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James Bullard on Government Regulation

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What is the most important issue that regulatory reform needs to address?

I think the most important issue coming out of this crisis for regulatory reform to address is the so-called "too-big-to-fail" problem. This is very large financial institutions may not necessarily be banks, and that often during this crisis, they were not banks. And you know, they get into trouble and the policy makers are faced with these impossible alternatives, which are that on the one hand, you could just let them fail, go to bankruptcy court. But if they go to bankruptcy court, you ignite a world panic. On the other hand, if you want to keep them alive or keep them from failure, you have to come in with taxpayer money to try to bail them out. Neither alternative is very attractive, and it's really an impossible situation. And this has got to be fixed; we cannot allow these institutions to continue to go on and say that in good times, they can make a lot of money and do very well, and in bad times, they really hold the government over a barrel and say, "Either we're going to ignite a worldwide panic, or you're going to hand us some taxpayer money." People are very upset about this and for very good reason. I think we have to have laser-like focus on solving this problem for the U.S. economy going forward. I also think that one of the other things that came out of this crisis was that this problem is very costly for the economy. It's probably been there implicitly, but because we didn't have a crisis, we didn't really see how much we had this too-big-to-fail problem, and I'd like to see it addressed.

What important issues related to too-big-to-fail should regulation address?

Some of the things that have been talked about for addressing too-big-to-fail, you know, partly has to do with resolution regimes, partly has to do with a new regulatory environment. Part of a new regulatory environment would be some kind of so-called systemic risk regulation. You would look at these firms that you think pose a threat in terms of systemic risk; that is, if they failed suddenly, they could ignite a panic worldwide or upset financial markets in a way that would be very damaging for the macroeconomy. If you think a company poses that kind of risk, you might be willing to put more regulations on that type of company, and there's many proposals to try to do that. Some of them involve giving that authority to the Fed; other proposals involve giving that authority to a council of regulators. There's a variety of arguments about that.

I think more important is the idea that you should have a resolution regime for these kinds of companies. One of the things that happens in small bank regulation is that we do allow failure of smaller banks, and when they do fail, we have a resolution regime in place. We do not send small banks to bankruptcy court when they fail; the FDIC actually closes down smaller banks. That system works pretty well, actually. What you'd like is something like that for these very large financial institutions. But it's much more difficult for the large institutions, the so-called too-big-to-fail institutions, partly because they're not just banks, they're bank conglomerates; they do many things other than just ordinary commercial banking. They're also global enterprises; many of them have 50 percent or more of their business outside the U.S. You would need some global coordination when you're thinking about how to shut them down in a crisis environment. And, you know, they're big, complicated enterprises. Still, though, you'd like to be able to say, "Fine, you go ahead, you run your business, you make your bets. And if it doesn't turn out well, we're going to come in and shut you down where you're not going to be able to get taxpayer money to get bailed out." So to be able to have the resolution regime in place is a way to enforce market discipline on these companies and get them not to take risk only with the upside potential and no downside for the company. If you face a businessperson with that kind of tradeoff, they're going to take too much risk, which is what many think happened coming into this crisis.

You have said in the past that smaller banks are not the problem. Can you elaborate?

A simple way to think about the banking environment in the U.S. is that there's 20 or so very large banks, and they really are quite large and they hold most of the assets of the banking system; and then there's many thousands of smaller banks. I think that these smaller banks did not cause this crisis and do not need to be reregulated coming out of the crisis; they already face quite a bit of regulation. That regulatory regime for the smaller banks actually works fairly well. We have a system of deposit insurance for those banks; the banks pay for the premium on the deposit insurance. We also have a system of prudential regulation for the banks in the prudential regulatory framework. All the banks get rated on how well they're doing from the so-called CAMELS ratings, from 1 to 5. That gives the regulator some idea about which banks are in trouble. This system allows failure, so it's capitalism at work; if they make bad loans, then they are going to fail. And when they do fail, we do not go to bankruptcy court; the FDIC comes in, seizes the firm and sells off the pieces, usually in a very transparent way that does not disturb the customers of the bank.

That process works pretty well. And of course, it's times of economic stress; we have lots of bank failures today. But as a regulatory process, we're able to handle those failures, and we're able to handle them in a way that does not create panic; we do not see people worried because one bank closed that maybe they should take their money out of the next bank, that is not in trouble at all. So that system is working pretty well. You'd like to have something like that for the very large institutions, but that's a very difficult thing to do, but that's where you'd like to go with regulatory reform. But I think the main point is that the smaller banks weren't really involved in most of the problems that precipitated this crisis. They're already a pretty heavily regulated industry. I think regulations on the banking industry during the last 20 years have

created a shadow banking industry, a group of firms that take some of the business away from the banks, even though they're nondepository institutions — that's why they're not banks — but they're able to move a lot of the types of business into an unregulated environment, and that's a lot of what has happened over the last two decades. You've got a banking sector that really has a regulatory regime in place that works pretty well, and we probably don't want to load them up with more regulation in response to this crisis, because that's not going to do to anything to prevent a crisis from recurring again in the future.