“Seeking Safety”

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Abstract: We propose a theory of intermediation and demandable debt based on preferences for safety. Investors with a minimum wealth level can invest and self-insure at different returns. The efficient allocation avoids self-insurance of low-return investors whose safety is ensured by early liquidation of risky investment. Competitive intermediaries backed by sufficient equity implement this allocation by carving safe claims out of investment, boosting its scale. However, intermediation creates a conflict over future risk choices when continuation has positive value but implies losses for senior claims. Demandable debt resolves this conflict as safety-seeking investors can withdraw in risky states and force partial liquidation of investment. We characterize how the volume and price of safe debt and investment respond to changes in safety demand, loss-absorption capacity, and imperfect competition. With public provision of safety, safe bank debt is crowded out by public debt but crowded in by deposit insurance.