



Risk-bearing by the state: When is it good public policy?☆



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ABSTRACT

The global financial crisis brought government guarantees to the forefront of the debate. Based on a review of frictions that hinder financial contracting, this paper concludes that the common justifications for government guarantees—i.e., principal-agent frictions or un-internalized externalities in an environment of risk neutrality—are flawed. Even where risk is purely idiosyncratic—and thus diversifiable in principle—government guarantees (typically granted via development banks/agencies) can be justified if private lenders are risk averse and because of the state's comparative advantage over markets in resolving the collective action frictions that hinder risk spreading. To exploit this advantage while keeping moral hazard in check, however, development banks/agencies have to price their guarantees fairly, crowd in the private sector, and reduce their excessive risk aversion. The latter requires overcoming agency frictions between managers and owner (the state), which would likely entail a significant reshaping of development banks' mandates, governance, and risk management systems.

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1. Introduction

The global financial crisis has brought public financial risk-bearing to the forefront. Governments came to the rescue of troubled financial markets and institutions through large risk-absorption-of-last-resort operations involving outright asset purchases, capital injections and a relaxation of collateral requirements for liquidity support. Some governments also absorbed large losses from the risk positions they had implicitly taken through their developmental commitments prior to the crisis. This was the case in particular of the US government, which found itself

in the obligation to absorb the losses of Fannie Mae and Freddie Mac, the two large government-sponsored mortgage companies. In developing countries, this has reawakened contentious issues one thought had been finally settled. These countries had in effect been moving away from public sector risk-bearing through the privatization of first-tier public banks and a refocusing of development banks toward second-tier lending and catalytic supports. However, development banks are now asking themselves whether they should grow bigger even in the good times, so as to play a more forceful role in the bad times.

In this context, interest in credit guarantee programs has surged. The expansion of such programs is viewed by some as a desirable middle ground to expand the risk-bearing role of the state while limiting the distortions resulting from its direct intervention in financial activities. However, the recent US experience has also been a useful reminder that public guarantees can be quite costly, in terms of both their fiscal implications and their impact on financial development and stability.

The concerns derived from the fiscal costs of government guarantees are compounded by the fact that the conceptual foundations of these programs are quite shaky. Often, the need for state

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guarantees is justified by the existence of such market failures as credit rationing or un-internalized externalities.¹ However, once a sufficiently broad welfare criterion is adopted (one that fully internalizes the fiscal cost of the guarantees and the way it is allocated among taxpayers), it becomes unclear why state guarantees are an adequate policy response to market failures and, more specifically, why a guarantee provided by the government can succeed in improving the equilibrium where markets failed. If guarantees are called for, why can't private market participants fill up the gap? Similar questions seem to apply to nearly all forms of public financial risk bearing, including loans.

Despite the worldwide popularity of public sector credit guarantees,² which are typically granted via national and multi-lateral development agencies and banks, the theoretical literature has devoted rather scant attention to the issue. As argued in this paper, [Arrow and Lind \(1970\)](#) remains as the most fundamental and enduring rationale for public sector guarantees, which hinges on risk aversion and the government's superior capacity to spread risk across space and time. Curiously, however, this seminal paper has been mostly ignored in the more applied work on public guarantees.

This paper contributes to the policy debate by setting the underpinnings of credit guarantees on a sounder theoretical footing. Following the conceptual framework developed in [de la Torre and Ize \(2010, 2011\)](#), it analyzes the foundations of public risk-bearing by examining the interactions between risk aversion and two types of market frictions, agency (bilateral) frictions, on the one hand, and collective (multilateral) frictions, on the other. The analysis is restricted to the case of idiosyncratic risk, where a rationale in favor of government guarantees is more difficult to establish because idiosyncratic risk is, in principle, diversifiable.³ However, this restriction hardly reduces the relevance of the analysis. In effect, many of the most popular government-supported guarantee programs concern idiosyncratic risk, including those for student loans, SME finance, and long-term housing and infrastructure finance.

The paper reaches three main conclusions. First, risk aversion is essential to explain the emergence of private guarantees in the marketplace as well as to make a case in favor of unsubsidized government guarantees.⁴ In the absence of risk aversion among lenders, it is highly unlikely that fairly priced state guarantees can be justified based on traditional agency failures (such as adverse selection, moral hazard or lack of pledgeable collateral, which

ration creditworthy borrowers or projects out of the credit circuit) or collective action failures (such as un-internalized externalities, coordination failures, and free-rider problems, which drive a wedge between the private and social interests). Agency failures alone justify neither guarantees nor subsidies; externalities alone can justify targeted subsidies but not fairly priced guarantees.

Second, the state can spread idiosyncratic risk more broadly than markets by coordinating and pooling atomistic agents that would otherwise not organize themselves, including to solve agency frictions. The need to solve principal-agent frictions lead to risk concentration (reflecting the need for sufficient "skin in the game" to align incentives) and thus get in the way of risk spreading. State guarantees may have an edge over private guarantees not because the state can better resolve agency frictions (the state probably faces a handicap in this regard) but because it can better resolve the collective action frictions that get in the way of risk spreading. Thus, public guarantees may be justified, at least on a transitory basis, when financial systems are not sufficiently developed to distribute risk finely enough. However, to keep monitoring incentives alive (and thus moral hazard in check) while spreading risk, the government should price its guarantees fairly (so as to cover expected losses), share risk with the private sector, and aim at crowding in (rather than crowding out) private guarantors. Indeed, the comparative advantages of the state in resolving collective action frictions and of markets in resolving agency frictions suggest that the state and markets should naturally complement, rather than substitute for, or compete with, each other.

Third, the state's comparative advantage in spreading risk should in principle allow it to take on riskier projects than the markets—i.e., to move the risk frontier out further than markets, where risk distributions are flatter or have fatter tails. This does not generally happen in practice, however. In the past, public-sector bankers were often driven by populist policies to ignore risks and dole out generous subsidies disguised within loans or guarantees, which led to recurrent losses.⁵ Instead, in more recent times, it is typically the case that public bankers stay well within the risk frontier and compete with private bankers in relatively low risk-high return activities. Such risk aversion arises from shareholder–manager agency frictions that increase with the level of risk. The more risk a public banker takes, the more difficult it becomes for the shareholder/evaluator (ultimately, the taxpayer) to sort out whether the losses he incurred were due to bad luck or poor risk management. This is compounded by the fact that the shareholder/evaluator tends to penalize mistakes much more intensively than to reward successes. Hence, unless clear mandates, suitable governance frameworks, effective risk management systems, and appropriate impact evaluation programs are established, public-sector (development) bankers' natural risk aversion (born from a legitimate concern with being dismissed or penalized) is likely to severely limit the scope for welfare-enhancing, unsubsidized risk-absorption by the state. This invites a major rethinking and reformulation of the mandate, transparency, governance, and risk-management capabilities of public development banks.

The rest of this paper is organized as follows. Section 2 deals with the case of risk neutrality. Section 3 combines risk aversion with borrower–lender agency frictions and collective action frictions that limit market participation and, hence, risk spreading. Section 4 adds shareholder–manager agency frictions for public-sector bankers. Section 5 concludes by discussing some policy implications.

¹ See, for instance, [Jaffee and Thomas \(1976\)](#), [Stiglitz and Weiss \(1981\)](#), [Mankiw \(1986\)](#), [Smith and Stutzer \(1989\)](#), [Bernanke and Gertler \(1990\)](#), [Innes \(1991\)](#), [Benavente et al. \(2006\)](#), and [Arping et al. \(2008\)](#). As discussed below, the papers that analyze government guarantees in a general equilibrium setting typically have focused on adverse selections problems and unanimously conclude that these problems do not justify guarantees (see [Greenwald and Stiglitz, 1986](#); [Gale, 1990](#); [Williamson, 1994](#); [Lacker, 1994](#); [Li, 1998](#)).

² As documented, for instance, in [Honohan \(2008\)](#) and [Beck et al. \(2008\)](#).

³ The case for government intervention through guarantees or insurance is arguably much easier to make with respect to aggregate or systemic risk that cannot be diversified away by markets. We have argued elsewhere ([Anginer et al., 2011](#)) that public guarantees can be effective in the case of aggregate (non-diversifiable) risk, even if all agents are risk neutral and there are no agency frictions. In effect, individuals faced with aggregate risk and constrained by bargaining costs can fail to coordinate so as to behave in a way that is consistent with their collective interest. By eliminating worst-case losses from private decisions and coordinating individuals around expected (average) losses, state guarantees can function as a coordination device, much as deposit guarantees and lender-of-last-resort facilities can eliminate self-fulfilling bank runs. See for instance [Caballero and Krishnamurthy \(2008\)](#) and [Caballero and Kurlat \(2009\)](#) on the role of public guarantees under systemic risk and uncertainty.

⁴ We use the terms "unsubsidized" and "fairly priced" guarantees indistinguishably, to refer to guarantees whose price covers expected losses.

⁵ See for instance [Dinc \(2005\)](#).

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