

Risky Business

BY JOHN WEINBERG

The term “safety net” usually has a positive connotation, conjuring images of a caring society that looks after its most unfortunate members. The safety net that protects individuals against financial misfortunes can come from many sources: personal savings, family assistance, or community-based charities. Some of this protection also comes from the government, in the form of such programs as unemployment insurance, food stamps, Social Security, and Medicaid. Taken together, it is common to refer to such government programs as the “social safety net.”

There is a second set of government policies that come under the safety net label. These are government programs that guarantee the debts of private borrowers. Federal Deposit Insurance, for instance, guarantees part of the “debt” owed by commercial banks to their depositors. Other programs guarantee the debts of individuals (for example, the Federal Housing Administration’s home loan guarantees) or of corporations (the guarantees offered to airlines in the wake of the terrorist attacks of September 11, 2001, for instance). All such programs comprise the “financial safety net.”

The problem with government guarantees of private debts is that they affect people’s willingness to take risky actions or make risky investments. Consider a business loan. The lender accepts the risk that the borrower’s business project will not generate a return sufficient to repay the loan. Given the exposure to this risk, the lender typically has an incentive to pay attention to the borrower’s use of funds. The interest rate and other terms of the loan will then depend on the lender’s assessment of the risks to be taken by the borrower. When repayment of a loan is guaranteed by a third party, however, the inclination of the lender to scrutinize the borrower’s actions and to assess the project’s risks may be reduced.

The pricing of government guarantees varies considerably, but in many cases these prices do not fully reflect risks taken by borrowers. In such cases, a government guarantee amounts to a subsidy for the borrower. Because they are protected from default, investors are willing to lend funds to guaranteed borrowers at lower interest rates than they would otherwise require. In short, the financial safety net distorts financial markets by directing funding away from unprotected sectors and toward those with guarantees. In addition, safety net protection tends to encourage borrower risk-taking.

While the magnitude of the distortions created by the

safety net is hard to determine, the safety net itself is quite large. My colleague John Walter and I have counted up the debts and other private liabilities that have explicit federal guarantees and found that over 16 percent of all private liabilities in the U.S. economy had such protection at the end of 1999. Insured deposits in banks and other financial institutions account for a large part of this number, but the explicit safety net also includes many other items, such as guarantees for student and small business loans. Occasionally, Congress also grants ad hoc guarantees, as in the bailout of Chrysler in 1980, although no such special programs were included in our estimate.

Perhaps even more worrisome than the explicit safety net is the prospect that some private debt might enjoy implicit protection. Many financial market observers believe that some market participants are so big or so important that they would not be allowed to fail. If investors believe that a particular borrower would be bailed out in a situation of financial distress, then that borrower will be able to obtain funding at terms similar to those available to explicitly guaranteed borrowers. In recent years, such government-sponsored enterprises as Fannie Mae and Freddie Mac have been the subject of a growing debate concerning the extent to which they benefit from implicit safety net protection.

While explicit guarantees often bring with them regulatory oversight to control the risk-taking by protected borrowers, such oversight is often much weaker for implicitly guaranteed borrowers. In addition, implicit guarantees, by their very nature, are not priced — increasing the potential for market distortions. Through our research, Walter and I estimate that implicit guarantees could account for as much as another 10 percent of all private liabilities. Taking the implicit and explicit safety nets together, then, perhaps a quarter of all private debts are shielded by the government from the risk of default. A safety net of this size suggests the potential for sizable distortions in private financial arrangements and assessments of risk.

The financial safety net arrived at its current state in a piecemeal fashion: individual guarantees have been extended in response to the perceived needs of an individual sector or class of borrowers. Maybe what is needed now is a comprehensive review of the government’s role as a guarantor of private debts.

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