The country needs more infrastructure investment to boost jobs and growth. However, the government must pay due attention to the scale and nature of the risk it accepts from lenders

***Mark Hellowell** explains the virtues of new legislation that would promote infrastructure projects by offering a government guarantee to lenders. However, he warns of the negative implications the proposals will have; namely, the introduction of adverse selection and moral hazard.*

David Cameron will soon give details of new legislation that will allow the government to guarantee up to £40bn in infrastructure projects and a further £10bn for new housing. Ministers are presenting the bill, which should be on the statute books by the end of October, as a key part of the administration's latest growth push.

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In fact, the plan to establish a 'UK Guarantees' scheme to accelerate investment in economic infrastructure was announced by the Chancellor George Osborne back in July.

To qualify for a government guarantee, projects must be 'nationally significant' and ready to start in the 12 months following a guarantee being confirmed. They must also have equity finance in place – and sponsors will need to persuade officials that they are unable to secure financing from private sources without state support.

So what to make of this plan? As the focus on 'shovel ready' projects indicates, the scheme is as much about stimulating growth and employment as it is about addressing Britain's need to update its energy, transport and communications infrastructure. Politically this matters. It shows that the coalition government has finally recognised the scale of market failure in the financial markets and the central role of the state in addressing it.

Four years after the collapse of Lehman Brothers, banks still face capital and liquidity constraints that significantly undermine their ability to lend to infrastructure projects. This is damaging the economy, which needs higher spending by water, power and network industries to offset the collapse in public sector and corporate investment.

But if the government has finally recognised the need to act, it is not willing to increase its own borrowing; at least that element of its borrowing that shows up in the headline measures of government debt. Instead of borrowing directly the idea is to use the coalition's 'hard won' credit-worthiness to guarantee payments to creditors and thus enable risk-averse banks, and perhaps institutional investors, to lend to major projects.

The assumption is that because of the 'safe haven' status of UK gilts, the government can take on contingent liabilities without spooking the markets. By allowing banks to transfer project risk to the public sector, lending will become safer for banks – and less expensive in terms of their capital reserve requirements. This should therefore boost lending. In addition, enhancing credit in this way might enable projects to be financed by bonds to be purchased by pension funds and insurance companies.

The key to institutional investor involvement is to improve the rating of bonds from BBB to 'single A', for which the market is deeper for a variety of reasons – partly the culture of institutional investors and partly because forthcoming international regulations will limit the capacity of such investors to buy assets without an A-rating.

But there are risks here for the government. Economists, who are (hopefully) reflecting on the origin of the financial crisis in processes of credit risk transfer by banks, might point to two key issues. First, there is the problem of *adverse selection* – the fact that projects seeking guarantees are precisely those that have been unable to secure financing in the private sector. It therefore seems reasonable to assume these projects present a relatively unfavourable balance between risk and return.

Second, there is the problem of *moral hazard* – a guarantee will insure lenders against the costs of default, which may then result in a lack of due attention to the risks presented by projects or their sponsors. A bank that has transferred credit risk to the government in this way has less incentive to carry out an appropriate level of due diligence on a loan or monitor the performance of the borrower after the loan is provided. Removing or weakening that due diligence function could generate fiscal and economic risks for the government unless the process is managed extremely assiduously — and there is a risk that it may not be in the rush for news stories with the word 'growth' in the headline.

Less problematic is the commitment to boost investment in housing developments. Sensibly it appears the government wants to give housing associations a new role. This is something that the LSE's Tim Leunig has been advising them to do for some time. Though the details of the plans was not available at the time of writing, the idea seems to be that associations will issue bonds – again, underwritten by government – to sell to institutional investors who want long-term assets at fixed interest rates. Housing associations would then contract with developers to build houses and flats and sell or rent them in the open market.

Of the two elements of the planned guarantees legislation, this looks like the less risky. As the private rental market is buoyant, the revenue stream associated with the new properties should be relatively stable, at least for the foreseeable future. However, development costs will still need to be well-managed which implies the requirement for associations to invest substantially in specialist human resources.

Britain remains in a deep recession of uncertain duration. The government's belated recognition of the state's central role in the recovery is welcome. As public capital spending is reined in and big corporates pull in their horns, the country undoubtedly needs more infrastructure investment to boost jobs and growth. Well-conceived projects can also be of huge benefit for economies in the long-run, especially in an era of rapid technological progress, climate change, urbanisation and growing congestion.

If the housing plan can provide a stimulus while allowing more people to be housed decently, then that is hugely desirable. Although, as the government scrabbles around for an off-balance sheet stimulus, it must pay due attention to the scale and nature of the risks it is accepting from lenders. As countries such as Portugal have recently found, contingent liabilities can prove catastrophically expensive when they crystalise.

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