Financial Stability
Through Properly Aligned Incentives;
Thomas M. Hoenig, Director,
Federal Deposit Insurance Corporation,
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Introduction

In 2011, with significant input from others at the Federal Reserve Bank of Kansas City, I proposed that the U.S. financial system be restructured by business lines with accompanying money market reforms. Since then, I often have been asked why I think there is any stomach for a modern version of Glass-Steagall or any other major financial reform when Dodd-Frank has not yet been fully implemented.

I recognize that enactment of such a proposal1 is no simple task, but doing so will reduce the subsidy for too-big-to-fail firms and better align their economic incentives and rewards. Importantly, a return to a more accountable financial system is an essential step if we expect to rebuild public trust in our financial institutions and in the government that regulates them. That trust can be reestablished and accountability can be put back into the system so that the banking industry can win without the rest of us losing.

It is well understood that our country faces many challenges that are beyond the financial system. Post financial crisis, the United States faces an expanding fiscal challenge that will affect future discussions on tax structure and spending priorities. We cannot hope to find meaningful solutions or common ground to work from regarding these challenges if the public fails to trust its financial and governmental institutions. Who will agree to make sacrifices for the good of the country if they judge that reforms will be poorly or unfairly applied? How can we possibly convince Americans that the fiscal steps will be equitable when we bailed out the largest banks and yet they remain -- larger, more powerful, and insulated from the market's discipline?

The Proposal

The proposal I have submitted would return the public safety-net -- deposit insurance and the discount window -- to the purpose for which it was intended: protecting from systemic disruptions the payments system and the intermediation of funds from depositor to borrower that is commercial banking. For this protection, commercial banks would again be restricted from engaging in higher risk/return activities such as trading, creating derivatives, or other broker dealer activities. However, they would continue to do trust and wealth management, and underwrite new issues of stocks and bonds, as those activities bring new capital to commercial firms.

The proposal also would rein-in the shadow banking system by requiring that money funds represent themselves for what they are: uninsured investments, the value of which changes daily. It would discipline the repo market by subjecting repo lenders that accept mortgage-related collateral to the same bankruptcy laws as other secured creditors.

The Wrong Incentives

This division of activities fundamentally describes the structure of the financial system between the great depression and 1999 -- a period of relative stability for the country's financial markets and strong growth of the economy. In 1999, however, the law changed to allow the melding of commercial banking, investment banking, and broker-dealer activities. With this change, the safety-net was expanded to cover higher-risk activities, which enabled them to be funded at lower costs and with more debt because of the government's guarantee.

This greatly changed the incentive structure in banking and finance, encouraging greater risk taking and ever-more leverage within the system. Firms expanded their business lines to ever-more esoteric activities. The largest firms saw their tangible capital to assets decline to less than 3 percent. Stated plainly, every dollar of assets in the largest firms was supported by less than 3 cents of capital.

Furthermore, cost advantages related to the safety-net encouraged and facilitated consolidation among market players resulting in the 10 largest financial firms increasing their control of industry assets from 31 percent to 68 percent. We acknowledged all too late that the failure of any one of these firms would have a severe systemic impact on the broader economy.

The changing structure also fundamentally changed the nature of some banks' business model. In commercial banking the model is set around win-win, where the success of the borrower means success to the lender in the repayment and growth of the credit relationship. In broker-dealer and trading activities, the incentives are centered around win-lose in which the parties are placing bets on asset price movements or directional changes in activity. Having this activity within the safety-net changes the risk/return trade-off, changes behavior, and adds significant new risks to commercial banking and vulnerability to the safety-net. What social purpose is served by subsidizing these activities with the safety-net? While such activities are essential to the market's function, they belong outside the safety-net where they can compete using private, uninsured funds.

Incentives and Crisis

A decade of expanding financial subsidies and misaligned incentives gave us an economy ripe for crisis, which erupted full bore in the fall of 2008. Its negative effects extended well beyond the firms that precipitated the crisis and onto the public that was

its victim. Early effects were channeled through the economy into significant declines in asset values, lost wealth, and lost jobs.

Containing the crisis required enormous amounts of FDIC and taxpayer support. The taxpayer-funded bailouts of the very firms that precipitated the crisis too often benefited creditors and shareholders when other less-generous solutions could have been implemented if a simpler, more manageable financial structure had been in place.

What is particularly troubling to many is that activities leading to the crisis continue today -- and continue to be subsidized -- well after the lessons should have been learned. Home mortgage loans that had been extended using irresponsible underwriting were foreclosed on without due process. Some of our largest financial institutions misled the markets regarding interest rates and profited by it. These rates still affect borrowers today. Firms using FDIC-insured funds continue to make directional bets on asset values and global events, made even more objectionable by ineffective risk management practices.

Given this record, it is alarming that CEOs of some financial firms fail to grasp why they are trusted so little nor appreciate the reputational damage they caused their industry. They acknowledge very little offense in taking a public subsidy and squandering it in a series of actions that place billions of taxpayer dollars at risk. They fail to appreciate how in so many ways it seems that the game is fixed in favor of a privileged few. The public is aware that there seems to be no accounting for the enormous damage inflicted on our economy. It is difficult to understand how this could have happened in a country like the United States, or how it is possible that a satisfactory solution has not been fully implemented.

More Regulation Is Not the Solution

In reaction to these events, new laws were passed and new regulations were written. The regulations are extensive, and the regulatory burden is significant. The result is thousands of pages of instructions meant to control nearly every aspect of a bank's operations with the expectation that future crises will be far less disruptive or costly.

I suggest that despite hundreds of added regulations, the incentives facilitating the excesses leading to the crisis remain largely unchanged. The reason is that the fundamental cause of the problem has not been fixed. The government safety-net has actually expanded to more firms. It protects firms engaged in the payments system, intermediation process, asset management, and broker-dealer activities. In addition and despite the Volcker rule, the safety-net will continue to cover most elements of derivatives trading and market-making activities, much of which could become veiled prop-trading.

The safety-net subsidy alters incentives, and incentives drive behavior. The behavior and practices leading to this crisis will soon reemerge and these highly complex, more vulnerable firms will have an even more devastating effect on the economy.

The public understands that accountability remains theory, not practice. While many cannot always define the problem in detail or articulate the technical jargon, they correctly sense that something is out of balance.

Failure to Act

Failure to act suggests that we are resigned to more of the same and that public guarantees -- both explicit and implicit -- will continue to subsidize an ever wider array of financial activities that should be subject to the forces of the market. Failure to act suggests that we accept the view that it is beyond our control and that the genie is out of the bottle.

This must not be the case. If it is, then capitalism is at risk and the government not the market will pick winners and losers. If it is, the most influential will win. Worse yet, only the least powerful will be held accountable for their actions.

We deserve better institutions and better outcomes. U.S. financial firms should not expect to remain the strongest banking and capital markets because investors grade on the curve and the rest of the world is in turmoil. We can do better. The large economy that gets the financial structure right first will be the most competitive and successful in this century. It should be the United States. We do have a choice. I understand the financial system, and it is not too late for meaningful restructuring. I'm not saying it's an easy choice, but it will bring greater financial stability and long-term economic benefit.

Simplifying the structure and realigning the industry's incentives are necessary steps toward this goal. Banks that operate within a fair, competitive, and accountable structure is capitalism as intended, not crony capitalism by default. In such a structure incentives are better aligned and success is determined by performance.

In my experience, the majority of CEOs of large or small banks act with integrity in carrying out the duties of their profession. They work to see that their communities and borrowers are well served. I am confident that U.S. bankers can be part of the solution in a global financial system that seeks to find its moorings.

However, bankers, like all of us, react to incentives that are placed before them. A banking structure carrying subsidies that skew incentives and misalign risk and returns must be limited in its scope of activities.

The Role of Financial Supervision

Finally, to those who say that the supervisory authorities failed in their role to oversee the financial markets. I agree. As deregulation accelerated through the decade of the ‘90s, supervisors too often ignored the effect of incentives and accepted the notion that bigger institutions were better, safer, and more competitive. The supervisors' emphasis changed from examining these firms to modeling them. They accepted the notion that

despite rising leverage and risks, the market would self regulate and their models would keep them informed. They bought the notion that the consumer would be best served under such a framework. In their enthusiasm for sophisticated oversight, the regulators lost sight of their job and mission, which was to examine banks for safety and soundness, to assure compliance with established rules, and to do so in a fair and impartial way.

With the proposed restructuring of the industry, there will be a clearer line of sight for carrying out our supervisory responsibilities. The role of supervisors is to ask tough questions, examine the books, be professional skeptics, and enforce rules on the books. We must not look the other way as financial firms gamble with insured deposits. We must more firmly apply anti-trust and financial standards for mega-mergers that create a more concentrated system with a weaker capital structure.

I do not expect institutions with a vested interest in the status quo to come along willingly, but they must be brought along. That's where integrity, fairness, and resolve from the regulators becomes the critical link to success. We are the referees, and like the best referees we must know the rules expertly and enforce them impartially. The market works best when the rule of law carries the day.

Conclusion

In television commercials, one large bank is advertising its celebration of 200 years in business. It is well documented that this bank has received U.S. government support four times in the last 100 years. What does that say to the small business struggling to succeed or wanting to expand?

We have slowly, perhaps unintentionally, expanded the safety-net and its subsidy beyond what is justified to serve the long-run interests of the economy. What started as a means to providing stability to the payments system and intermediation process -- both vital to our economy -- has become a tool for leverage and a subsidized expansion into activities that has led to greater instability.

The proposal I have put forward serves to reduce what is protected by the safety-net and realigns incentives so that the market has a much greater impact on the outcomes. Confining the safety-net to what it was intended to protect by separating banking from broker-dealing will not eliminate crises, but it will contain them and in the end allow for a stronger, more accountable system.

Can this be done? The actions of two presidents stand out as our country faces an issue of this nature. President Teddy Roosevelt, the trust buster, changed the competitive landscape of America for the good. President Franklin Roosevelt enacted the Glass-Steagall Act, from which decades of relative financial stability followed.

Americans are not easily fooled. Rather than ever more complicated and redundant regulation, it's time for meaningful reform in the U.S. financial system to lay a foundation for a stronger U.S. economy.

1My proposal to limit financial activities supported by the public safety-net can be found at http://www.fdic.gov/about/learn/board/Restructuring-the-Banking-System-05-24-11.pdf.

The views expressed are those of the author and not necessarily those of the FDIC.

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