Thomas M Hoenig: Financial reform – post crisis?

Speech by Mr Thomas M Hoenig, President of the Federal Reserve Bank of Kansas City, at Women in Housing and Finance, Washington DC, 23 February 2011.

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Thank you for inviting me here today to address this outstanding organization. It is my pleasure to do so. My remarks are entitled "Financial Reform: Post Crisis?" and will address financial regulatory reform and too big to fail. Like most Americans, I am a strong defender of free market capitalism and I'm here today to make an argument that our country should take the difficult steps required to move its financial industry back toward that system.

I acknowledge that there is more than one view on this topic. There are those who believe we have made great strides with Dodd-Frank and if we implement it well, all will be fine. Some believe that that the industry is over-regulated, which may be true, but we should not confuse over-regulated with well-regulated. And some of us are certain that in spite of all that's been done and debated, the soundness of the largest financial institutions and the systemic risks they continue to pose is no better. In my view, it is even worse than before the crisis. As well-intentioned as the Dodd-Frank Act may be, it will not improve outcomes. Today I will describe why I believe that is the case and, more importantly, what must be done to give the United States a financial system that is healthy and competitive, and that supports rather than endangers the economy.

There are many villains in the story of the recent crisis and much written to name them, describe them and even curse them. If you want to know how it happened, read "Thirteen Bankers" and "All the Devils Are Here." If you want to know how to fix the problem, I highly recommend "Regulating Wall Street," from New York University's Stern School of Business. If you want to understand why the American public refuses to ignore the injustices associated with executive compensation in bailed out companies versus budget cuts borne by the middle class, read Rolling Stone's article "Why isn't Wall Street in Jail?" If you wonder why "no one saw it coming" then I suggest you read up on Brooksley Born or, a decade later, Meredith Whitney.

Or, you might even read the remarks of an Iowa-educated bank regulator turned-policy maker in Kansas City. Fifteen years ago, I gave a speech entitled "Rethinking Financial Regulation," which summarized the major threats facing our financial system. My suggestion then was to take steps to reduce interdependencies among large institutions and to limit them to relatively safe activities if they chose to provide essential banking and payments services and be protected by the federal safety net. I also argued that safety net protection and public assistance should not be extended to large organizations extensively engaged in nontraditional and high-risk activities. A final point of those remarks was that central banks must pursue policies that preserve financial stability. I am going to repeat those suggestions today, and as often as the opportunity allows. History is on my side.

Today, I am convinced that the existence of too big to fail financial institutions poses the greatest risk to the U.S. economy. The incentives for risk-taking have not changed post-crisis and the regulatory factors that helped create the crisis remain in place. We must make the largest institutions more manageable, more competitive, and more accountable. We must break up the largest banks, and could do so by expanding the Volcker Rule and significantly narrowing the scope of institutions that are now more powerful and more of a threat to our capitalistic system than prior to the crisis.

The recent financial crisis

The recent financial crisis was one of the world's worst and most pervasive. Actions taken affecting an array of institutions during the crisis, like each crisis before it, set new precedent and invited new risks going forward. First, during the crisis public safety nets and assistance were stretched far beyond anything that we had done in past crises. Deposit insurance coverage was substantially expanded and public authorities went well beyond this with guarantees of bank debt instruments, asset guarantees at selected institutions, and many other forms of market support. Discount window lending sharply departed from previous practices in terms of nonbanks and special lending programs. Substantial public capital injections were further provided through TARP to the largest financial organizations in the United States and to several hundred other banks on a scale not seen since the Reconstruction Finance Corporation in the 1930s. These steps were similar to those that many other major countries took.

Second, at the heart of the financial collapse were some of the largest commercial and investment banks in the country, as well as the markets in which these institutions were key players. The five largest investment banks failed, were forced into mergers, or had to convert to bank holding company ownership to gain the necessary support. Bank of America and CitiGroup both required extensive assistance to pull through this crisis. Special assistance was provided to AIG, the largest insurance company in the United States. In addition, Fannie Mae and Freddie Mac belong in this group because of the influence they exert over the U.S. mortgage market, their enormous losses, and public takeover.

It is no coincidence that two principal features of this crisis were heavily bloated safety nets and major financial institutions that were treated as being too big to fail. History shows that these two elements have become more intertwined – the growth of one is linked to growth of the other, in an increasingly pernicious cycle.

Andrew Haldane of the Bank of England termed this relationship "Banking on the State" in his excellent speech and paper of the same title. Over time we have experienced a ratcheting process in which public authorities are pressured to widen and deepen their state safety nets after every financial crisis brought on by excessive bank risk taking. This expansion in safety nets then sets the stage for the next crisis by providing even greater incentives for risk taking and further expanding moral hazard problems.

As a result, we have become trapped in a repeating game in which participants continue to seek ever higher and more risky returns while "banking" on the State to fund any losses in a crisis. Large organizations, moreover, are the key players in this process as States become more immersed in the perception during a crisis that they must protect any bank regarded as systemically important. We must stop this game if we are to create a more stable financial system and not condemn ourselves to an escalating series of crises with rapidly rising costs.

Over the decades of crisis and bailouts there is considerable evidence of increasing levels of banking risk, which includes the long-term declining trend in bank capital and liquidity ratios, higher and much more variable returns on bank equity in recent years, and a link between higher leverage and the expansion in trading assets among large organizations.

In the United States, we observe with each crisis and market collapse that policymakers consistently intervene to protect an ever broader group of creditors and investors from loss. This includes the LDC debt crisis, the failure of Continental Illinois, and the thrift industry and stock market collapses of the 1980s. These previous public interventions, though, pale in comparison to what was done recently. Market participants and large financial institutions have little reason to doubt that they will be bailed out again.

Let me offer just one staggering example. When Gramm-Leach-Bliley was passed in 1999, the five largest U.S. banking organizations controlled $2.3 trillion in assets, or about 38 percent of all banking industry assets. Currently, Bank of America by itself and in spite of its need for government support during the crisis has the same level of assets – $2.3 trillion –

as the top five did in 1999 and the top five now have 52 percent of all banking industry assets. What clearer sign could we find that market discipline no longer exists?

Past actions and this growth have given our largest organizations significant competitive advantages over other financial institutions. For example, creditors and uninsured depositors at too-big-to-fail organizations believe that there is almost no chance that they will have to take a loss. This idea is formally acknowledged by the credit rating agencies when they give these organizations separate “support” and “standalone” ratings, which explicitly factor in the government support they likely will receive. The difference in these two ratings thus provides one measure of the funding advantages that too-big-to-fail organizations have over others.

Haldane estimated that this funding advantage amounted to about $250 billion in 2009 for 28 of the largest banks in the world. At the Federal Reserve Bank of Kansas City, we estimated the ratings and funding advantage for the five largest U.S. banking organizations during this crisis. In June 2009, these organizations had senior, long-term bank debt that was rated four notches higher on average than it would have been based on just the actual condition of the banks, with one bank given an eight notch upgrade for being too big to fail. Looking at the yield curve, this four-notch advantage translates into more than a 160 basis point savings for debt with two years to maturity and over 360 basis points at seven years to maturity.

In a competitive marketplace, where just a few basis points make a difference, these funding advantages are huge and represent a highly distorting influence within financial markets. I’ll name three. They don’t have to sell creditors on the strength of their condition. They have significant advantages in competing for funds. And, they have significant incentives to take on more risk, hold less capital, and book more assets.

We should also recognize that the perverse incentives associated with such a system not only can contribute to a crisis, but tend to impede our ability to recover from a crisis. Normally, market forces would steer funds away from institutions having trouble and toward those that are the strongest and most capable of fulfilling their roles as financial intermediaries. However, coming out of this crisis, much the opposite may have occurred. Too many dollars appear stuck in institutions that must restore capital and work through bad asset problems before they can think of pursuing new lending opportunities. One sign that this outcome may have happened is the significant holdings of excess reserves at large institutions and the various strategies they are adopting to use low-cost, short-term funds to go out on the yield curve for Treasuries and other instruments.

It is ironic that in the name of preserving free market capitalism in this country, we have undermined it so deeply.

The road to a more stable financial system

How can we change this game in which some institutions are repeatedly doubling up after taking losses, while public authorities are forced to underwrite the losing streaks? There are a number of options that currently are in the works: more effective regulation and supervision, higher levels of capital, and a resolution policy for too-big-to-fail institutions. However, one additional option used after the Great Depression still needs to be introduced: Glass-Steagell type limitations on the activities of those organizations that are otherwise too big to fail and that so dramatically affect our national and global economies. Let me take a moment to explain my views on each of these options.

More effective supervision. The idea of more effective regulation and supervision is a major focus in the Dodd-Frank Act. This act mandates enhanced supervisory standards for all systemically important financial institutions. Such standards are to include provisions for risk-based capital, leverage, liquidity, overall risk management, exposure concentration limits, and resolution plans and living wills.

With my supervisory background, I certainly support such efforts. But we should also recognize that supervision alone is not sufficient to address the challenges we face.

As an example, two decades ago we were told that supervision based on "prompt corrective action" was the answer to the thrift and banking crisis of the 1980s. This system may have led to more timely supervisory enforcement steps and established a timeframe for the resolution of most institutions. But prompt corrective action, other previous supervisory reforms, and enhanced supervision under Dodd-Frank, still must rely on examiners unfailingly coming up with an accurate picture of a bank's condition and then being able to act on those findings.

In large, complex organizations, this is an exceedingly difficult task and much more so than when I spoke about it 15 years ago. This crisis, in fact, confirm**s** that even the senior management, boards, and financial experts at our largest banks failed to assess adequately the risks they were taking, even though they were involved with such issues on a constant basis and had their reputations at stake.

Also, as I previously stated, the substantial incentives that large organizations have to take on more risk, with the government expected to pick up the losses should they incur, unfailingly lead to undue risks throughout the balance sheet. In the hands of any banker, the combination of competitive pressures and perverse incentives are almost certain to result in noticeably higher risk exposures. Against these odds, we cannot expect examiners to have a 100 percent success rate. Factoring in the political power of the largest institutions, we cannot expect even a modest success rate during the upswing in the cycle.

Higher capital standards. I also support stronger capital standards, especially in the form of a maximum leverage ratio based on equity capital. Basel III and the Dodd-Frank counter cyclical capital provisions may provide some constraint on excess risk in firms if they are implemented successfully.

But again, we must be cautious in what we can expect from this step by itself. Basel I and II were supposed to provide a better means for linking a bank's capital to the amount of risk it assumed. Along the way, we found that risk was very difficult to measure and that capital needs determined during normal circumstances were not enough for tail events or shocks that create financial crises. It is a fact that the largest financial firms easily met their risk based capital requirements just prior to this crisis.

In addition, too big to fail incentives have provided an irresistible motive for large banks to game any capital system, particularly since their uninsured creditors do not count on capital but on a bailout for protection. There were several notable signs of this "gaming" of capital standards leading up to the crisis, including the growth of off-balance sheet activities and the construction of subprime mortgage-backed instruments that marginally met the standards for AAA credit ratings. Even with firmer leverage standards, the incentive is for these organizations to increase balance sheet risks.

Resolution policy for too-big-to-fail institutions: A third option is to establish a framework for resolving systemically important institutions. I would add that this framework – to be successful – must convince all market participants that they are fully at risk when dealing with these entities.

Most important, this option offers the only direct means to address the incentive issues surrounding too big to fail and, as a result, provides the best opportunity to curtail the repeated game of expanded safety nets and escalating risk. Ending too big to fail in this manner would also bring market discipline back into play as a key force supporting supervision and capital standards.

The Dodd-Frank Act provides a framework for resolving systemically important organizations. While it adds to what we already have for closing commercial banks, there are important weaknesses with this framework. In particular, the final decision on solvency is not market driven but rests with different regulatory agencies and finally with the Secretary of the

Treasury, which will bring political considerations into what should be a financial determination.

So long as we have systemic organizations operating under the government's protection, we will face the matter of whether we have the will to allow the market and bankruptcy to resolve them. In a major crisis, there will always be an overwhelming impulse to avoid putting such institutions through receivership. Always, it is feared that public confidence will be shattered, creditors or depositors at other institutions will panic, and that there are too many connections that will bring down other institutions. In addition, important services will be lost and the international activities will be too complex to resolve.

Many of these fears are likely overstated. I maintain the view that the long-term consequences are much more severe if we fail to take action to end this cycle of repeated crises. In an environment where market participants are truly at risk, they will be much more likely to take steps to protect themselves, thus reducing the side effects of resolutions, and a failed institution's essential activities can be continued through bridge banks and other means.

A recent Moody's comment further voices a belief that the resolution regime, as outlined in the FDIC's interim rules, "will not work as planned, posing a contagion risk and most likely forcing the government to provide support in order to avoid a systemic crisis." Based on this belief, Moody's intends to continue assuming government support for the eight largest banking organizations, thus helping to carry on the funding advantage these entities have over other market players.

Separate risk taking from the safety net. If too big to fail organizations cannot be effectively supervised, capitalized, or resolved – which is exactly where I contend things stand right now – what option remains?

For me, the answer is firm: they must be broken up. We must not allow organizations operating under the safety net to pursue high-risk activities and we cannot let large organizations put our financial system at risk. Protected institutions must be limited in their risk activities because there is no end to their appetite for risk and no perceived end to the public purse that protects them. As we have seen in this crisis, size and expanded activities have not led to better and more diversified firms as many once argued, but instead have created very large firms with very similar risk profiles that closely mirror the overall financial system and economy.

The serious problems that too-big-to-fail organizations encountered in this crisis provide clear evidence that some have reached a level of complexity and size that defies good management and operational efficiency. A number of financial analysts have even argued that the separate parts of most too-big-to-fail firms would add up to a value much larger than each firm in its entirety.

Some have suggested that we should limit the overall size of a banking or financial organization, much like we do now with the 10 percent nationwide deposit cap. There were some failed efforts to include a size or funding cap in Dodd-Frank, but I agree it would be difficult to figure out a good way to restrict size. Having said that, real opportunities were missed to deal with size issues during the crisis. In the heat of the moment, rather than break firms into smaller more manageable firms, even the weakest U.S. organizations were allowed to acquire major entities that failed or needed assistance during the crisis. This compounded the too big to fail problem in an already concentrated financial industry. Instead of taking important steps to restructure these firms or resolving them as failures, regulators were required to turn their attention to such side issues as executive bonuses and how troubled institutions could be forced to lend more.

To me the evidence is overwhelming, we should vigorously pursue the restructuring of these firms in a manner that mitigates risk and that would influence the size and complexity of these firms. That is, we must expand the Volcker Rule and carve out business lines that are

not essential to the basic business of commercial banking or consistent with public safety nets and then require that these lines be spun off into separate firms.

In the excellent book, "Regulating Wall Street," several of the studies indicate that there are few synergies among financial activities that could lead to economies of scope. The studies also demonstrate that multiple functions in large, complex firms can actually increase systemic risk. Moreover, they suggest that the spun-off activities could thrive without explicit or implied government support.

The conclusion in this book is that separating activities in this manner, together with stronger resolution processes and better capital standards, would do much to strengthen our financial system, making it more accountable and stronger.

It is time we rethink how the world's largest firms should operate and what combination of activities should be permissible. For commercial banks operating under the safety net, any additional activities must necessarily be restricted to those regarded as relatively safe and amenable to prudential supervision. We should give more thought and analysis to those activities and their risk implication and impact on the safety net. It is time we ended the cycle of "failure and reward" and return to "failure as failure."

Conclusion

In a 2009 article on too big to fail and the problems that resulted from the repeal of Glass-Steagall, Martin Mayer gave a very good description of where we currently stand. He stated:

> "We know now that despite the violence of the shock, both the big banks and the cadre of bank regulators and supervisors – and academics – are shaking off the awful memories of 2008 and are setting up the same pins in the same alleys for the same players to try again. We will have to do this, at least, once more before we even try to get it right."

I share Mayer's concern that the United States is stuck in much the same game that came out so poorly this last time, but with the prospect for an even greater loss in the next game. We must make sure that large financial organizations are not in position to hold the U.S. economy hostage. But unlike Mayer, I refuse to accept that we must endure yet another crisis before we are willing to finally right the system.