Creating the Richmond Fed's Bailout Barometer

The Richmond Fed recently released new estimates of the size of the financial sector's government-provided safety net — a measure that we call the "bailout barometer." According to these estimates, 60 percent of the financial sector's liabilities — $25 trillion — are either explicitly or implicitly insured by taxpayers. Explicit guarantees include programs like deposit insurance for banks, while implicit guarantees cover liabilities for which market participants believe the government will provide support in times of distress. In some cases, these expectations have developed over time following earlier government bailouts of firms or markets deemed "too big to fail" (TBTF).

The size of the financial safety net is critically important. While guarantees against losses can help prevent panics by reassuring creditors, they also erode incentives for firms to minimize risk. Protected creditors have little incentive to be concerned over the riskiness of financial institutions' activities and will thus overfund risky activities. As financial firms grow in size and riskiness, policymakers may be motivated to protect them during times of distress to prevent damage to the rest of the economy. Such actions can increase the size of explicit and implicit safety net guarantees alike, however, creating a vicious cycle that perpetuates TBTF.

Despite legislation such as the Dodd-Frank Act aimed at eliminating the TBTF problem, the size of the safety net has remained roughly unchanged since 2009, and — as the cycle described above would predict — it has grown considerably since Richmond Fed researchers published our first bailout barometer estimates in 2002. I asked them to create the measure after I became director of research at the Richmond Fed in 1999. There was growing concern among policymakers and economists about TBTF at the time but no good estimate of just how large the financial safety net was.

Our researchers estimated that nearly 45 percent of financial sector liabilities in 1999 were either explicitly or implicitly protected by government guarantees. I was surprised by how high that number was. Industry experts and banking regulators in the 1990s had been saying that the banking industry was declining as a share of financial intermediation, as more nonbanks, like money market mutual funds, provided services traditionally handled by banks. Because a large portion of the safety net was composed of protected assets in what I had assumed was the shrinking banking sector, I had expected it to be much smaller than what our researchers actually found.

In hindsight, the size of the safety net should have alerted me to another problem: Financial firms outside of the banking sector had an incentive to mimic the dependence of banks on the type of short-term funding that is likely to receive government assistance during a crisis. Such funding would be less costly if it was perceived as benefiting from an implicit government guarantee. But relying more heavily on cheap short-term funding that can suddenly dry up would also make those firms, and the financial sector as a whole, more fragile. In fact, this is exactly what we saw leading up to the financial crisis of 2007-2008.

Before the crisis, I had been optimistic that policymakers would take steps to prevent the growth of the safety net. In a paper I wrote in 1999 with Marvin Goodfriend, then a senior vice president and policy adviser at the Richmond Fed (now on the faculty at Carnegie Mellon University), we speculated that policymakers might gradually see that liberal lending during crises was counterproductive, since it exacerbated the TBTF problem in the long run. Thus, it seemed reasonable to think they would commit not to rescue failing institutions.

While I was optimistic that we were heading in this direction, Marvin was less sanguine. He believed that policymakers were likely to continue to favor short-term relief of financial distress over the long-term goal of shrinking the financial sector's federal safety net. In the end, the rescues of financial firms that our researchers previously assumed to be outside the safety net during the financial crisis of 2007-2008 proved that Marvin's fears were well-founded.

The long-term solution to this problem is to restore market discipline so that financial firms and their creditors have an incentive to monitor and reduce risk-taking. The government can facilitate this by credibly committing not to fund bailouts in future crises. The Dodd-Frank Act includes a number of provisions aimed at helping policymakers establish such a commitment, including its requirement that the largest and most complex financial firms create resolution plans known as "living wills." These are detailed road maps for how regulators can unwind failed firms without threatening the rest of the financial system or requiring government assistance. Our researchers will continue to update the bailout barometer to gauge the progress that is being made toward shrinking the problem of "too big to fail." **EF**

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