Thomas M Hoenig: The financial foundation for Main Street

Speech by Mr Thomas M Hoenig, President of the Federal Reserve Bank of Kansas City, at the Capital Markets Summit: "Getting Main Street Back to Work", US Chamber of Commerce Center for Capital Markets Competitiveness, Washington DC, 24 March 2010.

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The views expressed by the author do not necessarily reflect those of the Federal Reserve System, its governors, officers or representatives.

History tells us that for a country to succeed and endure economically it must adhere to a simple set of principles. No matter the market's complexity, these principles anchor both its financial system and overall economy. And the most fundamental of these principles is a commitment to maintaining the integrity of the institutions within the system. This commitment provides a culture of sound business ethics, a confidence in the rule of law, the reliability of contracts, and a culture of fair play on a level field.

How the individual firms compete on this field is up to them. There is almost always a diversity of firms within a highly competitive and appropriately regulated commercial system. Some firms are large, many are small and all are dynamic. Those who relax, resist change, or cheat know that such lapses result in failure, which is determined by the market.

If we stray from our core principles of fairness or ignore the rule of law, we distort the playing field and inevitably cultivate a crisis. When the markets are no longer competitive, firms become a monopoly or an oligopoly and it matters more who you know than what you know. Then, the economy loses its ability to innovate and succeed. When the market perceives an unfair advantage of some over others, the very foundation of the economic system is compromised.

In these instances, for example, bonuses will far exceed the economic value provided, because the bonus is what we economists call an economic rent. It is not earned, it is only received. The protected will act as if they are protected, they will retain their status independent of performance, and the public will suffer. I like to say, "If you give someone a monopoly, they will act like a monopolist every time."

I open with these comments because our nation today is reacting to a financial crisis and an interruption in the flow of capital. It is also now in the process of addressing its causes in an effort to prevent its recurrence. While calling for action myself, I have been uneasy with what I have seen so far. The attempts to address capital markets and their role as the "Financial Foundation for Main Street," appear to place a much higher value on rhetoric than on substance and necessary reform.

As a nation, we have violated the central tenants of any successful system. We have seen the formation of a powerful group of financial firms. We have inadvertently granted them implied guarantees and favors, and we have suffered the consequences. We must correct these violations. We must reinvigorate fair competition within our system in a culture of business ethics that operates under the rule of law. When we do this, we will not eliminate the small businesses' need for capital, but we will make access to capital once again earned, as it should be.

The inevitable crisis

The banking system has gone through an unprecedented era of change starting in the 1980s when lawmakers began removing the roadblocks to interstate banking. This evolution continued to pick up speed in the years that followed through a number of legislative moves that validated the creation of ever larger banks. The scope of activities continued to grow

through the 1990s and by the end of the decade we saw the merger between Citicorp and Travelers Group. That merger required the divestiture of certain activities, but this became unnecessary with the passage of the Gramm-Leach-Bliley Act. The legislation allowed a single financial company to engage in commercial banking, investment banking, insurance underwriting and brokerage.

This expansion of activities, some argued, created a stronger system overall because the institutions were more diversified. For example, rather than being entirely reliant on a single community or industry, such as real estate, a stronger system was being created because banks were serving a broader nationwide base. A downturn in a single market would be offset by stability in other areas.

Although this new era of finance was widely supported, a critical ingredient was missing on the road to expansion and innovation: a framework that would limit dangerous excesses or the development of perverse incentives. Undoubtedly, the most important omission was a way to deal with the larger firms that were using the new growth opportunities to become "too big to fail (TBTF)."

Although banking legislation in 1991 specifically tried to limit the Federal Deposit Insurance Corporation's (FDIC) ability to protect failing banks and their creditors, regulators could make an exception for large institutions whose failure might pose a threat to the economy or to financial stability. As a result, TBTF was embedded in our legal framework.

The growth of large institutions has distorted the framework of the financial system in ways other than just TBTF. Larger and more complex institutions have become more difficult to regulate and supervise. In some cases, regulators did not have the resources or authority to keep up with a growing and innovative financial system, particularly during a period when some regulatory rules were being replaced with a risk-focused supervisory system. It has been very difficult for examiners to get large banks to tighten their operations, especially when the banks were generating tremendous profits.

These large institutions wield considerable influence. An obvious example of this is the way that Fannie Mae and Freddie Mac were both able to game the political system after their accounting problems and avoid tighter regulation and more realistic leverage constraints.

Looking back, one sees that the crisis was inevitable, if for no other reason than that these TBTF firms would push the boundaries until there was a crisis.

In a 1999 speech on financial megamergers, I concluded that "To the extent these institutions become "too big to fail," and … uninsured depositors and other creditors are protected by implicit government guarantees, the consequences can be quite serious. Indeed, the result may be a less stable and a less efficient financial system."

More than a decade later, the only thing I can change about this statement is that the government guarantees are no longer just implicit. Actions during the financial crisis have made this protection quite explicit.

The results

So, what does this protection mean?

TBTF status provides a direct cost advantage to these firms. Without the fear of loss to creditors, these large firms can use higher leverage, which allows them to fund more assets with lower cost debt instead of more expensive equity. As of year-end, the top 20 banking firms held Tier 1 common equity equal to only 5.1 percent of their assets. In contrast, other banking institutions held 6.7 percent equity. If the top 20 firms held the same equity capital levels as other smaller banking institutions, they would require $210 billion in new equity or reduced assets of over $3 trillion, or some combination of both. (See attached charts.) Stated

another way, almost one-quarter of the assets held by these large institutions are supported by less equity capital.

Furthermore, TBTF reduces the cost of the debt that these firms issue. Due to their implied government support, ratings agencies explicitly increase the debt ratings of the largest banking organizations above the intrinsic rating that would be assigned based on the bank's condition and the amount of leverage. Not only do these firms get to use more debt, but the debt is cheaper.

This framework has failed to serve us well. During the recent financial crisis, losses quickly depleted the capital of these large, over-leveraged companies. As expected, these firms were rescued using government funds from the Troubled Asset Relief Program (TARP). The result was an immediate reduction in lending to Main Street, as the financial institutions tried to rebuild their capital. Although these institutions have raised substantial amounts of new capital, much of it has been used to repay the TARP funds instead of supporting new lending.

In other words, I suggest that our economy would be better served by a more diverse financial system. Certainly community and regional banking organizations were hurt by the financial crisis and recession and many of these firms are facing large losses associated with problems in commercial real estate and other lending areas. But despite these problems, many smaller banks have continued to lend. In 2009, 45 percent of banks with assets under $1 billion increased their business lending.

Policy changes

All of these events bring us to where we are today, talking about the lack of credit availability for Main Street. The good news, such as it is, is that the market is slowly correcting, and credit growth is or will begin flowing to Main Street, providing job growth and economic recovery. However, it will not be rapid or easy.

The fact is that Main Street will not prosper without a healthy financial system. We will not have a healthy financial system now or in the future without making fundamental changes that reverse the wrong-headed incentives, change behavior and reinforce the structure of our financial system. These changes must be made so that the largest firms no longer have the incentive to take too much risk and gain a competitive funding advantage over smaller ones. Credit must be allocated efficiently and equitably based on prospective economic value. Without these changes, this crisis will be remembered only in textbooks and then we will go through it all again.

As steps toward avoiding this outcome and to assure a more consistent allocation to Main Street, I have three recommendations.

First, we must enable capitalism to work and reduce the incentive of our largest financial institutions to take on too much risk by allowing them to fail in an orderly manner. This can be accomplished, but to do so, we must have a credible resolution process that forces shareholders, responsible senior management, and creditors to incur loss if the company takes on excessive risk and becomes insolvent. To be credible, the resolution regime must be independent of the political process and based on the rule of law. Only then, will creditors force these firms to operate with lower leverage. The current legislation in both houses of Congress begins to address this issue. Unfortunately, both still leave considerable room for exception in the hands of the Treasury. This needs more attention. You can find my specific recommendations on how this can be accomplished on the Kansas City Fed's website. (www.KansasCityFed.org)

An often heard statement by many policymakers and financial market experts over the past couple years has been that if a financial firm is too big to fail, then it is too big. I couldn't agree more. Requiring that the largest financial firms be allowed to fail when they are

insolvent and that they must meet at least the same equity capital levels as smaller firms will create a natural limit on the size of firms. It will also do the most for returning our financial system to one that is more efficient and equitable.

Second, we must strengthen our supervision of financial firms by returning to simple, well-established rules, such as maximum leverage and loan-to-value ratios. In an age of "markets know best" and "growth must be accommodated," such rules were weakened in statutes and regulations. Today, we are paying the price. Leverage also tends to rise during economic expansions as investors, lenders, and borrowers forget past mistakes or come to believe that "this time it's different." We saw this in the years leading up to the current crisis. The acceleration of leverage and increase in loan-to-value ratios reflected a massive miscalculation that risks were low and easily manageable.

Third, we must improve the regulatory framework, which may involve reversing some of the deregulation that occurred in the 1990s. Specifically, adopting a version of the proposed Volcker rule would be healthy for long-term stability. It should (1) focus on banning financial holding companies from proprietary trading and investing in or sponsoring hedge funds, and (2) require trading and private equity investment to be housed in separately capitalized subsidiaries subject to strict leverage and concentration limitations. In addition, I strongly support increasing the transparency in financial markets by requiring standardized derivative transactions to be cleared through centralized counterparties, and to the extent feasible, traded on exchanges.

Conclusion

These reforms will encourage and serve to maintain a diverse and efficient banking system. This means a banking system that includes a healthy mix of community, regional, and large banking companies. The banking system's diversity allows the United States to have the world's most innovative and entrepreneurial economy, in large part, because both small and large firms are able to obtain the funding they need. The reforms I propose will promote fairness in our banking system. Fundamental principles are not anti-business. On the contrary, my recommendations are more pro-business than the current regulatory framework.

A credible resolution process, simple rules for leverage and loan-to-value limits, and the Volcker rule reforms will allow all banks to compete on an equitable basis. In the end, reinstating these fundamental principles will enhance consumer, business, and Main Street access to that most essential resource – capital.