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Fed's Fisher: Too-Big-To-Fail Problem Must Be Addressed

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NEW YORK (Dow Jones)--The government should stop short of breaking up Wall Street's biggest banks, but it may need to strip them of some of their riskier operations, Federal Reserve Bank of Dallas President Richard Fisher said Thursday.

The official was tackling the issue of what authorities should do to reduce the threat of the so-called too-big-to-fail financial institutions, which Fisher and many others consider a huge problem.

Fisher, who was speaking in Washington at an event held by the Cato Institute, said the financial crisis of the last two years can in large part be attributed to these massive financial institutions and the bad bets they made on housing prices. The one-sided nature of their bets and the large size of the firms forced the government to save these firms, fearing their failure would destroy the financial system.

The central banker also believes the too-big-to-fail issue must be addressed in order to allow the Fed's traditional way of managing the economy to function properly. The troubles suffered by these firms "reduced the effectiveness of monetary policy's transmission mechanisms," Fisher said, adding "obstructions in the monetary policy channels worsened a recession that has proven to be longer and, by many measures, more painful than any post-World War II slump."

"The sooner we are able to return to traditional policy making the better," Fisher said. "I do not believe we can do so without treating the basic pathology of too big to fail."

The policy maker said there are two main schools of thought when it comes dealing with the threat of the too-big-to-fail financial firms. Some would tighten regulations and require higher capital levels for these firms, while others would take the more drastic action of taking overly large firms and breaking them up into more manageable chunks.

Fisher proposed a different path. Authorities should develop "the least disruptive way to have (the firms) divest those parts of the 'franchise,' such as proprietary trading, that place the deposit and lending function at risk and otherwise present conflicts of interest."

He added the regulatory structure should be changed to prevent financial firms from again attaining a status where their failure could threaten the stability of the financial system as a whole. Part of that would include an explicit rollback of the government safety net, to ensure that those engaging in risky behavior do not do so believing the government will save them in a time of trouble.

Fisher, whose comments came from the text of his speech, spoke as Congress is mulling how to overhaul the financial regulatory structure. There's quite a bit of uncertainty about the outcome of the process, but Fed officials have by and large tilted against those who would break up the too-big-to-fail banking firms.

In a late October, Fed Chief Ben Bernanke called for "a more subtle approach" to dealing with very large financial firms. He said "we can address these issues in a way that doesn't destroy the economic value of large complex multifunction firms through other mechanisms," such as appropriate capital requirements and higher capital standards for systemically important firms.

Fisher reckons that if these too-big-too-fail institutions can be reformed, monetary policy can function the way it used to, which would allow the central bank to return to a more traditional profile.

Fisher said of the Fed's many emergency lending efforts: "It would be disingenuous of me to deny that these measures carry great and unprecedented risk."

The official noted the Fed's interventions and lending "give rise" to those who question the central bank's inflation-fighting mandate, and assist "suspicions that we are undertaking fiscal-like initiatives" better left to Congress. The actions also cast a shadow over the Fed's independence.

And on a more practical level, what the Fed has done over the last couple of years "bloat our balance sheet, requiring us to now craft and articulate an exit strategy that might take us even further from our traditional practices."

Fisher also observed of the dollar that its rally during the opening months of the financial crisis "probably had more to do with the perception that financial conditions at the very largest banks were worse in the U.K. and the rest of Europe than in the U.S." than other factors.

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