

REGULATORY REFORM AFTER THE FALL OF WALL STREET

James Bullard President and CEO

Financial Regulation Reform Collaborative Washington DC 19 June 2009

Any opinions expressed here are my own and do not necessarily reflect those of the Federal Open Market Committee members.



THE CLAMOR FOR REGULATORY REFORM

- The Panic of 1907 \implies Federal Reserve.
- The Depression \implies Glass-Steagall and the FDIC.
- The 1980s Thrift Crisis \implies FDICIA.
- Enron/Worldcom \implies Sarbanes-Oxley.
- Conclude:
 - Reform legislation unlikely to stall out.



WHAT CAN REFORM ACCOMPLISH?

- Better long-run growth prospects?
- Better stabilization?
- Bubble avoidance?



INTERMEDIATION AND LONG-RUN GROWTH

- Growth theories for industrialized economies tend to de-emphasize intermediation or the depth of financial markets.
- Instead, they tend to emphasize improvements in technology or human capital.
- Conclude: even perfect regulation probably will not improve long-run growth.
 - The literature on finance and growth applies to developing countries.



BETTER STABILIZATION

- Financial crises can be associated with recession.
- Avoiding this means avoiding the *panic element* of a crisis.
- In the past, this has meant avoiding "bank runs."
- Our system turned out to be susceptible to a new form of a "bank run."
- Conclude: It may be possible to address this problem in a reform.



AVOIDING BUBBLES

- Bubble has become an overused term.
- There is a large literature on multiple equilibria in macroeconomics.
- Usually, high-volatility vs. low-volatility equilibria.
- The high volatility equilibria are driven by self-fulfilling expectations.
- The policy response is to knock out the multiple equilibria.
- This leaves an economy that responds only to fundamental shocks and has no "extra volatility."
- Conclude: It may be possible to address this type of problem as well.



PLAN FOR THIS TALK

- What are the core problems?
 - Failure of financial engineering.
 - "Bank runs" on non-bank financial institutions.
 - Implicit insurance of creditors to financial institutions, a.k.a. TBTF.
- Some portions of the regulatory system work well. Why?
- What to do about the large financial institutions?
- The role of the Federal Reserve.



A FAILURE OF FINANCIAL ENGINEERING

- Securitization markets are in principle a good financial innovation.
- The initial success of mortgage-backed securities (MBS) masked underlying problems.
- By the time of failure, large quantities of MBS and related assets were held globally.
- Few major players escaped unscathed, suggesting few knew the dangers.
- Some parallels with other types of engineering failures.



MORE ON FAILED FINANCIAL ENGINEERING

- The resulting shock to the global macroeconomy is large and real.
- There is no escaping the adjustment that must occur.
- Government intervention cannot offset this large shock completely, only mitigate some of the effects.
- The design of the securities was a core problem: They did not perform well in some states of the world.
- Some reforms being discussed do at least indirectly address this.
- One goal should be to revive securitization markets.



"BANK RUNS" ON NON-BANKS

- Bank runs have been a macroeconomic hazard for hundreds of years.
- Conceptualized as simultaneous withdrawal of deposits from a depository institution.
- Diamond and Dybvig, 1983.
- Policy intervention:
 - Deposit insurance ...
 - ... plus prudential regulation.



More on "bank runs"

- This crisis has instead produced "runs" on non-bank, non-depository institutions.
- There was no regulation in place for this hazard
 - ... because it was not generally viewed as a hazard.
- Bear-Stearns, for instance, borrowed short-term, but against collateral.
- Deposit insurance does not solve this problem.
- What to do?
- Most reform suggestions do not address this problem either.
- "Keep a closer eye on these guys" does not work.



PORTIONS OF THE REGULATORY SYSTEM WORK WELL

- Bank regulation outside the largest financial institutions has worked well during the crisis.
- We do not see the small bank panic that characterized the Depression, even though this is a large crisis.
- The system of deposit insurance plus prudential regulation solves that problem.



MORE ON SUCCESSFUL REGULATION

- There are bank failures in the system, but they have not caused market disruption.
- Why the success?
- The first component is good monitoring.
- A fairly clear rating system is in place.
- The monitoring system means that the regulator is aware of which banks may fail and can prepare accordingly.



MORE ON SUCCESSFUL REGULATION

- The second component is a clear and credible resolution regime.
- Credibility means that all parties understand what will happen in the event of bank failure.
- The U.S. has a system for closing banks in a way that does not damage others in the industry.
- Conclude: Good regulation is good monitoring plus a clear, credible resolution regime.
- We can learn from the success of this system.



WHAT THE SUCCESSFUL REGULATORY STRUCTURE DOES

- The system is not designed to "keep banks in business at all costs."
- Nor is the system designed to tell owners how to run their business.
- It says little about internal incentive systems.
- The system in fact allows some failure to occur.
- What it is designed to do is to turn potentially disorderly failures into orderly failures.
- The system succeeds here.



LARGE, GLOBAL ENTERPRISES

- Key problems involve large banks and large non-bank financial firms.
- These are often global enterprises.
- Cross-border regulatory competition is a powerful force.
- It is far from clear how much real progress can be made on global regulatory coordination.



TWO MISSING PIECES

- The monitoring problem for large institutions is much more difficult.
- As a result, it has been difficult to discern how these firms are coping with the financial engineering failure.
- The firm's incentive is to say "all is well" until the bitter end.
- Firms near failure might alert authorities only days before the event.
- So the first part of good regulation was missing: monitoring was poor.
- In addition, the resolution regime is unclear.
- The second part of good regulation, a clear, credible resolution regime, was also missing.



TOO BIG TO FAIL QUICKLY

- Large financial firms are often considered "too big to fail" because of the market disruption that might be caused.
- The correct phrase is "too big to fail ... quickly."
- All firms fail eventually.
- Regulators may encounter fraud—for example: Enron.
- Some plan has to be in place to shut down the failed institution in that case.



RESOLUTION REGIMES

- We want an *orderly* resolution regime that will close down the failed firm without creating problems for the remaining firms in the industry.
- Ronald Feldman and my colleague Gary Stern emphasize that this resolution regime must be credible.
- Credible means that all parties understand what the regime is and that it will indeed be employed in the event of failure.
- Is the resolution regime in the Treasury proposal credible?



RESOLUTION REGIMES AND PRICING

- The resolution regime affects the entire equilibrium pricing structure.
- Market players are pricing in the probability of failure along with their payout in that state of the world.
- Uncertainty about the resolution state injects uncertainty into all financial market prices.
- For this reason the resolution regime may be the most important reform.
- Chairman Bernanke has repeatedly emphasized the need for a resolution regime to handle large financial institutions.
- Used correctly, this will turn disorderly failures into orderly failures and avoid panic.



EXISTING RESOLUTION REGIMES

- Bankruptcy court has been considered inadequate for certain types of large non-bank financial firms.
- A simple reform would be to rewrite the bankruptcy code to allow for special considerations that apply to financial firms.
- This would not help us with the monitoring question: the filing may still be "sudden."



SIZE LIMITATIONS

- One simple approach that has been suggested might be to limit the size of firms.
- This would bring large financial institutions within a regulatory framework which is robust and is known to work well, even in a crisis.
- Still, it is questionable whether size restrictions could be adequately enforced.
- The global aspect of these firms might also make this idea difficult to implement.
- A version of this would be to place a tax on firm size.
 - A tax does not seem to help either with monitoring or with resolution.



MONITORING WITHOUT A RESOLUTION REGIME

- The most common response to the situation has been that we need more monitoring of large financial firms.
- It is unclear what monitoring by itself can accomplish. We need the resolution regime.
- Monitoring can help authorities track which firms are likely to fail.
- It cannot do very much about poor business decisions.
- Regulators are not going to have a better idea than business leaders as to which direction their firm should go in order to be profitable.



THE LENDER OF LAST RESORT

- The Fed is the nation's lender of last resort.
- If the Fed may be lending to institutions, it will need to have a role in regulating those institutions.
- Otherwise, the Fed will be unable to make a judgement on whether to lend and under what terms.
- The role of Fed lending in mitigating the current crisis has been substantial.



THE NATION'S MONETARY AUTHORITY

- The Fed also runs the monetary policy of the nation.
- To perform this function effectively, the Fed needs to know the condition of the financial system.
- This also argues for a substantial Fed role in the regulation of these firms.
- The need to know the status of financial markets has been underscored by recent events.



SYSTEMIC RISK REGULATION

- The Fed has been the *de facto* systemic risk regulator.
- Many financial market problems, whether under the official Fed purview or not, have come to the Fed during this crisis.
- The world expects the Fed to fix financial market problems as they occur.



A POORLY DEFINED DEBATE

- The debate on systemic risk regulation needs to be sharpened substantially.
- The definition of systemic risk regulation is far from clear.
- A macro-prudential view: does the Fed already do this?
- A narrower, institutional view: what new powers to assign?



A MACRO-PRUDENTIAL VIEW

- A macro-prudential view often emphasizes a regulator that "takes everything into account."
- Coupled with monetary policy, it means taking everything into account when setting interest rates.
- I think the Fed already does this.
- Certainly, policy debates in the last twenty years have discussed bubbles in technology stocks and in housing prices.



The Fed and Systemic Risk

• Three important systemic calls by the Fed:

- William Poole on GSEs.*
- Gary Stern on "Too Big to Fail."**
- Ned Gramlich on subprime.***

*"Financial Stability," 2002; "Housing in the Macroeconomy," 2003; and "Reputation and the Non-Prime Mortgage Market," 2007.

**Gary H. Stern, Ron J. Feldman, Too Big To Fail: The Hazards of Bank Bailouts, Brookings Institution Press, 2004.

***Edward M. Gramlich, Subprime Mortgages: America's Latest Boom and Bust, Urban Institute Press, 2007.

JAMES BULLARD



A NARROWER VIEW

- A narrower view would contain the idea that certain market practices may need to be curtailed.
- Alternatively, business practices at certain firms might need to be discouraged, should they be viewed as systemically risky.
- What is unclear is what powers a new regulator would need to carry out these tasks.
- How would firms operate, knowing that a particular practice might be found "too risky" at some point in the future?
- I do not think the answers are clear at this point.
- The debate needs a much sharper focus.



CONCLUSIONS

- For smaller banks, the U.S. regulatory system works well and is robust during a crisis.
- This is important: It solved a problem that plagued our nation for decades.
- For large banks and non-bank financial firms, monitoring is more difficult and the resolution regime is unclear.
- Key improvements would be to develop a credible resolution regime for large financial institutions, and to upgrade monitoring.
- The Fed's lender of last resort and monetary policy functions mean that it will have to remain closely involved in the regulatory structure.
- The systemic risk regulation debate needs to sharpen up.



Federal Reserve Bank of St. Louis stlouisfed.org

 $\frac{C E N T R A L}{to}$ A M E R I C A' S $E C O N O M Y^*$

Federal Reserve Economic Data (FRED) research.stlouisfed.org/fred2/

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