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President James Bullard Addresses Questions on Regulatory Reform Proposals

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Will regulatory reform address the problem of runs on financial institutions?

The core problem is a run on Bear Stearns. Bear Stearns is not a deposit-taking institution. We know bank runs. We've been around bank runs for a hundred years or hundreds of years; we know what they're like. All the depositors lose confidence; they all take out their money at the same time; the bank fails. But Bear Stearns was not a deposit-taking institution; they funded short term — on collateral. They funded short term on collateral. We did not really think that kind of institution was susceptible to a run, but it was.

We know how to fix bank runs. In bank runs, we say, "Okay, we're going to have deposit insurance, which will take away the incentives of the depositors to run; that fixes the problem." It creates other problems, because you have to regulate the bank to make sure they don't take advantage of the deposit insurance. That system worked great over all these years since the Great Depression. But now you've got shadow banking institutions that are susceptible to runs. I don't see anything in the legislation that's going to fix that. So people say, "Well, how about higher capital requirements?" Think about a bank. You've got a bank, it takes deposits. If the depositors lose faith in the bank, they're going to run on the bank — they all take their money out; the bank fails. Now you say, "I'm going to fix this by having higher reserve requirements." The bank can't lend out all its deposits; it can only lend out a portion of its deposits.

This does not fix the bank run problem. If I lose confidence in the bank, I still am going to run on the bank and try to get all my money out. Milton Friedman said, "Well, you can fix that, but you have to set 100 percent reserve requirements. That would fix the bank run problem." That's true, but then you don't get any lending out of the bank, because they have to keep all the deposits sitting at the bank.

The analogy for somebody like Bear Stearns is to — what people are saying today, including the Treasury Secretary and others, what they're saying is, "Are we going to have higher capital requirements?" But that's the same problem; it doesn't really fix the run problem that we saw for Bear Stearns and other large financials during this crisis. You need some analog of deposit insurance, but for non-depository financial institutions — that's what you need. I don't see enough work on that, and I don't see us fixing that. What I think is going to happen going forward, we're going to remain susceptible to these kinds of events going forward, because there isn't anything that anyone's talking about that's going to fix that problem. Large pension funds and others are lending every day — they're lending every day on collateral, overnight. But you would think since they have collateral that they shouldn't run; but they ran anyway. They said, "The collateral's going to be so illiquid; I'm going to have to hold it on my balance sheet. I sure don't want to hold it on my balance sheet, so I'm going to quit lending to you overnight, because I think you won't pay me back tomorrow." The company's out of business, and the panic is on.