}^{N_i} w_j^2 (1 - \xi_d)\right)}.$$  

The gains from diversification make the Gaussian variance of the index lower than that of its constituents. Similarly, the idiosyncratic tail risk of the financial sector index is much lower than that of any individual stock:

$$\delta_{d_i}^{index} = \delta_d \sqrt{\sum_{j=1}^{N_i} w_j^2}$$
and \( \theta_d^{index} = \theta_d = 0 \). The growth rate of the sector’s dividends is then given by:

\[
\Delta d_{t+1}^{\alpha} = \mu_d + \phi_d \sigma_c \epsilon_{t+1} + \sigma_d^{index} \epsilon_{t+1}, \quad \text{if no disaster}
\]

\[
\Delta d_{t+1}^{\alpha} = \mu_d + \phi_d \sigma_c \epsilon_{t+1} + \sigma_d^{index} \epsilon_{t+1} - J_{d,index}^{a} - J_{t+1}^{a}, \quad \text{if disaster}
\]

where we have assumed \( \sum_{j=1}^{J} w_j \lambda_{d,j} = 1 \). Since \( J_{d,index}^{d} \) has mean zero, \( \exp(-J_{t+1}^{a}) \) is the recovery rate of the index in case the rare event is realized.

## 6 Quantitative Model Predictions

The goal of this section is threefold. First, we argue that a (state-of-the-art) structural model with bailout guarantees can explain the pattern in option prices and stock returns we document in the previous section. Second, we show that a model without bailout guarantee cannot. Third, we use the structural parameters of the model to infer the effect of the government guarantee on financial firms’ expected return and stock price. We finish by showing robustness of our main conclusions to variations in the details of the model.

### 6.1 Parameter Choices

We calibrate the model at the annual frequency to match it up with option prices with one-year maturity.

**Disaster probabilities** We set the number of Markov states \( I \) equal to 2 and treat the first state as the pre-crisis state and the second state as the crisis state. We think of the pre-crisis period (January 2003-July 2007) as a period of low probability of a financial disaster (as well as the actual realization of a financial disaster). We think of the crisis (August 2007-June 2009) as a period of elevated probability of a financial disaster. Since we want to match data for this particular 78 month period, we choose the elements of the transition probability matrix so that the Markov chain resides in a crisis 29.5% of the time (23 out of 78 month). This leads us to set \( \pi_{11} = .79 \)
and $\pi_{22} = .50$. We calibrate the steady-state probability of a financial disaster to a much longer time series. In particular, we match the 13% historical frequency of financial disasters in the U.S. since 1800; see Reinhart and Rogoff (2009). Given the Markov transitions and $p_{ss} = 13\%$, we set the probability of a financial disaster equal to 7% in state 1 and 28% in state 2 so as to have a big spread in probabilities.

**Consumption** We set $\mu_c$ equal to real per capita total consumption growth during the pre-crisis period, which is 2.21% in our sample. Coincidentally, that is also the average over the full 1951-2010 sample. Unconditional average consumption is $\mu_c - p_{ss}\theta_c$ in the model. We choose $\theta_c = .065$ to match average annual real consumption growth of 1.37% over our 2003-2009 sample. That means that annual consumption drops 4.3% (2.2%-6.5%) in real terms in a disaster. This consumption drop is close to the 5.9% annual consumption drop during a typical financial crisis in developed economies, as reported in Reinhart and Rogoff (2009).\(^{10}\) We choose $\sigma_c(1) = .0035$ to match the standard deviation of real per capita consumption growth (annualized from overlapping quarterly data) of 0.35% in the pre-crisis period. We set $\delta_c = .035$ to allow for non-trivial dispersion around the size of the consumption disaster and we allow for a doubling of Gaussian consumption risk to $\sigma_c(2) = .0070$. This delivers an unconditional consumption growth volatility of 0.92% per year given all other parameters. This is close to the observed volatility of 0.81% in our sample and exactly matches the 0.92% in the 1951-2010 sample. Seen from the model’s perspective and interpreting the period 2007-2009 as the realization of a disaster, the observed consumption growth rate of -0.7% (or 2.9% lower than in the non-disaster state) was one standard deviation above the mean growth rate in disasters.

**Preferences** We set the coefficient of relative risk aversion equal to 10 and the inter-temporal elasticity of substitution equal to 3. The combination of a high risk aversion and a high EIS allows us to simultaneously generate a meaningful equity risk premium and a low risk-free rate. The high

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\(^{10}\)Reinhart and Rogoff find that the (worldwide) average financial crisis is associated with a 35.5% fall in GDP over six years. Barro and Ursua (2008) find that consumption disasters are typically of the same magnitude as GDP contractions during crises.
risk aversion will also be necessary to match the high OTM put prices observed during the crisis. We set the subjective time discount factor $\beta = .9555$. The unconditional real risk-free rate that results is 2.44\% per year. It is 3.43\% in state 1 and 0.07\% in state 2, reflecting the additional precautionary savings motive when a disaster is more likely. This compares to an observed average yield on a one-period zero coupon government bond of 0.66\% in the pre-crisis period and 0.05\% in the crisis period, after subtracting realized inflation. Lowering average interest rates, as well as the difference between the interest rates in state 1 and 2, is possible if we further increase the EIS, while simultaneously increasing the time discount factor. We opt not to do this because the EIS is already high. Furthermore, we need strictly positive interest rates in both states in order to be able to compute Black-Scholes implied volatilities for comparison with OptionMetrics data. Our parameter choices are a compromise that still delivers the low interest rate environment of our sample period. The unconditional volatility of the risk-free rate is low at 1.54\% per annum, matching the 1.59\% volatility in our sample.

**Dividends** Next, we calibrate the parameters that govern the dividend growth rate of the firms in the financial sector. The mean growth rate of any firm, and therefore of the index, is $\mu_d = .08$ in order to match the high observed dividend growth rate on the financial sector index in the pre-crisis period. We set $\phi_d = 3$, a standard choice for the leverage parameter. This delivers a negligible Gaussian equity risk premium ($\gamma \phi_d \sigma^2_c$) of four basis points in state 1 and 15 basis points in state 2. The entire equity risk premium in the model reflects compensation for disaster risk.

The key objects of the model are the parameters that govern Gaussian risk and, especially, tail risk. We use a representative set of index weights for the financial sector index constituents (that of 04/09/2010, 79 firms on that day) for $w_j$ where $\sum_{j=1}^J w_j = 1$. The concentration metric $\sqrt{\left(\sum w_j^2\right)}$ is 0.22 for the financial sector (on that day).\(^{11}\) This measure would only be half as large (0.11) if all 79 firms had equal size. We keep $\sigma_d$ constant across Markov states in our benchmark calibration for simplicity. We set $\omega = 1$, which implies that the average number of jumps during a disaster is one, $\theta_d = 0$, which implies that the idiosyncratic jump is truly idiosyncratic, and

\(^{11}\)Using the holdings from a different day has only minor quantitative effects on our results.
\[ \lambda_d = 1, \text{ which implies that the average exposure to the aggregate tail risk process is one. These are innocent normalizations. The parameters that remain to be calibrated are } \Theta = (\sigma_d, \xi_d, J, \theta_r, \delta_r, \delta_d). \]

Together these parameters determine the equity risk premium, the volatility of dividend growth and returns at the individual and index level, the pairwise correlation between stock returns, and all option prices. It is the parameters in \( \Theta \) that we vary between our benchmark calibrations with and without a bailout.

### 6.2 Economy with a Bailout Guarantee

In a first exercise, we ask whether we can match average prices on deep OTM puts and calls \((\Delta = 20, \text{ TTM}=365)\) on the financial sector index, the basket of financial stocks, and their spread in both the pre-crisis (state 1 in the model) and the crisis period (state 2). Simultaneously, we are interested in matching the correlation between return pairs and the volatility of index returns in both states. That is 16 moments. Our benchmark calibration for the financial sector sets

\[
\Theta^F = (\sigma_d, \xi_d, J, \theta_r, \delta_r, \delta_d) = (0.15, 0, 0.921, 0.815, 0.55, 0.516).
\]

Because the disaster probability is modest in state 1, Gaussian risk is what mostly drives the standard deviation of the index and the correlation among stocks in that state. The choice \( \xi_d = 0 \) implies that all the unpriced Gaussian dividend growth risk is idiosyncratic. This creates relatively more idiosyncratic risk, increasing the basket-index spread for both calls and puts in both states 1 and 2. It also allows us to lower the pairwise return correlation (by increasing \( \sigma_d \)) without causing much of an increase in the volatility of the index return. The choice \( \sigma_d = .15 \) allows us to match the 46% pairwise correlation between stock returns in the pre-crisis period. It generates financial index return volatility of 19%, which is reasonably close to the 12% volatility observed in the pre-crisis period.

We choose a high value for the aggregate tail risk parameter, \( \theta_r = .815 \), as well as a high dispersion, \( \delta_r = .55 \). This means that, absent bailout options, the financial sector would suffer a return drop of 81.5% or 55.7% in levels, with a wide confidence interval around it. However, the
bailout option $J$ substantially limits the losses for the index. The mean loss $\theta_a$, which takes into account the bailout, is 46.5% or 37.2% in levels. At the same time, there is substantial idiosyncratic tail risk, $\delta_d = .516$, meaning that some firms fare much better than others in a financial disaster. Importantly, the bailout only applies to aggregate and not idiosyncratic tail risk. Our parameters are such that there is enough residual aggregate tail risk (after the bailout) to make all options expensive enough, and enough idiosyncratic tail risk to make individual options more expensive than index options. However, there cannot be too much idiosyncratic tail risk or else the pairwise correlation of stock returns would fall from state 1 to state 2, counter-factually implying very low correlation during a crisis. We return to this point in the next subsection.

As Panel B of Table IV shows, our model is able to quantitatively account for observed option prices. It matches the put basket and index prices in the crisis (state 2) perfectly. It also generates about the right level for put prices in the pre-crisis period (state 1), but it understates the put spread in state 1. The model is able to account for a large run-up in the put spread between the pre-crisis period and the crisis period. In the model, this run-up is caused by a four-fold increase in the probability of a financial disaster. Similarly, the model generates the right prices for deep OTM call options. In particular, it captures the feature of the data that the call spread decreases from the pre-crisis to the crisis period. The model slightly overstates the call spreads. The option-implied volatility from the put index increases from 31.2% pre-crisis to 46.7% in the crisis inside the model. The latter number is only slightly above the model’s realized index volatility in a disaster of 46.4%. The difference between option-implied and realized volatility shrinks substantially during the crisis: from 12% to 0.3%. In the data, the pattern is the same with implied volatility 9.8% above realized volatility pre-crisis and 4.7% in the crisis.

Panel B of Table V shows that the model also generates an increase in the volatility of index returns, thanks to the large amount of aggregate tail risk. Finally, the model generates a substantial increase in the pairwise correlation of returns from pre-crisis to crisis. While it still understates the rise in the data, the increase is important and goes hand in hand with the bailout option. Intuitively, in state 1 the correlation mostly reflects Gaussian risk and the Gaussian correlation
is low because all $\epsilon$ shocks are idiosyncratic. Because of the substantial amount of aggregate tail risk (relative to the idiosyncratic tail risk), the correlation between returns in the disaster state is higher (40% versus 16% in the non-disaster state). Since state 2 gives the disaster state more weight, the correlation rises from state 1 to 2. Absent a bailout, this amount of aggregate tail risk would lead to option prices that are too high.

The large amount of idiosyncratic Gaussian and tail risk deliver individual stock returns that are volatile: 27% in the pre-crisis and 44.5% in the crisis. Conditional on a disaster, individual stock return volatility is 69.5%, not unlike the observed 72.9% realized volatility of individual financial firms during the crisis period. Implied volatility from the put basket is 61.3% during the crisis in the model, substantially below realized volatility of 69.5%. The same is true in the data, where implied volatility is 59.5%, below the realized volatility of 72.9%.

### 6.3 Economy without a Bailout Guarantee

Having shown that we can match the option prices of interest in the presence of a bailout guarantee, we now show that the bailout guarantee is essential. To that end, we set $J = +\infty$, and search over the remaining parameters of $\Theta$ to best match the 16 moments of interest. We find the best match for:

$$\Theta^{NB} = (\sigma_d, \xi_d, J, \theta_r, \delta_r, \delta_d) = (0.15, .628, +\infty, 0.2825, 0.25, 0.65).$$

This calibration features a higher level of idiosyncratic tail and a much lower level of aggregate tail risk. The aggregate dividend falls 25% during a disaster, with substantially less dispersion around it. It also has a lower level of Gaussian tail risk because $2/3$ of the $\epsilon$ shocks are now common across firms.

As Panel C of Table IV shows, the model without a bailout guarantee matches put option prices in the crisis equally well. It also does a reasonably good job matching put prices in the pre-crisis period, but understating the put spread just like the model with bailouts. The match for call prices is worse than for the model with bailouts. In particular, this model shows a negative call spread in the pre-crisis which rises during the crisis. The opposite is true in the data. The implied volatility
from basket calls and puts is about the same, while it is much lower for calls than for puts in the data. The latter again reflects the high degree of idiosyncratic tail risk in this calibration.

The main problem with this calibration, however, is that the correlation between stock returns goes down in the crisis, as can be seen in Panel C of Table V. The reason is that correlations between stocks are very low during disasters in this model. In order to generate high spreads with no bailout, idiosyncratic tail risk must be set excessively high while aggregate tail risk is low. To match the pre-crisis correlation, the model must make most of the Gaussian risk systematic. This decline in correlation is a highly counter-factual and undesirable feature of the model without bailouts. Another counter-factual consequence of this is that idiosyncratic tail risk is so high that the price-dividend ratio of individual stocks blows up (it is 225,602 in levels while the one for the index is a reasonable 19).

6.4 Non-Financial Sectors

Next, we ask whether the model can explain the options prices and return moments for the non-financial sectors. We documented smaller increase in put spreads between the pre-crisis and crisis averages, as repeated in the top panel of Table VI. Table VII also shows a much smaller increase in the volatility of individual stock and index returns for non-financials than for financials. Volatilities are higher in the pre-crisis than for financials, but substantially lower during the crisis. Also, return correlations are lower, but increase to the same high level as for financials, implying a stronger increase. Matching these return facts necessitates a recalibration of the dividend growth parameters for the non-financial sector. All other parameters stay at their benchmark values. We choose

$$\Theta^{NF} = (\sigma_d, \xi_d, J, \theta_r, \delta_r, \delta_d) = (0.17, 0.14, \infty, 0.219, 0.15, 0.23).$$

This calibration features no bailout option, substantially less idiosyncratic and aggregate tail risk, and slightly more unpriced Gaussian risk, a larger fraction of which is aggregate. This allows us to match the return volatility and correlation moments well, as shown in Panel B of Table VII. The option prices in Panel B of Table VI also provide a good match to the put prices in the crisis.
They generate the 1.6 cents put spread of the data. They also generate a large increase in the put spread from pre-crisis to crisis. The model also captures the decline in the call spread that we found in the data, but overstates OTM call price levels and spreads somewhat. These results suggest that, to a first-order approximation, it is appropriate to think of the bailout guarantee as being confined to the financial sector. However, a modest bailout guarantee may be needed to explain the maximum (as opposed to the average) put spread in the non-financial sector.

We argued that the presence of a bailout option should more strongly affect put than call spreads, crisis than pre-crisis period, and financial than non-financial firms. To quantify this prediction, we construct a triple difference of basket-index spreads: we subtract from the change over time in put spreads the change over time in call spreads. We then subtract that number for the financial sector from that for the non-financial sector. In the data, the triple difference is 2.44. The calibrated model generates a very similar positive triple difference of 2.32.

6.5 Cost of Capital and Systemic Risk Measurement

We now use the model’s parameters to gauge the effect of the bailout option on the cost of capital of financial firms and to compute a measure of the total value of the subsidy implied by the collective bailout guarantee.

The benchmark model’s equity risk premium for the financial sector index is 4.7% per year in the pre-crisis and rises to 14.0% during the crisis. The bailout guarantee plays an important role in keeping the equity risk premium down. Without it, and holding all other parameters constant, the equity risk premium would be exactly twice as large. We conclude that option prices tell us that the bailout option substantially reduces the cost of capital for systemically risky financial firms. Similarly, we find that the price-dividend ratio in the model with bailout guarantees is 49.5% lower pre-crisis (in state 1) and 61% lower in the crisis state (state 2) than it would be absent guarantee. This implies that the bailout guarantee accounts for fully half of the value of the financial sector when calibrated to our sample.

Our model also enables us to measure systematic risk in the presence of a bailout guarantee.
In particular, our calibration of the financial sector model with bailout guarantees delivers the aggregate amount of tail risk is that the financial sector takes on. Absent guarantees, the average financial firm would suffer a return fall of 55.7% in a financial disaster, compared to 37.2% with guarantees. The guarantee also affects the higher-order moments of the recovery distribution. The high and variable aggregate tail risk would presumably incur much higher (systemic) regulatory capital charges if detected and measured properly. The structural model allows us to do so.

6.6 Robustness

We now investigate robustness of our main results. First, we consider a model that better fits the correlation increase. Second, we study a model that simultaneously matches put options of different moneyness. Third, we consider a 3-state model. Fourth, we consider a simple Gaussian benchmark model. Finally, we study heterogeneity between large and smaller banks.

6.6.1 Return Correlation Fit

While it avoids the decline in correlation of the model without bailout guarantees, our benchmark calibration does not generate enough of an increase in return correlation from the pre-crisis to the crisis period. Depending on whether one interprets the crisis as an elevated probability of a disaster or as the actual realization of a disaster, the model’s return correlation in state 2 is 51.1% or 40.7%. Both are below the observed 57.6%. To improve on this, we estimate the four key parameters \((J, \theta_r, \delta_r, \delta_d)\) so as to best match the put and call basket, index, and spread prices in pre-crisis and crisis (12 moments), as well as the volatility of individual and index returns and return correlations in pre-crisis and crisis (6 moments). We give the return correlation moment a higher weight in the optimization and interpret the crisis data as the actual realization of a disaster. Our best fitting calibration generates a correlation that matches the 45.8% in the pre-crisis period and that increases to 58.7% or 51.2% in state 2 depending on whether a disaster is more likely or actually realized, respectively. They straddle the observed 57.6%; see Table IX. The option pricing fit deteriorates slightly, but the model is still able to capture the observed patterns in put
and call spreads reasonably well; see Table VIII. Interestingly, the parameters in this calibration imply that 50% of the value of the financial sector is attributable to the bailout guarantee, just as in the benchmark calibration.\footnote{The equity risk premium on the financial sector index is 4.3\% in state 1 and 12.8\% in state 2 with guarantees and 10.1\% in state 1 and 32.5\% in state 2 without guarantees.}

6.6.2 Moneyness

Options with different moneyness may be informative about the degree of Gaussian versus tail aggregate and idiosyncratic risk. To investigate this possibility, we recalibrate our model to best fit financial sector basket and index put option prices with moneyness $\Delta = 20, 30, 40, \text{and} 50$, and their basket-index spread in pre-crisis and crisis (6 moments each), alongside the return volatility and return correlation moments, for a total of 30 moments. Keeping the Gaussian volatility $\sigma_d$ constant across states at 15\% and keeping the fraction of it that is common at 0\%, Panel B of Table X shows a reasonably good fit for the various put prices. However, the model overstates the basket put price in the pre-crisis and understates it in the crisis for at-the-money options. A much better fit is obtained when we allow the Gaussian volatility to rise from 14.5\% in state 1 to 30\% in state 2 while simultaneously increasing the fraction of Gaussian shocks that are common from 0\% in state 1 to 30\% in state 2. This implies more Gaussian dividend (and return) risk during the crisis and more of it common across firms. We then reoptimize over the other four structural parameters to best fit the 30 moments under consideration. While the loss rate in a disaster $\theta_d$ of 42.0\% in logs or 34.3\% in levels is similar to that of our benchmark model (46.5\% in logs and 37.2\% in levels), the parameters $\theta_r = 1.28$ and $\delta_r = .95$ are substantially higher while the bailout parameter $J = .79$ is substantially lower. The amount of idiosyncratic tail risk, governed by $\delta_d = .36$, is also lower because there is now more idiosyncratic Gaussian risk. As a result of the higher aggregate tail risk parameters, our estimates of the cost-of-capital savings from the bailout guarantee go up substantially. Removing the bailout option would result in an increase of the equity risk premium by a factor of 3.3-3.5 (from 4.0\% to 13.1\% in state 1 and from 12.1\% to 42.9\% in state 2), as opposed to a factor 2 in our benchmark calibration. That suggests our benchmark numbers are...
We also consider a model with somewhat richer dynamics for the probability of a disaster. In particular we want to differentiate between the relatively mild crisis of the August 2007-August 2008 and April 2009-June 2009 and the sharp crisis of September 2008-March 2009. A 3-state Markov model allows us to capture the idea that, conditional on being in a mild crisis there is a chance of a substantial deterioration in the health of the financial sector. We leave the disaster probability in state 1 at 7% and set the disaster probability in state 2 to 14% and to 60% in state 3. The 3-state model has the same 13% unconditional disaster probability. Consumption volatility is 0.35% in state 1, 0.75% in state 2, and 1.5% in state 3. As in the benchmark 2-state model, we hold $\sigma_d = 0.15$ and $\xi_d = 0$ constant across states. We choose the remaining four parameters to best fit the usual put and call price, and return moments (27 moments). The model generates a large increase in put spread from 0.6 in state 1 to 1.2 in state 2 to 8.3 in state 3. In the data, the put spread increases from 0.8 pre-crisis to 2.7 in the mild crisis subsamples, and to 6.4 in the severe crisis. The model generates a decline in the call spread from 0.2 to -0.2 from pre-crisis to severe crisis, compared to 0.3 to -0.1 in the data. The model is also broadly consistent with the sharp increases in individual and index volatility during the severe crisis, and with the increase in return correlations in both crisis subsamples. Detailed results are available upon request. The model implies an equity risk premium of 5.6% pre-crisis, 21.4% in the mild crisis, and 29.2% in the severe crisis. Absent the bailout option, the risk premium would be 12.3, 39.2, and 73.2%; the value of the financial sector would be 45% lower.

### 6.6.4 Gaussian Model

Not only are we not able to explain the data in a model with financial disasters without government guarantees, we are also not able to account for the data in a model without disasters. We study a standard Black-Scholes model with only Gaussian risk. To give this model a chance of explaining

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\[ \Pi = [0.85, 0.15, 0; 0.506, 0.286, 0.208; 0, 0.5, 0.5] \]
the data, we increase Gaussian consumption growth volatility to $\sigma_c(1) = 0.01$ pre-crisis and $\sigma_c(2) = 0.05$ during the crisis. We allow for the Gaussian risk to vary across two Markov states and set parameters $\sigma_d(1) = 0.133$, $\sigma_d(2) = 0.698$, $\xi_d(1) = .705$, $\xi_d(2) = 0.315$ so as to match the observed individual and index return volatility in the financial sector exactly. Matching the high individual return volatility of 72.9% in the crisis requires a large amount of idiosyncratic risk in state 2. Matching the index volatility of 43.8% during the crisis, requires assuming that 31.5% of Gaussian dividends shocks are common. Because the index volatility is relatively high compared to individual volatility, we need to choose a much higher fraction of common shocks in the pre-crisis period. This parameter configuration has the consequence of a very high 84% stock return correlation pre-crisis, which falls to 37% during the crisis. This pattern is highly counter-factual. This calibration generates basket and index put prices that are essentially zero pre-crisis. During the crisis, it generates basket prices that are too high and index prices that are too low, so that the put spread is 7.8 in the model compared to 3.8 in the data. Call spreads go up in the model, but down in the data. We conclude that a Gaussian risk model cannot account for the patterns observed in the data and suffers from the same correlation problem as the disaster model without bailout guarantees.

6.6.5 Heterogeneity across Large and Small Banks

So far, we have considered models were all banks are ex-ante identical. One might think that large banks are more systemically risky and may therefore enjoy larger government guarantees. All else equal, that would result in comparatively lower costs of capital for large banks. To investigate this hypothesis, we consider two groups of banks. The first group consists of the largest ten banks by market capitalization as of the end of July 2007 (see right column of Table A) plus Fannie Mae (number 11) and Freddie Mac (number 14). We refer to this group as the “big 12.” The second group contains all other banks in the financial sector index. When we loose a member of the big 12 in our option data set, we replace it the next-largest bank as of the end of July 2007.\footnote{There are four such replacements (for Fannie and Freddie on September 8, 2008 and for Wachovia and Merrill Lynch on January 1, 2009) so that BNY-Mellon, US Bancorp, Metlife and Prudential join the big 12, in that order. The resulting big 12 group has a stable market share between 45 and 55% of the total market capitalization of all firms in the financial sector index over our sample. A sample without replacement would have a declining market share during the crisis.}

For
these two groups of banks, we hold fixed all aggregate risk parameters \((J, \theta_r, \delta_r, \sigma_c)\) at their values from the calibration discussed in Section 6.6.1. We continue to set \(\xi_d = 0\) so that all non-priced Gaussian dividend shocks are idiosyncratic in nature. We allow for heterogeneity across the groups in the parameters \((\lambda_d, \delta_d, \sigma_d(1), \sigma_d(2))\). The first parameter governs how much exposure a bank has to the aggregate tail process \(J^a\), the second its idiosyncratic tail risk, and the last two the Gaussian idiosyncratic risk. We set the parameter \(\lambda_d = 1.208\) for large banks and \(\lambda_d = 0.936\) for small banks in order to match the (within-group average) regression coefficients of individual stock returns on a constant and the financial sector index return using only the most extreme 10% of index returns on the downside. We recall that we normalized \(\lambda_d = 1\) for the full sample of banks. Thus, the data suggest that large banks have more aggregate tail risk exposure than small banks.

We choose the remaining three parameters for each group so that they are on opposite sides of the common parameter choice of Section 6.6.1, and so that they best fit the return correlation and volatility and the put and call prices of the options for each group.

Panel A of Table XI shows the observed put and call prices for the big 12 (Panel A.1) and the other banks (Panel A.2). They are the value-weighted averages within each group, taken over the two pre-crisis and crisis subsamples. They also indicate the put and call spreads, which subtract from the option basket the (common) index option price. Finally, the table reports the (value-weighted) average individual return volatility and pairwise correlation among the stocks within a group. From pre-crisis to crisis, the increase in return volatility and put spread are much larger for the big 12 than for the smaller banks while the increase in return correlation is much smaller. Panel B shows that our model can match these facts for both groups. In addition to a higher aggregate tail risk exposure, large banks have more idiosyncratic tail risk, which is needed to explain their high return volatility during the crisis, and less Gaussian idiosyncratic risk, which is needed to explain their high pre-crisis return correlation which increases only modestly during the crisis. The opposite is true for small banks; the parameter choices are listed in the table caption. Having shown that we can account for the heterogeneity in option price and return features of each group, we can ask how much higher the cost of capital would be for each group absent a bailout guarantee,
holding fixed the other group-specific parameters. We find that the cost of capital for large banks would increase by 12% points, 1.5 times the 9% point increase for the small banks. This suggests that large banks’ options were “cheap” because they disproportionately enjoyed the government guarantee.

7 Alternative Explanations

We consider three alternative explanations to collective bailout options: mispricing and short sale restrictions, liquidity, and time-varying correlation risk premia. We conclude that none is consistent with the patterns in the data.

7.1 Mispricing and short-sale restrictions

Recent research has documented violations of the law of one price in several segments of financial markets during the crisis. In currency markets, violations of covered interest rate parity have been documented (see Garleanu and Pedersen, 2009). In government bond markets, there was mispricing between TIPS, nominal Treasuries and inflation swaps (see Fleckenstein, Longstaff, and Lustig, 2010). Finally, in corporate bond markets, large arbitrage opportunities opened up between CDS spreads and the CDX index and between the corporate bond yields and the CDS (see Mitchell and Pulvino, 2009). A few factors make the mispricing explanation a less plausible candidate for our basket-index put spread findings.

First, trading on the difference between the cost of the index options and the cost of the basket does not require substantial capital, unlike some of these other trades (CDS basis trade, TIPS/Treasury trade). Hence, instances of mispricing in the options basket-index spread due to capital shortages are less likely to persist (see Mitchell, Pedersen, and Pulvino, 2007; Duffie, 2010).

Second, if we attribute our basket-index spread findings to mispricing, we need to explain the divergence between put and call spreads. This asymmetry rules out most alternative explanations except perhaps counter-party risk. The state of the world in which the entire financial sector, or the whole economy, is at risk is the state of the world in which OTM index put options pay off.
However, these are exchange traded options and hence are cleared through a clearing house; no clearing house has ever failed. All options transactions on the CBOE are cleared by the Options Clearing Corporation. This is the first clearinghouse to receive Standard & Poor’s highest credit rating. Hence, these options are very unlikely to be affected by counterparty default risk.

Finally, our analysis of implied volatility on index options has established that these index options are cheap during the crisis even when comparing implied to realized volatility. This comparison does not rely on individual option prices, which may be more subject to mispricing.

A related alternative explanation is short sale restrictions on financial sector stocks. A short sale ban could push investors to express their bearish view by buying put options instead of shorting stocks. Market makers or other investors may find writing such put options more costly when such positions cannot be hedged by shorting stock. The SEC imposed a short sale ban from September 19, 2008 until October 8, 2008 which affected 800 financial stocks. From July 21, 2008 onwards, there was a ban on *naked* short-selling for Freddie Mac, Fannie Mae, and 17 large banks. However, exchange and over-the-counter option market makers where exempted from both SEC rules so that they could continue to provide liquidity and hedge their positions during the ban. Both the short window of the ban, compared to the period over which the put spread increased (recall it peaks first on October 13 after the ban is lifted and again in March 2009), and the exemption for market makers make the short sale ban an unlikely explanation for our findings.

### 7.2 Liquidity

Another potential alternative explanation of our findings is that individual put options are more liquid than index put options, and that their relative liquidity rose during the financial crisis. The same must not be true for call options. We now argue that these liquidity facts are an unlikely explanation for our findings, often pointing in the opposite direction.

Table XII reports summary statistics for the liquidity of *put* options on the S&P 500 index, sector indices (a value-weighted average across all 9 sectors), the financial sector index, all individual stock options (a value-weighted average), and individual financial stock options. The table reports
daily averages of the bid-ask spread in dollars, the bid-ask spread in percentage of the midpoint price, trading volume, and open interest. The columns cover the full range of moneyness, from deep OTM \( (\Delta < 20) \) to deep ITM \( (\Delta > 80) \), while the rows report a range of option maturities. We separately report averages for the pre-crisis period (January 2003 until July 2007) and the crisis period (August 2007 until March 2009). It is worth pointing out that a substantial fraction of trade in index options takes place in over-the-counter markets, which are outside our database. Hence, these numbers overstate the degree of illiquidity. However, absent arbitrage opportunities across trading locations, the option prices in our database do reflect this additional liquidity.

Deep OTM put options with \( \Delta < 20 \) have large spreads, and volume is limited. OTM puts with \( \Delta \) between 20 and 50 still have substantial option spreads. For the long-dated OTM puts (maturity in excess of 180 days), the average pre-crisis spread is 5.5\% for the S&P 500, 12.8\% for the sector options, 10.8\% for the financial sector options, 6.8\% for all individual stock options, and 7.0\% for individual stock options in the financial sector. Financial sector index options appear, if anything, more liquid than other sector index options. The liquidity difference between index and individual put options is smaller for the financial sector than for the average sector.

Interestingly, during the crisis, the liquidity of the options appears to increase. For long-dated OTM puts, the spreads decreased from 5.5\% to 4.7\% for S&P 500 options, from 12.8 to 7.8\% for sector options, from 10.8\% to 4.5\% for financial sector options, from 6.8 to 5.5 \% for all individual options, and from 7.0\% to 5.8\% for financial firms’ options.\(^{15}\) At the same time, volume and open interest for long-dated OTM puts increased. For example, volume increased from 400 to 507 contracts for the S&P 500 index options, from 45 to 169 for the sector options, from 287 to 1049 for financial index options, and from 130 to 162 for individual stock options in the financial sector. During the crisis, trade in OTM financial sector put options invariably exceeds not only trade in the other sector OTM put options but also trade in the OTM S&P 500 options. The absolute increase in liquidity of financial sector index puts during the crisis, and the relative increase versus individual put options suggests that index options should have become more expensive, not cheaper.

\(^{15}\)Absolute bid-ask spreads increase during the crisis but this is explained by the rise in put prices during the crisis. Absolute bid-ask spreads increase by less than the price.
during the crisis.

Short-dated put options (with maturity less than 10 days) are more liquid than long-dated options; they experience a larger increase in trade during the crisis. We verified above that our results are robust across option maturities. When expressed in comparable units, the increase in the basket-index put spread seemed larger for short-dated maturities, if anything.

Table XIII reports the same liquidity statistics for calls. Calls and puts are similarly liquid yet display very different basket-index spread behavior. Finally, the increase in the basket-index spread during the crisis is also (and even more strongly) present in shorter-dated options, which are more liquid. All these facts suggest that illiquidity is an unlikely candidate.

7.3 Time-Varying Price of Correlation Risk

Index put options are typically considered to be expensive. Returns on index put options are large and negative: -90% per month for deep OTM put options (see Bondarenko, 2003). CAPM alphas are large and negative as well, and Sharpe ratios on put writing strategies are larger than those on the underlying index. However, this does not imply these options are mispriced (see Broadie, Chernov, and Johannes, 2009). Stochastic volatility models and models with jumps can explain many features of these returns.

Driessen et al. (2009) attribute the expensiveness of index options to a negative correlation risk premium. The value of an index option increases when correlations of the basket constituents increase. This is because an increase in correlation constitutes a deterioration in the investment opportunity set, and index options provide investors with a hedge against such increases. A related stylized fact is that the implied index volatility is always higher than the expected realized index volatility, but the implied volatilities for individual stocks are not significantly higher than their expected realized volatilities. These features arise from models with (i) a zero risk price for idiosyncratic variance risk and (ii) a negative risk price for correlation risk.

We showed that the patterns for financial sector put options during the crisis were exactly the opposite. Implied volatility is often lower than the realized volatility for the index but not
for the individual stocks during the crisis, and the index put option decreases in price relative to the individual options despite an increase in return correlations. These patterns for puts could in principle be consistent with a decrease in the price of correlation risk (in absolute value) over time. But, if anything, one would expect the price of correlation risk to increase in absolute value during the crisis. Furthermore, such a decreased price of correlation risk would have counter-factual implications for call spreads, which would be predicted to increase as well. The data instead show a decline in call spreads during the crisis.

8 Conclusion

We propose a structural model that can disentangle true exposure to aggregate tail risk from exposure implied by market prices and thus accounts for distortions due to the implicit promise of bailouts. Our model identifies the magnitude of the collective bailout guarantee to the financial sector from the difference between the price of a basket of put options on individual financial firms and the price of a put option on the financial sector index. It ascribes the increase in the put spread to an increased probability of a financial disaster. During such periods, there is an increase in the relative amount of aggregate versus idiosyncratic tail risk, which helps to explain the increased return correlation between stocks. Put spreads can only rise because of a collective bailout guarantee which makes index options artificially cheap. Our model calibration suggests that the government’s backstop massively reduced the cost-of-capital to the financial sector over our 2003-2009 sample. The substantial amount of aggregate tail risk the sector takes on would lead to a fifty percent reduction in its market value if the guarantee were taken away.

References


47


This table reports summary statistics for the basket-index spread in the cost of insurance per dollar insured. Numbers reported are in cents per dollar of the strike price. The full sample covers 1/2003-6/2009. The pre-crisis sample covers 1/2003-7/2007. The crisis sample covers 8/2007-6/2009. ∆ is 20. In the top panel, Time to maturity is 365 days. In Panel I, we choose the index option with the same ∆ as the individual options. In Panel II, we choose the index option with the same share-weighted strike price as the basket.
Table II: Summary Stats for Spreads on Options sorted by Moneyness

<table>
<thead>
<tr>
<th></th>
<th>Financials</th>
<th>Non-financials</th>
<th>F Minus NF</th>
<th>Financials</th>
<th>Non-financials</th>
<th>F Minus NF</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Puts</td>
<td>Calls</td>
<td>Puts</td>
<td>Calls</td>
<td>P Minus C</td>
<td>Puts</td>
</tr>
<tr>
<td>Full mean</td>
<td>1.693</td>
<td>0.238</td>
<td>1.106</td>
<td>0.208</td>
<td></td>
<td>2.133</td>
</tr>
<tr>
<td>Delta = 20</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Delta = 30</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pre-Crisis mean</td>
<td>0.810</td>
<td>0.315</td>
<td>0.911</td>
<td>0.249</td>
<td></td>
<td>1.193</td>
</tr>
<tr>
<td>std</td>
<td>0.197</td>
<td>0.056</td>
<td>0.442</td>
<td>0.052</td>
<td></td>
<td>0.293</td>
</tr>
<tr>
<td>min</td>
<td>0.078</td>
<td>2.593</td>
<td>3.265</td>
<td>-0.033</td>
<td>-1.899 -0.498 -1.732</td>
<td>0.227 0.101 0.023 0.269 0.074 -0.023 -0.285 0.074 -0.139 -0.125 -0.125 -0.125</td>
</tr>
<tr>
<td>max</td>
<td>2.269</td>
<td>5.462</td>
<td>8.090</td>
<td>3.090</td>
<td>9.070 0.440 9.568</td>
<td>14.090 0.843 5.345 0.683 11.002 0.789 11.691</td>
</tr>
<tr>
<td>Crisis mean</td>
<td>3.792</td>
<td>0.055</td>
<td>1.572</td>
<td>0.111</td>
<td>2.220 0.057 2.277</td>
<td>4.370 0.142 2.042 0.258 2.328 0.116 2.444</td>
</tr>
<tr>
<td>std</td>
<td>2.393</td>
<td>0.166</td>
<td>0.904</td>
<td>0.100</td>
<td>1.705 0.130 1.791</td>
<td>2.573 0.336 1.006 0.165 1.807 0.277 2.007</td>
</tr>
<tr>
<td>min</td>
<td>-0.133</td>
<td>-0.437</td>
<td>-0.122</td>
<td>-0.253</td>
<td>-0.538 -0.498 -0.740</td>
<td>0.279 0.101 0.023 0.269 0.074 -0.023 -0.285 0.074 -0.139 -0.125 -0.125 -0.125</td>
</tr>
<tr>
<td>max</td>
<td>12.458</td>
<td>0.487</td>
<td>4.128</td>
<td>0.359</td>
<td>9.070 0.440 9.568</td>
<td>14.090 0.843 5.345 0.683 11.002 0.789 11.691</td>
</tr>
<tr>
<td>Delta = 40</td>
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</tr>
<tr>
<td>Delta = 50</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pre-Crisis mean</td>
<td>1.620</td>
<td>0.957</td>
<td>1.740</td>
<td>0.791</td>
<td>-0.116 0.167 0.283</td>
<td>2.114 1.403 2.262 1.184 -0.145 0.221 -0.365</td>
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<tr>
<td>std</td>
<td>0.305</td>
<td>0.175</td>
<td>0.519</td>
<td>0.152</td>
<td>0.441 0.191 0.378</td>
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</tr>
<tr>
<td>min</td>
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<td>0.093</td>
<td>0.029</td>
<td>0.367</td>
<td>-2.825 -0.908 -2.213</td>
<td>0.586 0.375 0.348 0.173 0.038 -0.032 -0.285 0.074 -0.139 -0.125 -0.125 -0.125</td>
</tr>
<tr>
<td>max</td>
<td>2.955</td>
<td>1.406</td>
<td>4.771</td>
<td>1.303</td>
<td>2.033 0.584 1.705</td>
<td>4.015 2.178 5.895 2.254 2.290 1.187 1.734</td>
</tr>
<tr>
<td>Crisis mean</td>
<td>4.867</td>
<td>0.303</td>
<td>2.511</td>
<td>0.490</td>
<td>2.356 -0.188 2.544</td>
<td>5.387 0.586 3.019 0.830 2.368 -0.214 2.613</td>
</tr>
<tr>
<td>std</td>
<td>2.655</td>
<td>0.563</td>
<td>1.022</td>
<td>0.243</td>
<td>1.855 0.489 2.215</td>
<td>2.748 0.877 1.069 0.380 1.946 0.820 2.546</td>
</tr>
<tr>
<td>min</td>
<td>0.643</td>
<td>-1.743</td>
<td>0.325</td>
<td>-0.241</td>
<td>-0.734 -2.154 -0.469</td>
<td>0.486 -2.770 0.719 -0.322 -1.287 -3.579 -1.246</td>
</tr>
</tbody>
</table>

This table reports summary statistics for the basket-index spread in the cost of insurance per dollar insured. Numbers reported are in cents per dollar insured. The full sample covers 1/2003-6/2009. The pre-crisis sample covers 1/2003-7/2007. The crisis sample covers 8/2007-6/2009. We choose the index option with the same Δ as the individual options.
Table III: Percentage Basket-Index Spreads on Options with Varying Moneyness

<table>
<thead>
<tr>
<th></th>
<th>Financials</th>
<th>Non-financials</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Puts</td>
<td>Calls</td>
</tr>
<tr>
<td>Full Sample</td>
<td>mean 29.69%</td>
<td>18.41%</td>
</tr>
<tr>
<td></td>
<td>std 9.38%</td>
<td>11.95%</td>
</tr>
<tr>
<td></td>
<td>max 80.53%</td>
<td>51.73%</td>
</tr>
<tr>
<td>Pre-Crisis Sample</td>
<td>mean 26.67%</td>
<td>24.68%</td>
</tr>
<tr>
<td></td>
<td>std 5.78%</td>
<td>6.80%</td>
</tr>
<tr>
<td></td>
<td>max 43.71%</td>
<td>51.73%</td>
</tr>
<tr>
<td>Crisis Sample</td>
<td>mean 36.80%</td>
<td>3.47%</td>
</tr>
<tr>
<td></td>
<td>std 12.04%</td>
<td>7.46%</td>
</tr>
<tr>
<td></td>
<td>max 80.53%</td>
<td>20.97%</td>
</tr>
<tr>
<td>Δ = 30</td>
<td>Full Sample</td>
<td>mean 28.22%</td>
</tr>
<tr>
<td></td>
<td>std 7.66%</td>
<td>12.03%</td>
</tr>
<tr>
<td></td>
<td>max 68.84%</td>
<td>48.15%</td>
</tr>
<tr>
<td>Pre-Crisis Sample</td>
<td>mean 26.84%</td>
<td>25.47%</td>
</tr>
<tr>
<td></td>
<td>std 6.19%</td>
<td>7.09%</td>
</tr>
<tr>
<td></td>
<td>max 44.00%</td>
<td>48.15%</td>
</tr>
<tr>
<td>Crisis Sample</td>
<td>mean 31.50%</td>
<td>4.41%</td>
</tr>
<tr>
<td></td>
<td>std 9.61%</td>
<td>7.62%</td>
</tr>
<tr>
<td></td>
<td>max 68.84%</td>
<td>22.48%</td>
</tr>
<tr>
<td>Δ = 40</td>
<td>Full Sample</td>
<td>mean 27.99%</td>
</tr>
<tr>
<td></td>
<td>std 7.17%</td>
<td>11.91%</td>
</tr>
<tr>
<td></td>
<td>max 57.82%</td>
<td>51.69%</td>
</tr>
<tr>
<td>Pre-Crisis Sample</td>
<td>mean 27.87%</td>
<td>25.69%</td>
</tr>
<tr>
<td></td>
<td>std 6.78%</td>
<td>7.46%</td>
</tr>
<tr>
<td></td>
<td>max 47.14%</td>
<td>51.69%</td>
</tr>
<tr>
<td>Crisis Sample</td>
<td>mean 28.22%</td>
<td>5.39%</td>
</tr>
<tr>
<td></td>
<td>std 8.04%</td>
<td>7.57%</td>
</tr>
<tr>
<td></td>
<td>max 57.82%</td>
<td>23.14%</td>
</tr>
<tr>
<td>Δ = 50</td>
<td>Full Sample</td>
<td>mean 28.17%</td>
</tr>
<tr>
<td></td>
<td>std 7.26%</td>
<td>11.35%</td>
</tr>
<tr>
<td></td>
<td>max 51.71%</td>
<td>55.53%</td>
</tr>
<tr>
<td>Pre-Crisis Sample</td>
<td>mean 29.02%</td>
<td>24.93%</td>
</tr>
<tr>
<td></td>
<td>std 7.13%</td>
<td>7.62%</td>
</tr>
<tr>
<td></td>
<td>max 47.47%</td>
<td>55.53%</td>
</tr>
<tr>
<td>Crisis Sample</td>
<td>mean 26.11%</td>
<td>6.43%</td>
</tr>
<tr>
<td></td>
<td>std 7.10%</td>
<td>7.53%</td>
</tr>
<tr>
<td></td>
<td>max 51.71%</td>
<td>24.35%</td>
</tr>
</tbody>
</table>

This table reports summary statistics for the basket-index spread. Numbers reported are in percent of the cost of the index put. The full sample covers 1/2003-6/2009. The pre-crisis sample covers 1/2003-7/2007. The crisis sample covers 8/2007-6/2009. Δ is 20. We choose the index option with the same Δ as the individual options.
Table IV: Option Prices in Model and Data in Financial Sector

The table reports option prices and implied volatility for the financial sector index, for its constituents, and pairwise correlations between the stocks in the financial sector index. Panel A is for the January 2003-June 2009 data. Panel B is for a model with parameters \( \sigma_d(1) = \sigma_d(2) = 0.15, \xi_d(1) = \xi_d(2) = 0, \delta_d = 0.516, J = 0.921, \theta_r = 0.815, \) and \( \delta_r = 0.55. \) Panel C sets \( \sigma_d(1) = \sigma_d(2) = 0.15, \xi_d(1) = \xi_d(2) = 0, \delta_d = 0.65, J = +\infty, \theta_r = 0.2825, \) and \( \delta_r = 0.25. \)

<table>
<thead>
<tr>
<th>Puts Calls</th>
<th>Basket Index Spread Basket Index Spread</th>
<th>Panel I: Data</th>
</tr>
</thead>
<tbody>
<tr>
<td>Option Prices</td>
<td></td>
<td></td>
</tr>
<tr>
<td>pre-crisis</td>
<td>4.0</td>
<td>3.2</td>
</tr>
<tr>
<td>crisis</td>
<td>13.7</td>
<td>9.9</td>
</tr>
<tr>
<td>Implied Vol</td>
<td></td>
<td></td>
</tr>
<tr>
<td>pre-crisis</td>
<td>25.9</td>
<td>21.7</td>
</tr>
<tr>
<td>crisis</td>
<td>59.5</td>
<td>48.5</td>
</tr>
</tbody>
</table>

Panel II: Model with Bailout

<table>
<thead>
<tr>
<th>Option Prices</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>pre-crisis</td>
<td>4.3</td>
<td>4.1</td>
<td>0.3</td>
</tr>
<tr>
<td>crisis</td>
<td>13.7</td>
<td>9.9</td>
<td>3.8</td>
</tr>
<tr>
<td>Implied Vol</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>pre-crisis</td>
<td>34.1</td>
<td>31.2</td>
<td>2.9</td>
</tr>
<tr>
<td>crisis</td>
<td>61.3</td>
<td>46.7</td>
<td>14.6</td>
</tr>
</tbody>
</table>

Panel III: Model without Bailout

<table>
<thead>
<tr>
<th>Option Prices</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>pre-crisis</td>
<td>3.8</td>
<td>3.4</td>
<td>0.4</td>
</tr>
<tr>
<td>crisis</td>
<td>13.7</td>
<td>9.9</td>
<td>3.8</td>
</tr>
<tr>
<td>Implied Vol</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>pre-crisis</td>
<td>32.2</td>
<td>29.2</td>
<td>3.0</td>
</tr>
<tr>
<td>crisis</td>
<td>62.9</td>
<td>48.6</td>
<td>14.3</td>
</tr>
</tbody>
</table>

Table V: Return Moments in Model and Data in Financial Sector

The table reports realized volatility for the financial sector index, for its constituents, and pairwise correlations between the stocks in the financial sector index. The crisis numbers for the model represent the unconditional moment in state 2, taking disasters into account probabilistically. The number in italic for the model report the moments in state 2 of the model conditional on a disaster realization.

Panel A is for the January 2003-June 2009 data. Panel B is for a model with parameters \( \sigma_d(1) = \sigma_d(2) = 0.15, \xi_d(1) = \xi_d(2) = 0, \delta_d = 0.516, J = 0.921, \theta_r = 0.815, \) and \( \delta_r = 0.55. \) Panel C sets \( \sigma_d(1) = \sigma_d(2) = 0.15, \xi_d(1) = \xi_d(2) = 0, \delta_d = 0.65, J = +\infty, \theta_r = 0.2825, \) and \( \delta_r = 0.25. \)

<table>
<thead>
<tr>
<th>Index Individual Stocks</th>
<th>Volatility</th>
<th>Volatility Correlations</th>
<th>Panel I: Data</th>
</tr>
</thead>
<tbody>
<tr>
<td>pre-crisis</td>
<td>11.9</td>
<td>18.1</td>
<td>45.8</td>
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<tr>
<td>crisis</td>
<td>43.8</td>
<td>72.9</td>
<td>57.6</td>
</tr>
<tr>
<td>Panel II: Model with Bailout</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>pre-crisis</td>
<td>19.2</td>
<td>26.7</td>
<td>42.3</td>
</tr>
<tr>
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<td>31.9</td>
<td>44.5</td>
<td>51.1</td>
</tr>
<tr>
<td>46.4</td>
<td>69.5</td>
<td>40.7</td>
<td></td>
</tr>
<tr>
<td>Panel III: Model without Bailout</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>pre-crisis</td>
<td>18.7</td>
<td>26.0</td>
<td>43.8</td>
</tr>
<tr>
<td>crisis</td>
<td>28.7</td>
<td>44.4</td>
<td>35.8</td>
</tr>
<tr>
<td>42.8</td>
<td>76.7</td>
<td>26.7</td>
<td></td>
</tr>
</tbody>
</table>

53
Table VI: Option Prices in Model and Data in Non-Financial Sector

The table reports option prices and implied volatility for the non-financial sector index, for its constituents, and pairwise correlations between the stocks in the financial sector index. Panel A is for the January 2003-June 2009 data. Panel B is for a model with parameters $\sigma_d(1) = \sigma_d(2) = 0.17$, $\xi_d(1) = \xi_d(2) = 0.14$, $\delta_d = 0.23$, $J = +\infty$, $\theta_r = 0.219$, and $\delta_r = 0.15$.

<table>
<thead>
<tr>
<th>Puts Basket</th>
<th>Index</th>
<th>Spread</th>
<th>Calls Basket</th>
<th>Index</th>
<th>Spread</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Panel I: Data</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>pre-crisis</td>
<td>4.3</td>
<td>3.4</td>
<td>0.9</td>
<td>1.8</td>
<td>1.5</td>
</tr>
<tr>
<td>crisis</td>
<td>7.9</td>
<td>6.3</td>
<td>1.6</td>
<td>2.2</td>
<td>2.0</td>
</tr>
<tr>
<td>pre-crisis</td>
<td>28.6</td>
<td>21.7</td>
<td>6.9</td>
<td>23.2</td>
<td>15.9</td>
</tr>
<tr>
<td>crisis</td>
<td>41.7</td>
<td>34.2</td>
<td>7.5</td>
<td>32.1</td>
<td>24.3</td>
</tr>
<tr>
<td><strong>Panel II: Model without Bailout</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>pre-crisis</td>
<td>2.8</td>
<td>2.3</td>
<td>0.5</td>
<td>1.5</td>
<td>0.9</td>
</tr>
<tr>
<td>crisis</td>
<td>7.9</td>
<td>6.3</td>
<td>1.6</td>
<td>2.0</td>
<td>1.6</td>
</tr>
<tr>
<td>pre-crisis</td>
<td>27.1</td>
<td>22.4</td>
<td>4.7</td>
<td>17.0</td>
<td>8.4</td>
</tr>
<tr>
<td>crisis</td>
<td>42.6</td>
<td>35.6</td>
<td>7.0</td>
<td>25.1</td>
<td>20.0</td>
</tr>
</tbody>
</table>

Table VII: Return Moments in Model and Data in Non-financial Sector

The table reports realized volatility for the financial sector index, for its constituents, and pairwise correlations between the stocks in the non-financial sector index. The crisis numbers for the model represent the unconditional moment in state 2, taking disasters into account probabilistically. The number in italic for the model report the moments in state 2 of the model conditional on a disaster realization. Panel A is for the January 2003-June 2009 data. Panel B is for a model with parameters $\sigma_d(1) = \sigma_d(2) = 0.17$, $\xi_d(1) = \xi_d(2) = 0.14$, $\delta_d = 0.23$, $J = +\infty$, $\theta_r = 0.219$, and $\delta_r = 0.15$.

<table>
<thead>
<tr>
<th>Index Individual Stocks</th>
<th>Volatility</th>
<th>Correlations</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Panel I: Data</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>pre-crisis</td>
<td>12.2</td>
<td>21.5</td>
</tr>
<tr>
<td>crisis</td>
<td>25.1</td>
<td>35.1</td>
</tr>
<tr>
<td><strong>Panel II: Model without Bailout</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>pre-crisis</td>
<td>12.7</td>
<td>20.7</td>
</tr>
<tr>
<td>crisis</td>
<td>19.9</td>
<td>27.7</td>
</tr>
<tr>
<td></td>
<td>28.7</td>
<td>39.5</td>
</tr>
</tbody>
</table>

Table VIII: Robustness: Improving Correlation Fit

The table reports option prices and implied volatility for the financial sector index, for its constituents, and pairwise correlations between the stocks in the financial sector index. Panel A is for the January 2003-June 2009 data. Panel B is for a model with parameters $\sigma_d(1) = \sigma_d(2) = 0.15$, $\xi_d(1) = \xi_d(2) = 0$, $\delta_d = 0.39$, $J = \infty$, $\theta_r = 0.95$, and $\delta_r = 0.71$.

<table>
<thead>
<tr>
<th>Put Prices Basket</th>
<th>Index</th>
<th>Spread</th>
<th>Call Prices Basket</th>
<th>Index</th>
<th>Spread</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Panel I: Data</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>pre-crisis</td>
<td>4.9</td>
<td>3.2</td>
<td>0.8</td>
<td>1.6</td>
<td>1.3</td>
</tr>
<tr>
<td>crisis</td>
<td>13.7</td>
<td>9.9</td>
<td>3.8</td>
<td>2.4</td>
<td>2.3</td>
</tr>
<tr>
<td><strong>Panel II: Model with Bailout</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>pre-crisis</td>
<td>3.9</td>
<td>3.7</td>
<td>0.2</td>
<td>1.4</td>
<td>1.0</td>
</tr>
<tr>
<td>crisis</td>
<td>11.7</td>
<td>8.8</td>
<td>2.9</td>
<td>2.3</td>
<td>2.1</td>
</tr>
</tbody>
</table>
Table IX: Robustness: Improving Correlation Fit

The table reports realized volatility for the financial sector index, for its constituents, and pairwise correlations between the stocks in the non-financial sector index. The crisis numbers for the model represent the unconditional moment in state 2, taking disasters into account probabilistically. The number in static for the model report the moments in state 2 of the model conditional on a disaster realization. Panel A is for the January 2003-June 2009 data. Panel B is for a model with parameters $\sigma_d(1) = \sigma_d(2) = 0.15$, $\xi_d(1) = \xi_d(2) = 0$, $\delta_d = 0.39$, $J = 0.84$, $\theta_r = 0.95$, and $\delta_r = 0.71$.

<table>
<thead>
<tr>
<th>Index Individual Stocks</th>
<th>Panel I: Data</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Volatility</td>
</tr>
<tr>
<td>pre-crisis</td>
<td>11.9</td>
</tr>
<tr>
<td>crisis</td>
<td>43.8</td>
</tr>
<tr>
<td></td>
<td>Panel II: Model without Bailout</td>
</tr>
<tr>
<td>pre-crisis</td>
<td>17.9</td>
</tr>
<tr>
<td>crisis</td>
<td>31.5</td>
</tr>
<tr>
<td></td>
<td>44.2</td>
</tr>
</tbody>
</table>
The table reports basket and index put option prices for puts with moneyness $\Delta = 20$, 30, 40, and 50. It also reports realized volatility for the financial sector index, for its constituents, and pairwise correlations between the stocks in the non-financial sector index. Panel A is for the January 2003-June 2009 data. Panel B is for a model with parameters $\sigma_d(1) = \sigma_d(2) = 0.15$, $\xi_d(1) = \xi_d(2) = 0$, $\delta_d = 0.47$, $J = 0.82$, $\theta_e = 1.2$, and $\delta_e = 0.95$. Panel C is for a model with parameters $\sigma_d(1) = 0.145$, $\sigma_d(2) = 0.30$, $\xi_d(1) = 0$, $\xi_d(2) = 0.30$, $\delta_d = 0.36$, $J = 0.70$, $\theta_e = 1.28$, and $\delta_e = 0.95$. The crisis numbers for the model represent the unconditional moment in state 2, taking disasters into account probabilistically. The number in italics for the model report the moments in state 2 of the model conditional on a disaster realization.

<table>
<thead>
<tr>
<th>Puts Delta = 20</th>
<th>Puts Delta = 30</th>
<th>Puts Delta = 40</th>
<th>Puts Delta = 50</th>
<th>Return moments</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Basket</td>
<td>Index</td>
<td>Spread</td>
<td>Basket</td>
</tr>
<tr>
<td>pre-crisis</td>
<td>4.0</td>
<td>3.2</td>
<td>0.8</td>
<td>5.8</td>
</tr>
<tr>
<td>crisis</td>
<td>13.7</td>
<td>9.9</td>
<td>3.8</td>
<td>17.8</td>
</tr>
<tr>
<td>Panel A: Moments in Data</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

|                  | Basket | Index | Spread | Basket | Index | Spread | Basket | Index | Spread | Basket | Index | Spread | Index vol | Indiv vol | Indiv Correl |
| pre-crisis       | 4.0    | 3.8   | 0.2    | 5.7    | 5.1   | 0.5    | 8.3    | 6.4   | 1.9    | 12.4   | 8.7   | 3.7    | 18.0      | 25.4      | 41.5        |
| crisis           | 12.8   | 9.3   | 3.5    | 16.0   | 13.6  | 2.4    | 18.8   | 16.6  | 2.1    | 21.8   | 18.7  | 3.0    | 31.9/46.0 | 42.1/66.2 | 52.3/44.4   |
| Panel B: Moments in Model with Bailout; fix Gaussian risk |

|                  | Basket | Index | Spread | Basket | Index | Spread | Basket | Index | Spread | Basket | Index | Spread | Index vol | Indiv vol | Indiv Correl |
| pre-crisis       | 3.7    | 3.6   | 0.1    | 5.3    | 4.9   | 0.3    | 8.0    | 6.1   | 1.8    | 12.8   | 8.2   | 4.6    | 17.2      | 23.5      | 45.6        |
| crisis           | 12.3   | 8.9   | 3.4    | 16.4   | 13.0  | 3.4    | 20.4   | 16.3  | 4.1    | 24.4   | 19.1  | 5.3    | 35.1/46.6 | 46.2/62.9 | 53.4/51.4   |
| Panel C: Moments in Model with Bailout; change Gaussian risk |

Table X: Option and Return Moments by Option Moneyness
Table XI: Heterogeneity: Option and Return Moments for Large and Small Banks

The table reports basket put and call prices for options with moneyness $\Delta = 20$ and maturity of one year, as well as the spread over the corresponding index option price with the same $Delta$ and maturity. It also reports individual stock return volatility and pairwise return correlations for the firms within each group. The two groups of firms are discussed in the main text. Panel A is for the January 2003-June 2009 data. Panel B is for the model with common parameters $J = 0.84$, $\theta_r = 0.95$, $\delta_r = 0.71$, and $\xi_d(1) = \xi_d(2) = 0$.

The big 12 group of large banks has parameters $\lambda_d = 1.208$, $\sigma_d(1) = 0.11$, $\sigma_d(2) = 0.09$, $\delta_d = 0.50$. The group of all other banks has parameters $\lambda_d = 0.936$, $\sigma_d(1) = 0.18$, $\sigma_d(2) = 0.20$, $\delta_d = 0.32$. Within each group, all firms are ex-ante identical. The crisis numbers for the model represent the unconditional moment in state 2, taking disasters into account probabilistically. The number *in italics* for the model report the moments in state 2 of the model *conditional* on a disaster realization.

<table>
<thead>
<tr>
<th></th>
<th>Panel A.1: Big 12</th>
<th>Panel A.2: All other banks</th>
<th>Panel B: Model</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Put prices</td>
<td>Call prices</td>
<td>Returns</td>
</tr>
<tr>
<td></td>
<td>basket spread</td>
<td>basket spread</td>
<td>indiv vol correl</td>
</tr>
<tr>
<td>pre-crisis</td>
<td>4.0 0.8</td>
<td>1.6 0.3</td>
<td>17.0 57.0</td>
</tr>
<tr>
<td>crisis</td>
<td>14.5 4.6</td>
<td>2.4 0.1</td>
<td>84.7 59.4</td>
</tr>
<tr>
<td>crisis</td>
<td>72.3 50.6</td>
<td></td>
<td>55.1 53.1</td>
</tr>
<tr>
<td>Pre-Crisis Sample</td>
<td>10 Days TTM ≤ 90 Days</td>
<td>90 Days TTM ≤ 180 Days</td>
<td>180 Days TTM ≤ 365 Days</td>
</tr>
<tr>
<td>-------------------</td>
<td>------------------------</td>
<td>------------------------</td>
<td>-------------------------</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>0.450 80.5% 1072 15783</td>
<td>1.295 9.4% 2219 16594</td>
<td>1.821 5.8% 663 6807</td>
</tr>
<tr>
<td>All Sector SPDRs</td>
<td>0.133 150.5% 80 3205</td>
<td>0.141 35.0% 867 7606</td>
<td>0.167 13.7% 269 3221</td>
</tr>
<tr>
<td>Financial SPDR</td>
<td>0.096 142.3% 10494</td>
<td>0.109 30.9% 1791 19708</td>
<td>0.125 12.4% 502 7907</td>
</tr>
<tr>
<td>Indiv. Stocks</td>
<td>0.088 106.3% 169 5447</td>
<td>0.106 13.2% 836 9225</td>
<td>0.152 6.2% 473 5990</td>
</tr>
<tr>
<td>Fin. Indiv. Stocks</td>
<td>0.095 103.5% 142 4534</td>
<td>0.116 13.4% 691 7667</td>
<td>0.169 6.4% 380 4888</td>
</tr>
</tbody>
</table>

Figure 1: Dollar Value of the Equity Bailout Guarantee for the Financial Sector

The dashed (full) line shows the dollar value of the equity bailout guarantee inferred from the basket-index spreads for puts. Δ is 20. Time to maturity is 365 days. We choose the index options with the same Δ as the individual options.

Figure 2: Cost Per Dollar Insured - Financial Sector

The dashed (full) line shows the cost per dollar insured for the index $Call_{index}^{basket}$ (basked, $Call_{basket}^{basket}$). The dotted line plots their difference. Δ is 20. Time to maturity is 365 days. We choose the index option with the same Δ as the individual options. The top panel looks at puts. The bottom looks at calls.
Figure 3: Basket-Index Spread in Cost Per Dollar Insured Inferred from Puts

The dashed (full) line shows the difference in the cost per dollar insured between the basket and the index: $P_{i}^{\text{basket}} - P_{i}^{\text{index}}$ for financials (non-financials). The dotted line plots their difference. $\Delta$ is 20. Time to maturity is 365 days. We choose the index option with the same $\Delta$ as the individual options.

Figure 4: Realized Equity Return Correlations

The dashed (full) line shows the average pairwise correlations within the financial sector (non-financial sectors). Daily pairwise conditional correlations for stocks are estimated using the exponential smoother with smoothing parameter 0.95. Pairwise correlations within the financial sector are then averaged each day, weighted by the pairs’ combined market equity. To address stocks’ entry into and exit from the S&P 500 index during the sample period, a pair’s correlation is only included in the average on a given day if both stocks were members of the index that day. To remain comparable to the average pairwise correlation among financial stocks, the non-financials average correlation reflects only correlations between pairs of stocks within the same sector, omitting cross-sector correlations from the average. The (within sector) pairwise correlations are then averaged across the eight non-financial sectors, according to their relative market capitalization.
Figure 5: Four Regimes during Crisis

The dashed solid line shows the basket-index spread for the financials index $P_{cdi, i}^{basket} - P_{cdi, i}^{index}$. The bottom solid line shows the spread for non-financials. The dotted line is the difference between these spreads. $\Delta$ is 20. Time to maturity is 365 days. The first line is the Oct 14 Treasury announcement. The second line is the Jan. 16, 2009 announcement by the Federal Reserve, the FDIC and the Treasury.
Figure 6: Timeline of The Financial Spread and Announcement Dates

The solid line shows the basket-index spread for the financials index $Put_{ci,1}^{basket} - Put_{ci,1}^{index}$. The dotted line shows the spread for non-financials. $\Delta$ is 20. Time to maturity is 365 days. The vertical lines are the announcement dates.
Figure 7: The Financial Spread around Announcement Dates

The solid line shows the average response of the basket-index spread for the financials index $P_{t_{cdi,i}^{basket}} - P_{t_{cdi,i}^{index}}$. The left panel looks at positive announcement dates. The right panel looks at negative announcement dates. $\Delta$ is 20. Time to maturity is 365 days.