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Bernanke Endorses Expanded Authority

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New Tools Needed To Avert Crises, Fed Chairman Says

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Federal Reserve Chairman Ben S. Bernanke yesterday endorsed major changes to the ways the financial system is regulated, advocating new tools to make sure big financial firms that fail do not damage the overall economy.

Bernanke said that if the Fed were to gain more responsibility for guarding against financial crises, that responsibility would need to come with the power to regulate the activities of a wide range of financial players.

He also advocated more authority for the Fed over the plumbing of the financial system, including the processes banks use to pay one another, and for investment banks to be overseen by a regulator with more explicit legal authority. Bernanke said he may extend a special loan program for investment firms, enacted during the March collapse of Bear Stearns, into 2009.

"Regulators must consider what can be done to make the U.S. financial system itself more stable without compromising the dynamism and innovation that has been its hallmark," Bernanke said in a speech at the Federal Deposit Insurance Corp.'s forum in Arlington on mortgage lending to low-income households. His ideas amount to several significant changes in how Wall Street is regulated, but not the kind of sweeping overhaul contained in a blueprint from the Bush administration.

Bernanke endorsed the idea of creating a formal, established process by which investment firms can be liquidated. In the absence of such a formal system, the Fed decided to rescue failed investment bank Bear Stearns in March in the middle of the night, in an improvised fashion and using emergency authority.

"Congress may wish to consider whether new tools are needed for ensuring an orderly liquidation of a systemically important securities firm that is on the verge of bankruptcy, together with a more formal process for deciding when to use those tools," Bernanke said, citing the FDIC's procedures for liquidating the assets of failed banks as an example of how it might work.

Bernanke acknowledged that his decision to extend loans to investment banks created new risks, and he said it is important that any new law be structured to make clear that government intervention will be undertaken only in rare, dire circumstances. "The Fed's decision to lend to [investment firms], although it was necessary to avoid serious financial disruptions, could tend to make market discipline less effective in the future," he said.

Some outside experts argue that changes such as the ones Bernanke advocated yesterday could create more problems than they solve.

"We have an established system for liquidating assets, and it's called bankruptcy," said Peter Wallison, who studies financial regulation at the American Enterprise Institute. "As soon as you set up a special government system for dissolving one of these institutions, you're signaling you're prepared to take them over and bail out the creditors."

Bernanke gave a partial endorsement to a proposal, first made by Treasury Secretary Henry M. Paulson Jr., to give the Fed more explicit power to combat financial crises, swooping into any segment of the financial world that poses a risk to the system as a whole.

Such power would make sense, Bernanke said, only if the Fed also has extensive power to examine the inner workings of financial institutions. "To fulfill its responsibilities, the Fed would also need to have the ability to look at financial firms as a whole . . . and the authority to set expectations and require corrective actions as warranted in cases in which firms' actions have potential implications for financial stability," he said.

The Paulson plan, by contrast, would reduce the Fed's role in the direct day-to-day oversight of commercial banks, while giving it new powers across the financial world.

Some experts both inside and outside the Federal Reserve system are uneasy about the Fed being made formally responsible for preventing financial crises.

"I'm not sure if it's realistic to expect it to be possible to eliminate financial instability," Jeffrey M. Lacker, president of the Federal Reserve Bank of Richmond, said in an interview yesterday. "I'm a little wary of being given a mandate for financial stability without some understanding of what in the world that means."

Bernanke also called for Congress to give the agencies that regulate Wall Street firms more explicit authority. Currently, large investment firms voluntarily agree to broad oversight by the Securities and Exchange Commission.

"Legislation may be needed to provide a more robust framework for the prudential supervision of investment banks and other large securities dealers," Bernanke said.

Congress is beginning to consider overhauling financial regulation to try to prevent crises like that of the last year from recurring, and yesterday's speech was Bernanke's most extensive airing of his views of how the laws should evolve. He and Paulson are scheduled to testify to the House Financial Services Committee on the subject tomorrow, though Congress is unlikely to undertake new legislation in a serious way until next year.

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