Opening Statement by
FDIC Director Thomas M. Hoenig
to the
Financial Institutions Subcommittee
of the
US Senate Committee on Banking, Housing
, and
Urban Affairs
May 9, 2012

Chairman Brown, Ranking Member Corker and Members of the Subcommittee, thank you for the opportunity to testify on issues relating to improving the safety and soundness of our nation's banking system. Having joined the Board of the FDIC less than one month ago, it is a privilege to serve and to be part of a Board that can draw from a depth of collective experiences and diverse backgrounds that will inform our discussions and decisions.

The Subcommittee has asked me to discuss a paper, titled "Restructuring the Banking System to Improve Safety and Soundness," that I prepared with my colleague Chuck Morris in May 2011 when I was President of the Federal Reserve Bank of Kansas City. I welcome this opportunity to explain the recommendations in the paper. One note--while I am a board member of the FDIC, I speak only for myself today.

I appreciate the Subcommittee's interest in this paper. I have studied and lived these issues as an economist and as a bank supervisor. As I said at my confirmation hearing last November, I am not against "big," I am against "too big to fail." I am a proponent of free market capitalism. With that in mind we outlined a series of steps that will serve to return our country's financial industry to that system, restoring accountability and reducing the likelihood of future bailouts funded by the American taxpayers.

First, banking organizations should be allowed to conduct the following activities: commercial banking, underwriting securities and advisory services, and asset and wealth management services. Most of these 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.

In contrast, dealing and market making, brokerage, and proprietary trading extend the safety net's coverage and yet do not have much in common with core banking services. Under the safety net and the incentives that follow from it, risks are created that are difficult for management and the markets to assess, monitor or control. Thus, under the proposal, banking organizations would not be allowed to do trading, either proprietary or for customers, or make markets which requires the ability to do trading. Allowing customer trading makes it easy to game the system, "concealing" proprietary trading as part customer trading. Also, prime brokerage services require the ability to trade, and 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, financial crisis and government bailouts.

Furthermore, these actions alone would provide limited benefits if the newly restricted activities migrate to shadow banks 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.

The first change addresses potential disruptions coming from money market funding of shadow banks that fund long term assets. 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 would be greatly reduced by requiring share values to float with their market values.

The second recommendation is to change the bankruptcy law to eliminate the automatic stay exemption for mortgage-related repurchase agreement collateral. This exemption allowed all of the complicated and often risky mortgage securities to 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.

The proposal would not eliminate risk in the financial system, it would shift it away from the incentives of the safety net. This plan would return U.S. banks to a position of financial clarity and strength from which the country enjoyed decades of its greatest global economic advantage. It would improve the stability of the financial system by clarifying where risks reside for management and for regulators; improving the pricing of risk; and, thus, enhancing the allocation of resources within our economic system. It would promote a more competitive financial system, as it levels the playing field for all financial institutions in the U.S.

Finally, it will raise the bar of accountability for actions taken and, to an important degree, give further credibility to the supervisory authority's commitment to place these firms into bankruptcy or FDIC receivership when they fail, thus reducing the likelihood of future bailouts.

I would be pleased to answer any questions from the Subcommittee.

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