Back to the Business of Banking

Thomas M. Hoenig
President
Federal Reserve Bank of Kansas City

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Introduction

Today's meeting and sessions are about financial reform, and I congratulate the organizers of this conference for keeping this important topic in the mainstream of discussion. Much remains to be done around reform if we are to ensure a more stable financial system. Topics today will focus on housing, the Dodd-Frank Act, government-sponsored enterprises (GSEs), the safety net and other reform efforts that necessarily follow the recent financial crisis that has so devastated our national economy.

Understandably, major financial interests are lobbying to change and mitigate the impact of Dodd-Frank or influence the reform efforts that will affect the GSEs. One reform effort, for example, that is especially difficult for some interests to accept is the Volcker Rule. This rule will restrict banking organizations from engaging in proprietary trading activities and involvement with hedge and private equity funds. It will affect the largest institutions most directly, confining their risk profile and limiting the advantages of leverage that currently drive behavior among these firms. How it is implemented will influence not only the behavior of these firms in the future but the discussion of other reform efforts yet to be undertaken.

I strongly support the Volcker Rule and suggest it should be implemented with resolve and should be strengthened in its reach and impact. Over the next few minutes, I want to outline my reasons for this position. Supporting my remarks this morning is a more extensive white paper prepared with colleagues at the Federal Reserve Bank of Kansas City. This paper is posted on our Bank's website, *www.KansasCityFed.org*.

A Brief History

A fundamental characteristic of the United States is that its citizens have an enormous suspicion and distrust of concentrated power—political or financial. For nearly 200 years, state and federal laws placed limits on bank activities and resource concentration, resulting in a relatively open U.S. banking system that has served the country well. In fact, some of the largest institutions in this country started small: The Bank of New York, for example, was founded, in part, by Alexander Hamilton, and the Mellon Bank was founded by a farm boy who built his own financial empire. Thousands of banks, from small community banks to large global players, have operated in this country for most of our 200 years.

Banking in the United States thrived under the principles of competition and accountability—as opposed to having a few mega-institutions with the power to allocate a majority of financial resources and decide who wins and who loses. Rather, success followed a structure in which thousands of banks operated; competed; and, in the end, helped build the greatest middle class the world has known.

In 1913, when the Federal Reserve was brought into existence, 21,000 commercial banks operated across the country. At that time, the five largest banks controlled assets that we estimate were the equivalent of about 2.6 percent of our gross domestic product (GDP). As late as 1980, the United States had 14,000 commercial banks, and the five largest controlled, in assets, the equivalent of about 14 percent of GDP. Our nation had a lightly concentrated and highly competitive commercial banking and financial system. We saw the ascendancy of the United States as the greatest economic system in the world. And we saw our country change from an agrarian-based economy to a successful agriculture and industrial complex.

Today the United States has far fewer banks and a highly concentrated financial industry. We have fewer than 7,000 banks operating across the country. The five largest institutions control assets that are equivalent to almost 60 percent of GDP, and the largest 20 institutions control assets that are the equivalent of 86 percent of GDP. The remaining nearly 7,000 banks control assets the equivalent of only 14 percent of GDP. More noteworthy perhaps is the fact that it was several of the 20 largest institutions that nearly brought down the U.S. economy during this most recent global crisis.

We did not get to such a circumstance by accident or a Darwinian “survival of the fittest” process. We got there through policies that reflected good intentions along the way, but ultimately resulted in bad outcomes. Following earlier crises, such as the 1907 Panic and the Great Depression, we understandably wanted a more resilient system that protected small depositors. So, we first created the Federal Reserve and then the FDIC to provide a safety net of central bank liquidity for solvent banks and limited deposit insurance.

During the past 30 years, however, we have expanded the use of the safety net far beyond its original intent. During the crisis of the 1980s and early ’90s, the government confirmed that some institutions were too systemically important to fail—the largest institutions could put money anywhere, and its creditors would not be held accountable for the risk taken. More striking perhaps in the late 1990s, despite recent experience, Congress repealed the Glass-Steagall Act, which separated activities protected through the safety net from a host of other more-highly risk-oriented and opaque activities.

As risks intensified and new crises emerged, this safety net was continually expanded to where the Federal Reserve, the FDIC and the Treasury were empowered to allocate enormous resources to ensure systemically important institutions didn’t bring down the economy. This process inevitably led to the picking of winners and losers—not through competition and performance, but through bureaucracy. The result is increased concentration and, as just proven, less financial stability.

Also, as conditions allowed and incentives encouraged, complexity within the financial industry expanded exponentially and so did industry risks. First, the expansion of the safety net enabled and encouraged banks to increase their return on equity by lowering capital levels and increasing leverage. Second, with the elimination of Glass-Steagall, the largest institutions with the greatest ability to leverage their balance sheets increased their risk profile by getting into trading, market making and hedge fund activities, adding ever greater complexity to their balance sheets. Third, perception was reality, as certain complex institutions were bailed out and therefore were in fact the safest places for money to go despite the risk. The market's ability to discipline was mitigated, and these institutions became so complex that supervision could not control their risk.

The conclusion of this experience is that the United States must reform its banking and financial structure if we hope to have a competitive; accountable; and, in the long run, less volatile system. There are good reasons to expand the Volcker Rule and to narrow the scope of activities for institutions operating under the public safety net. The consequence of expanding the safety net to an ever-increasing range of activities is to invite a repeat of our most recent crisis. Yes, with separation of activities, risks will remain in the financial system, but unlike the past decade, this risk will be priced more correctly and failure can be resolved more equitably.

Proposal to Reduce Costs and Risks to the Safety Net and Financial System

Let me turn briefly to the reforms that I judge necessary if we hope to more successfully manage the risks and costs to the safety net and financial system. First, banking organizations that have access to the safety net should be restricted to the core activities of making loans and taking deposits and to other activities that do not significantly impede the market, bank management and bank supervisors in assessing, monitoring and controlling bank risk-taking. However, these actions alone would provide limited benefits if the newly restricted activities migrate to shadow banks without that sector also being reformed. Thus, we also will need to affect behavior within the shadow banking system through reforms of money market funds and the repo market.

Restricting activities of banking organizations

The financial activities of commercial, investment and shadow banks can be categorized into the following six groups[1]:

- Commercial banking: deposit-taking and lending to individuals and businesses.
- Investment banking: underwriting securities (stocks and bonds) and advisory services.
- Asset and wealth management services: managing assets for individuals and institutions.
- Intermediation as dealers and market makers: securities, repo and over-the-counter (OTC) derivatives.
- Brokerage services: retail, professional investors and hedge funds (prime brokerage).

[1] This categorization of financial activities is from Matthew Richardson, Roy Smith and Ingo Walter in Chapter 7 of *Regulating Wall Street: The Dodd-Frank Act and the New Architecture of Global Finance*, edited by Viral V. Acharya, Thomas F. Cooley, Matthew Richardson, Ingo Walter, New York University Stern School of Business, John Wiley & Sons, Inc., 2010.

- Proprietary trading: trading for own account, internal hedge funds, private equity funds, and holding unhedged securities and derivatives.

Based on the criterion that permissible activities should not significantly impede the market, bank management and the supervisory authorities in assessing, monitoring and controlling bank risk-taking, banking organizations should be allowed to conduct only the following activities: commercial banking, underwriting securities and advisory services, and asset and wealth management services. Underwriting, advisory, and asset and wealth management services are mostly fee-based services that do not put much of a firm's capital at risk. In addition, asset and wealth management services are similar to the trust services that have always been allowable for banks.

In contrast, the other three categories of activities – dealing and market making, brokerage, and proprietary trading – extend the safety net and yet do not have much in common with core banking services. Within the protection of the safety net, they create risks that are difficult to assess, monitor or control. Thus, banking organizations would not be allowed to do trading, either proprietary or for customers, or make markets because such activity requires the ability to do trading. In addition, allowing customer but not proprietary trading would make it easy to game the system by "concealing" proprietary trading as part of the inventory necessary to conduct customer trading. Also, prime brokerage services not only require the ability to conduct trading activities, but also essentially allow companies to finance their activities with highly unstable uninsured "deposits." This combination of factors, as we have recently witnessed, leads to unstable markets and government bailouts.

The proposed activity restrictions will enable and require bank management to focus their activities on the traditional banking business and manage their exposure to risks inherent in these activities. Banking is based on a long-term customer relationship where the interests of the bank and customer are more aligned. Both the bank and loan customers benefit if borrowers do well and are able to pay off their loans. In contrast, as shown only too clearly with this recent crisis, trading is an adversarial zero-sum game – the trader's gains are the losses of the counterparty, who is oftentimes the customer. Also, for those firms with access to the safety net and large amounts of credit, the advantage in the game goes to them. Thus, restricting these activities removes a conflict of interest between a bank and its customers, which encourages a more stable financial environment.

In addition, the inherent riskiness of securities trading, dealing and market-making attracts, and in fact requires, people who are predisposed to taking short-term risks rather than lenders with a long-term outlook. The combination of securities and commercial banking activities in a single organization provides opportunities for the senior management and boards of directors to be increasingly influenced by individuals with a short-term perspective. As a result, the increased propensity of these corporate leaders to take high risks for short-term gain leads to more of a short-term-returns culture throughout the organization.

Historically, bank investments were restricted to loans and investments in investment-grade securities. As demonstrated in the financial crisis, the complexity of many asset-backed securities made it very difficult to determine their credit quality. As a result, "complicated" multilayer structured securities should be treated as other non-investment-grade assets are, and commercial banks should be limited or prohibited from holding them.

Critics of restricting activities have raised concerns that it would cause problems for U.S. banks because they would face a competitive disadvantage relative to universal banks that are allowed to conduct the full range of activities. They say it would drive U.S. banks and jobs to other countries. If this were accurate, it would be an unfortunate outcome, certainly. However, this conclusion should be considered carefully before it is accepted. First, we have 200 years of banking success in this country that tends to refute that assertion. Second, it seems improbable that any other country should be willing or able to expand its safety net to new large and complex banking organizations. Third, and finally, the U.S. authorities should consider carefully whether it is wise to insure and therefore protect creditors of foreign organizations that operate in this country outside of the U.S.'s prudential standards.

Reforming the shadow banking system

Critics of restricting the activities of banking organizations also argue that it could worsen the risk of financial instability by pushing even more activities to the unregulated shadow banking system. I agree that focusing solely on the regulated banking industry would not solve the problem and might in fact expand the shadow banking sector that was an integral part of the financial crisis.

However, much of the instability in the shadow banking system stemmed from its use of short-term funding for longer-term investment. This source of systemic risk can be significantly reduced by making two changes to the money market.

The first change addresses potential disruptions coming from money market funding of shadow banks – money market mutual funds and other investments that are 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 and the associated threat of disruptive runs would be greatly reduced by eliminating the fixed $1 net asset value and requiring share values to float with their market values.

The second recommendation addresses potential disruptions stemming from the short-term repurchase agreement, or repo, financing of shadow banks. Under bankruptcy law, repo lenders receive special treatment as compared to other secured lenders because they are allowed to take possession of the underlying collateral if the borrower defaults. In other words, repo lenders are not subject to the automatic stay that all other creditors are subject to when default occurs. The bankruptcy law also specifies the eligible assets for the automatic stay exemption.

One of the changes in the 2005 bankruptcy reform law was to make mortgage-related assets used in repo transactions exempt from the automatic stay. Prior to 2005, only very safe securities were exempt from this stay. The change meant that all of the complicated and often risky mortgage securities could be used as repo collateral just when the securities were growing rapidly and just prior to the bursting of the housing price bubble. One of the sources of instability during the 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.

Therefore, to improve the stability of the shadow banking market, the bankruptcy law for repo collateral should be rolled back to the pre-2005 rules and eliminate the automatic stay exemption for mortgage-related repo collateral. This would discourage such activity and tend to reduce the potential instability that is associated with repo runs. Term wholesale funding would continue to be provided by institutional investors such as mutual funds, pension funds and life insurance companies.

Overall, these changes to the rules for money market funds and repo instruments would increase the stability of the shadow banking system because term lending would be less dependent on “demandable” funding and more reliant on term funding, and the pricing of risk would reflect the actual risk incurred.

Conclusion

The proposal I am placing before you today will not take all risks out of the financial system. Reasonable risk is, in fact, part of the financial system and essential to our economic success. However, the proposal will improve the stability of the financial system by clarifying where risks reside; improving the pricing of risk; and, thus, enhancing the allocation of resources within our economic system. It also will promote a more competitive financial system, as it levels the playing field for all financial institutions. And finally, it will raise the bar of accountability for actions taken and, to an important degree, reduce the likelihood of future bailouts funded by the American taxpayers.