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Statement No. 285

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Statement of the Shadow Financial Regulatory Committee on

Improving the Transparency of the Cost of Policies that Expand the Financial Safety Net

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Each new financial crisis teaches that the financial sector safety net consists of much more than the support explicitly promised to deposit institutions by their access to formal deposit insurance coverage and the Federal Reserve’s discount window. The federal safety net also comprises ad hoc aid that authorities provide in exigent circumstances not only to banks, but to nonbank financial firms and counterparties.

Accountability requires that each new intervention be accompanied by a projection of the future costs that it is likely to generate. Although individual projections would be subject to measurement error, being able to track and capitalize the sum of such projections would help to identify and control the costs of ongoing safety net expansion.

Costing out the value of ad hoc interventions has been a longstanding concern of the Shadow Financial Regulatory Committee. This concern is illustrated by a series of timely warnings about the growing insolvency of the Federal Savings and Loan Insurance Corporation and taxpayer loss exposures in Fannie Mae, Freddie Mac, and the Pension Benefit Guarantee Corporation[1].

[1] See, for example, Statement No. 8: “Recapitalizing FSLIC and Zombie S&L’s” (June 9, 1986); Statement No. 131: “Extending the Credit Reform Act of GSEs” (February 12, 1996); and Statement No. 93:”Taxpayer Risks in the Pension Benefit Guarantee System” (March 1, 1993).

To manage the true deficit efficiently, authorities must first measure all of its elements. Today no federal agency is responsible for projecting and compiling on a regular basis the complete burden that financial regulation and intervention impose on taxpayers. Although private institutions could help in this task by drawing on public data to estimate a portion of these values, government officials can construct better estimates because they can draw on confidential financial institution data and can require the collection of pertinent additional data.

The Federal Credit Reform Act was initiated by the Congressional Budget Office to bring the cost of explicit federal loans and guarantees onto the federal budget. But, important other forms of contingent federal credit support, particularly those associated with the financial sector safety net are not accounted for. Governance would be improved if the range of costs that safety net extensions are likely to engender as circumstances change were estimated comprehensively.

This task could be assigned to the Office of Management and Budget (OMB), with its initial work product reviewed officially by the Government Accountability Office (GAO) and the Congressional Budget Office (CBO). OMB could begin by requiring regulated financial firms to compile and report quantitative estimates of the reduced borrowing costs and other benefits that the safety net provides to them. OMB would have the authority to challenge the regulated firms' methods of estimation and to require information on items that it, the GAO or the CBO determines to deserve special attention. This flexibility in data collection provides a way to investigate the possibility that de facto safety net extensions might be engendered by new or fast-growing balance sheet and off-balance sheet positions.