St. Louis Fed's Bullard: Fed is the Nation's "Best Chance" for Avoiding Future Financial Crises

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RICHMOND, Va.—In remarks today to the CFA Virginia Society in Richmond, Va., St. Louis Fed President James Bullard provided an overview of the origins of the financial crisis and explained why most of the regulatory reform proposals under debate in Washington will not be adequate for preventing future crises.

In his presentation, "Will Regulatory Reform Prevent Future Crises," Bullard called for a strengthened Fed with "appropriately broad regulatory authority to provide the nation with the best chance of avoiding a future crisis."

Bullard said the financial crisis revealed that large financial institutions worldwide are indeed "too big to fail." He added, "We can let large financial firms fail suddenly, but then global panic ensues. Any reform proposals have to face this fact."

At the same time, he noted that "Smaller banks did not cause the crisis and do not need to be re-regulated. Current regulation works well for the thousands of smaller banks in the U.S. The system features deposit insurance plus prudential regulation. It allows failure, but prevents bank runs and the panic associated with them."

The Fed had detailed knowledge only of part of the financial landscape: that for which it had supervisory authority. "Yet, all eyes turned to the Fed as the lender-of-last-resort. This always happens in a crisis—only the central bank can play the lender-of-last-resort role," Bullard said.

The Reform Proposals

Since "the Fed will also be at the center of all future crises because of its lender of last resort role, the reform response should be to provide the Fed direct access to detailed information across the entire financial landscape—not less, as is the focus of current policy discussions," Bullard said. "Only a few of the current financial regulatory reform proposals are likely to help prevent future crises."

Bullard summarized several of the reform proposals now under discussion, including the following:

Financial Services Oversight Council (FSOC)

The proposed interagency FSOC would monitor systemic risks posed to the financial system, while the Federal Reserve would serve as an agent of the FSOC.

"Would this prevent a future crisis? I think the evidence is far from clear," Bullard said. "It seems like it would be difficult for an interagency Council to come to agreement on a specific risk and an associated action when times are good. In crises, decisions need to be made quickly, not subjected to long committee debates. It is also possible to overreact by shutting down a particular practice that, in reality, does not pose a systemic risk."

He added, "The Fed would be better at navigating this type of decision-making, which occurs commonly in monetary policy. The Fed is also more politically independent than such a council could be."

Expanded FDIC Receivership Authority

In the House bill, the FDIC would be granted expanded authority to put systemically important firms into receivership.

"This reform goes in the direction of strengthening market incentives. A resolution regime is a way of putting market discipline on very large financial firms—we could allow failure without creating panic," Bullard said. "The fear of failure would then prevent the firms from taking excessive risks and from being able to borrow at low rates. Would this prevent a future crisis? It might."

He said that his main concern with this aspect of the bill is how credible the regime would be and how much global cooperation could be expected.

"If it is not credible and the government is going to come in after all, then it is useless," he said. "'Funeral plans' for the firm in the event of failure do not strike me as credible."

Limited 13(3) Lending Authority

Another portion of the bill involves restrictions on Section 13(3) of the Federal Reserve Act, which allows the Fed to lend to any individual, partnership or corporation in "unusual and exigent circumstances."

"In the House bill, significant restrictions are placed on Fed lending to non-banks under the 'unusual and exigent circumstances' clause," Bullard said. "Would this prevent a future crisis? No. This will probably exacerbate a future crisis."

With such a potential restriction, "a future Fed facing a crisis will be more likely to say that it does not have the authority to act, letting the crisis roll on," he added.

The Consumer Financial Protection Agency

In addition, the House bill creates a separate Consumer Financial Protection Agency (CFPA) with rule-writing authority for all banks and non-banks that extend consumer credit.

"Would this prevent a future crisis? I don't think so," Bullard explained. "A fair playing field is certainly desirable in all consumer products. But the housing boom was a classic gold rush: most people bought houses because they thought the prices would keep rising. A CFPA would not have changed the gold rush dynamic."

Creditor Haircuts

Finally, the House bill would potentially require secured creditors to take a 10 percent haircut if the government has to step in and take over a failing firm.

"Would this prevent a future crisis? Probably not," Bullard said. "However, this provision does go in the direction of enhancing market discipline. Creditors would have greater incentives to understand and analyze risk at large financial firms."

However, Bullard questioned why creditor exposure should be limited to just 10 percent, citing “lots of evidence that money-at-risk is available.” He said the moral hazard created by implicit or explicit government credit insurance is a problem.

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