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Will Regulatory Reform Prevent Future Crises?

James Bullard

President and CEO

CFA Virginia Society

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TOPICS FOR TODAY

- Main idea: Try to assess the state of the regulatory reform debate.
- Consider some of the origins of the financial crisis.
- Ask two questions of current financial regulatory reform proposals:
 - Could these proposals have prevented the current financial crisis?
 - Would they prevent *future* crises?

PREVIEW OF MAIN CONCLUSIONS

- Only a few of the current financial regulatory reform proposals are likely to help prevent future crises.
- As the nation's lender of last resort, the Fed will be at the center of any future financial crisis.
- This argues for the Fed playing the lead role in the new regulatory structure.
- *A Fed with appropriately broad regulatory authority provides the nation with the best chance of avoiding a future crisis.*

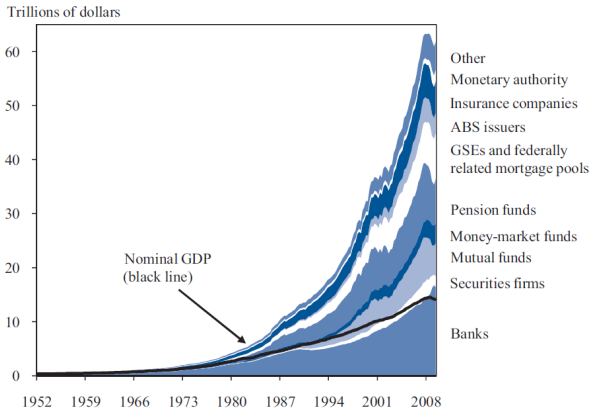
Origins of the Crisis

ORIGINS OF THE CRISIS

- Fundamentally, the crisis was caused by a failure of financial engineering.
 - First, a securitization boom.
 - Second, a housing boom followed by a dramatic decline in housing prices.
 - Securitized products did not take the possibility of a decline in housing prices into account appropriately.
 - Securitized paper was worth much less than most anticipated, and it was held by financial entities worldwide, who had to accept large losses.
- The crisis caused runs in the shadow banking sector ...
 - ... institutions that did not take deposits and so were not thought to be susceptible to a run ...
 - ... and because of this were not regulated as tightly as banks.

FINANCIAL SECTOR ASSETS BOOM

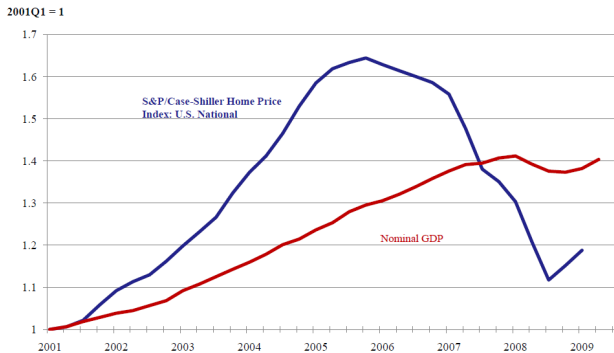
Financial Sector Assets



Sources: Federal Reserve Board, Flow of Funds; Department of Commerce (Bureau of Economic Analysis), National Income and Product Accounts Table I.1.5.

HOUSING BOOM AND BUST

Housing Prices and GDP



Source: S&P, Fiserv, and MacroMarkets LLC and Bureau of Economic Analysis. Quarterly Data. Last observation is 2009:Q3 for Price Index and 2009:Q4 for GDP.

IT'S MOSTLY SHADOW BANKING

Large S&P 500 Financial Firms (As of 2007:Q4)

Firm	Total Assets, Bill. (2007:Q4)	Pct. of Tot. Assets in S&P 500 Fin.	Cum. Percent	Type of Firm (2007: Q4)
Citigroup Inc.	\$2,187	10.9%	10.9%	BHC
Bank of America Corp.	1,715	8.5	19.5	BHC
JPM Chase & Co.	1,562	7.8	27.3	BHC
Goldman Sachs Grp.	1,119	5.5	32.9	Inv. Bank
AIG	1,060	5.3	38.2	Insurance
Morgan Stanley	1,045	5.2	43.4	Inv. Bank
Merrill Lynch	1,020	5.1	48.5	Inv. Bank
Fannie Mae	882	4.4	53.9	GSE
FHL Mortg.	794	3.9	56.9	GSE
Wachovia Corp.	782	3.9	60.8	BHC

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Firm	Total Assets, Bill. (2007:Q4)	Pct. of Tot. Assets in S&P 500 Fin.	Cum. Percent	Type of Firm (2007:Q4)
Lehman Bros.	691	3.4	64.2	Inv. Bank
Wells Fargo	575	2.8	67.1	BHC
MetLife Inc.	558	2.7	69.9	Insurance
Prudential Financial	485	2.4	72.3	Fin. Adv./Ins.
Hartford Financial Svcs.	360	1.8	74.1	Insurance
Washington Mutual	327	1.6	75.7	Thrift
U.S. Bancorp	237	1.1	76.9	BHC
Countrywide Financial Corp.	211	1.0	78.0	Thrift
Bank of NY Mellon Corp.	197	0.9	79.0	BHC
Lincoln National	191	0.9	79.9	Insurance

SUMMARY OF THE TABLE

- As the crisis started, 20 firms accounted for about 80 percent of financial sector assets in the U.S.
- About 1/3 of this total was in banks.
- About 2/3 was non-bank financials: Government sponsored enterprises, investment banks, insurance companies, and thrifts.
- A large fraction of financial assets in the U.S. were not in the bank regulatory system.
- All of these firms faced severe stress during the crisis, regardless of the type of firm or the nature of regulation.

THE FINANCIAL LANDSCAPE

- The crisis encompassed a far larger segment than just commercial banking.
- Many non-bank financial firms, outside the banking sector, were at the heart of the crisis.
- These firms were not regulated by the Fed or other banking regulators.
- The crisis showed that large financial institutions worldwide were “too big to fail.” (TBTF)
- We can let large financial firms fail suddenly, but then global panic ensues.
 - *Reform proposals have to face this fact.*

SMALLER BANKS ARE NOT THE PROBLEM

- Regulation works well for the thousands of smaller banks in the U.S.
- The system features deposit insurance plus prudential regulation.
- The system allows failure, but prevents bank runs and the associated panic.
- *Smaller banks did not cause the crisis and do not need to be re-regulated.*
- Changing this part of the regulatory environment as we are trying to cope with high stress makes no sense.

What Needs to Be Done

THE FED AND BANKING SUPERVISION

- The U.S. has a primary regulator system for the nation's 8,000+ commercial banks and thrifts.
- The primary regulator has the key authority for the regulation of the bank.
- As of January 2007:
 - The Fed had primary regulatory responsibility for about 12 percent of the banks.
 - About 14 percent by assets.
- More than 85 percent of banks and assets had non-Fed primary regulators.

THE FED AND THE FINANCIAL LANDSCAPE

- Banks are only one part of the financial landscape.
- Non-bank financial firms turned out to be the most troublesome entities in this crisis.
- The Fed had no supervisory authority over these entities:
 - Investment banks like Goldman Sachs and Bear Stearns.
 - Insurance companies like Prudential and AIG.
 - Financial hybrids like GE Capital and GMAC.
- Bottom line: *The Fed had access to a limited view of the financial landscape as the crisis began.*

THE CRISIS UNFOLDS

- As the crisis began, 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.
- But the Fed had detailed knowledge only of part of the financial landscape: that for which it had supervisory authority.
- The Fed had limited access to information on institutions outside its supervisory authority, especially non-bank financial firms.
- Many of the critical lending decisions involved the controversial non-bank financials like Bear Stearns.

THE REFORM RESPONSE

- The clear lesson is that the Fed had insufficient access to information about the financial landscape going into the crisis.
- The Fed did not fully understand the potential for feedback between the financial sector and the rest of the economy.
- Yet, 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.
 - *A Fed with appropriately broad regulatory authority provides the nation with the best chance of avoiding a future crisis.*

Reform Proposals

REGULATORY REFORM PROPOSALS

- The House Bill (H.R. 4173; passed December 11, 2009).
- The Senate Banking Committee draft legislation.
- General debate.

SYSTEMIC RISK

- The House bill creates an interagency Financial Services Oversight Council (FSOC) to monitor systemic risks posed to the financial system.
 - In the House bill, the Federal Reserve would serve as the “agent” to the Council and not as the systemic risk regulator.
 - Other debate has suggested investing the Council with more direct authority.
- Would this prevent a future crisis? I think the evidence is far from clear.

MORE ON SYSTEMIC RISK

- 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, shutting down a particular practice which in reality does not pose a systemic risk.
- 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 a Council.

A RESOLUTION REGIME

- In the House bill, the FDIC is granted expanded authority to put systemically important firms into receivership.
 - Other debate has suggested a special bankruptcy court for large financial firms.
- Would this prevent a future crisis? It might.
- 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 really could allow failure without creating panic.
- The fear of failure would then prevent firms from taking excessive risks and from being able to borrow at low rates.

A RESOLUTION REGIME: KEY CONCERNS

- Key concern: How credible will the regime be? If it is not credible and the government is going to come in after all, then it is useless.
 - “Funeral plans” for the firm in the event of failure do not strike me as credible.
- Key concern: How much global cooperation can be expected?

RESTRICTIONS ON 13(3) LENDING

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

CONSUMER PROTECTION

- 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.
 - This has been very controversial in the Congress.
 - Other debate has suggested putting this in other agencies or not including it in the bill.
- Would this prevent a future crisis? I don't think so.
- A fair playing field is certainly desirable in all consumer products.
- But the housing boom was a classic gold rush: most people bought the houses because they thought the prices would keep rising.
- A CFPA would not have changed the gold rush dynamic.

SECURED CREDITORS

- In the House bill, secured creditors may be required to take a 10% haircut if the government has to step in and take over a failing firm.
- Would this prevent a future crisis? Probably not.
- But, 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.
- Why limit creditor exposure to 10%?
 - Lots of evidence that money-at-risk is available.
 - Problem is "moral hazard" created by implicit or explicit government credit insurance.

SINS OF OMISSION

- GSE reform not addressed in current legislative proposals.

Conclusions

CONCLUSIONS

- Only a few of the current financial regulatory reform proposals are likely to help prevent future crises.
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