

**Statement of
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On
Avoiding Taxpayer Funded Bailouts
By
Returning to Free Enterprise
And
Pro Growth Bank Regulatory Policies
before the
Committee On Financial Services,
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The views expressed by the author are his own and do not necessarily reflect those of the Federal Deposit Insurance Corporation, its directors, officers or representatives.

Chairman Hensarling, Ranking Member Waters and Members of the Committee, I appreciate the opportunity to testify on issues relating to improving the safety and soundness of our nation's banking system. How policymakers and regulators choose to structure the financial system to allocate the use of the government's facilities and subsidy will define the long-run stability and success of the U.S. economy. My testimony today is based on a paper, titled "Restructuring the Banking System to Improve Safety and Soundness," that I prepared with my colleague Chuck Morris in May 2011. I welcome this opportunity to explain the pro-growth and pro-competition recommendations for the financial system in the paper, which I have attached to this testimony (Attachment 1). Although I am a board member of the FDIC, I speak only for myself today.

Too Important to Fail

Almost three years after passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), an issue that remains critical to the long-run stability of our financial and economic system is the degree to which the government should subsidize and therefore facilitate ever-greater risk taking among our most dominant financial firms. These firms by their very size and complexity affect the broader economy to an overwhelming degree; and since the recent financial crisis, they have only become more influential and the economy more dependent on their performance.

The largest U.S. financial holding company has nearly \$2.4 trillion of assets under GAAP accounting, which is equivalent to 15 percent of nominal GDP. If we take into account the gross fair value of its derivative book, it has nearly \$4 trillion of assets, equivalent to 25 percent of nominal GDP. The largest eight U.S. global systemically important financial institutions in tandem hold \$10 trillion of assets under GAAP

accounting, or the equivalent of two-thirds of U.S. GDP, and \$16 trillion of assets when including the gross fair value of derivatives, which is the equivalent of 100 percent of GDP.

My concern with the largest financial institutions is not only their size but their complexity and the subsidy that facilitates each. Over time, the government's safety net of deposit insurance, Federal Reserve lending and direct investment has been expanded to an ever-broader array of activities outside the historic role of commercial banks -- transforming short-term deposits into long-term loans and operating the payments system that transfers money around the country and the world. In the U.S., the Gramm-Leach-Bliley Act allowed commercial banks to engage in a host of broker-dealer activities, including proprietary trading, derivatives and swaps activities -- all within the federal safety net. Following passage of this Act, in order to compete with subsidized firms, broker-dealers found it necessary to either merge with commercial banks or change their business model by taking on dramatically greater debt and risk. For example, firms like Bear Stearns began to borrow short to lend long and to engage in other bank-like activities. As they increased in size and complexity, the markets correctly assumed that the safety net would extend to these firms. Therefore, institutions engaged in banking activities significantly contributed to the crisis whether they were called "banks" at the time or not.

Even today, following enactment of the Dodd-Frank Act, government support of these dominant firms, explicit and implied, combined with their outsized impact on the broader economy, gives them important advantages and encourages them to take on ever-greater degrees of risk. Short-term depositors and creditors continue to look to governments to assure repayment rather than to the strength of the firms' balance sheets and capital. As a result, these companies are able to borrow more at lower costs than they otherwise could, and thus they are able increase their leverage far beyond what the market would otherwise permit. Their relative lower cost of capital also enables them to price their products more favorably than firms outside of the safety net can do. For your information, I have included with my testimony a chart (Attachment 2) that shows current leverage ratios for some of the world's largest financial firms. History tells us that without the safety net, the market would have allowed far less leverage.

The Subsidy

The advantages I describe above translate into a subsidy that represents a sizable competitive advantage and which leads to a more concentrated industry. A large and growing body of evidence supports the existence of such a subsidy. A summary of studies is included with my written testimony (Attachment 3). While the estimated size of the subsidy may vary in degree, depending on the methodology, nearly all independent studies calculate the value to be in the billions of dollars. This government subsidy facilitates these firms' growth beyond what economies of size and scope can otherwise justify and subjects the broader economy to the adverse effects of management misjudgments, which in turn entrenches the behavior of repeated financial bailouts within modern economies.

The Dodd-Frank Act was intended to address the build-up of systemic risk and, if necessary, the management of its fallout on the economy. However, there remain systemically important financial firms that are of a size and complexity that would expose the broader economy to overwhelming consequences should they encounter problems. The Dodd-Frank Act unfortunately does not change the fundamental incentive of the safety net's subsidy, which continues to encourage these firms to leverage and take on excessive risk for higher returns. As long as the subsidy exists, we will have highly leveraged, highly vulnerable institutions that will negatively impact our national economy

The Proposal

To improve the chances of achieving long-run financial stability and making the largest financial firms more market driven, we must change the structure and the incentives driving behavior. The safety net should be narrowed and confined to commercial banking activities as intended when it was implemented with the Federal Reserve Act and the Banking Act of 1933. Importantly, such reforms only will be effective if the shadow banking system is also reformed and its activities subjected to the market's discipline.

Commercial banking organizations that are afforded access to the safety net should be limited to conducting the following activities: commercial banking, securities underwriting and advisory services, and asset and wealth management. Most of these latter services are primarily fee-based and do not disproportionately place a firm's capital at risk. They are similar to the trust services that have long been a part of banking.

Extending the safety net to broker-dealer activities is unnecessary and unwise. While trading and investment activities are important parts of the financial system, they operate more efficiently and safely without government protections. Keeping them inside the safety net exposes the FDIC Deposit Insurance Fund and the taxpayer to loss. Therefore, activities that should be placed outside the safety net and thus subject to market forces are: most derivative activities; proprietary trading; and trading for customer accounts, or market making. Allowing customer trading makes it easy to game the system by "concealing" proprietary trading as part of it. Also, prime brokerage services require the ability to trade, and essentially allow companies to finance their activities with highly unstable, uninsured, wholesale "deposits" that come with implied protection. This combination of factors, as we have recently witnessed, leads to unstable markets and government bailouts.

Reforming the Shadow Banking System

These actions alone would provide limited benefits if the newly restricted activities migrate to shadow banks -- broker-dealers, for example -- without that sector also being

reformed. We need to change incentives within the shadow banking system through reforms of money market funds and the repo market.

First, we must address potential disruptions coming from money market funding of shadow banks that fund long-term assets. Money market mutual funds and other investments that are currently allowed to maintain a fixed net asset value of \$1 should be required to have floating net asset values. Shadow banks' reliance on this source of short-term funding would be greatly reduced by requiring share values to float with their market values.

Second, we must change bankruptcy laws to eliminate the automatic stay exemption for mortgage-related repurchase agreement collateral. This exemption, introduced in 2005, resulted in a proliferation in the use of repos based on mortgage-related collateral. This preferential treatment made it possible for complicated and often risky long-term mortgage securities to be used as collateral when the volume of securities was growing rapidly just prior to the bursting of the housing price bubble. One of the sources of instability during the recent financial crisis was repo runs, particularly on repo borrowers using subprime mortgage-related assets as collateral. Essentially, these borrowers funded long-term assets of relatively low quality with very short-term liabilities.

The reforms specified in the proposal I am describing today would not – and are not intended to – eliminate natural market-driven risk in the financial system. They do address the misaligned incentives causing much of the extreme risks stemming from the safety net's coverage of nonbank activities. The result would be a return to a system of free enterprise where broker-dealer related activities are subject to greater market discipline.

The Industry's Reply

Objections to the proposal I offer suggest that it would undermine the competitive position of U.S. firms internationally. However, under the proposal, the largest financial firms would remain large and would be more competitive. It recognizes that the public should not accept the premise that it must subsidize highly risky financial activities in order to compete for international dominance. It is a serious error to presume that if these activities were not subsidized at U.S. commercial banks, they would cease to be offered by other non-subsidized U.S. firms. Our dynamic markets would continue to provide these services via independent broker-dealers but in a more competitive manner where the taxpayer is not part of the transaction.

Each country is unique in what banking structure best supports its economic growth. I am not aware of research that suggests the U.S. financial system would be less competitive or that economic growth would suffer with commercial banking separated from broker-dealer activities. It is a fact that the emergence and continued success of the U.S. economy from the end of World War II to the 1990s happened during a period where commercial banking was separate from investment banking. Here's one data

point: the growth rate of real GDP averaged 3.3 percent from 1955 to 1990, but only 2.3 percent from 1990 to the present.

The argument for bank deregulation prior to 1999 was that size and diversification of activities reduces risk. While in theory that may have seemed a real possibility, we can surely observe that history – from the 1980s to the most recent crisis – suggests otherwise. In each of these periods of financial crisis, regional and smaller banks failed and didn't bring down the economy. In the recent crisis, some of the largest banks would have failed had they not been bailed out to prevent a total economic collapse. Regardless of TARP repayment at a generously low interest rate, millions of American jobs and trillions of dollars in economic wealth remain lost.¹

Large banks and large broker-dealers are critical components of the U.S. economy. But I oppose their government-backed ability, when combined as conglomerates, to carry a size and complexity that evidence suggests exceeds what economies of scale would otherwise justify² and thus exposes the real economy to levels of risk that are unnecessary.

Benefits of Change

The proposal outlined in my paper would return U.S. financial firms to a more market-driven model. It would reduce the opaqueness of these firms' operations, enabling the market and supervisors to better oversee their actions. It also would improve the pricing of risk, thus enhancing the allocation of resources within our economic system. In addition, it would promote a more competitive financial system with more – not fewer – firms, as it levels the playing field for financial institutions in the U.S.

As a further benefit, the proposal would facilitate the implementation of Titles I and II of the Dodd-Frank Act, allowing the resolution of a failed SIFI by simplifying the structure of these large financial institutions, making the entire system more manageable through a crisis. Finally, it would raise the bar of accountability for actions taken and, to an important degree, give further credibility to the supervisory authorities' commitment to place these firms into bankruptcy or FDIC receivership when they fail, thus reducing the likelihood of future bailouts.

Conclusion

I will close my remarks by recalling that twice within the past century Americans have experienced the tragedy of vast job and wealth losses due to the economy's exposure to financial crisis. Most recently, the Financial Crisis Inquiry Commission identified a series of abuses that opened our economy to crisis. These included using special purpose vehicles and affiliates to engage in and fund speculative off-balance-sheet activity, and participating in and syndicating for sale low-quality assets.

Finally, I want to conclude by mentioning two admonitions of Adam Smith. First, he argued well that specialization most often increases productivity. I suggest that in the

financial services industry, specialization would do much to increase productivity, innovation and other overall benefits to our economic system. Second, Adam Smith wisely warned that,

"The interest of the dealers....is different from, and even opposite to, that of the public. To widen the market and to narrow the competition, is always the interest of the dealers. To widen the market may be agreeable to the public; but to narrow the competition is against it, and enables the dealers, by raising profits above what they naturally would be, to levy an absurd tax upon their fellow-citizens."

In the United States we must reform financial conglomerates so we have a more stable, more innovative, more competitive system that continues to support the largest, most successful economy in the world.

1 The GAO reports that estimates of the economic cost in lost output of the 2007 crisis could range from a few trillion dollars to over \$10 trillion.

<http://www.gao.gov/assets/660/651322.pdf> .

2 Gambacorta, Leonardo and van Rixtel, Adrian. 2013. "Structural bank initiatives: approaches and implications," BIS Working Paper No. 412, April.

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