A Turning Point:
Defining the Financial Structure

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The discussion of financial firms being too-big-to-fail has taken on renewed prominence in the United States, putting us on a course that will do much to shape the economic landscape for decades ahead.

Driving this interest is the perception among many Americans that they remain financially vulnerable to the largest, most complex firms. The reported lapses in controls and failed risk-management systems disturb them. Each new scandal adds to their doubts about the ability of any one person to manage these conglomerates and any bank supervisor to understand and regulate them.

There is concern that the financial system has become ever more concentrated, with the largest firms holding increasing sway over the allocation of economic resources. The 10 largest U.S. banking companies, for example, held assets the equivalent of 25 percent of GDP in 1997, 58 percent in 2006 and, since the crisis, it has increased to over 71 percent.

The public remains uneasy that the current structure of the largest firms puts the entire economy in jeopardy should they falter. History and current events suggest that unless the companies are reconfigured, the government's impulse will be to protect creditors with public funds rather than risk a market breakdown.

As we renew discussions about the structure of our financial system, the debate should be vigorous, for much is at stake.

The Consequences of Maintaining the Status Quo

I share the view that the current configuration of the financial system remains a risk to the public and an impediment to the competitive vitality and strength of our economy. Coming out of the crisis our financial system is more concentrated, and under current policies this trend almost certainly will continue. These conglomerates will become yet more complex, and their financial position will define financial stability for the broader economy.

The incentives toward risk-taking remain essentially unchanged from pre-crisis times. The safety net of central bank loans, deposit insurance and ultimately sovereign support has been expanded beyond where it is needed, covering more types of businesses and activities; the funding advantage for the largest most complex firms appears as great as before the crisis; and the incentives that encourage excessive leverage and risk remain compelling.

As this trend continues, ever-more complex regulations will follow in an attempt to control these banks' actions and the risk to the safety net that protects them. Over time I suspect the industry will be treated like and eventually become public utilities.

This is a discouraging trend. However, there are choices.

Structure Matters

One alternative to continuing our current policies is to rethink the safety net and the structure of the industry for which it would be available. The objective would be to confine the safety net to a limited set of financial services and activities directly tied to the payments system and longer-term lending, and place other activities outside the net in order to encourage a more competitive, market oriented and pro-growth financial system.

In considering this choice, it is helpful to first briefly consider the role of the safety net in helping to create the too-big-to-fail situation. As you are aware, following the Great Depression, the safety net was expanded to include FDIC insurance, which was in addition to the Federal Reserve's discount window. In doing this, lawmakers understood it would deepen a moral hazard problem because depositors and other creditors would be less attentive to the banks' condition, relying instead on government oversight and possible bailouts. To confine the moral hazard, FDIC insurance was made available only to commercial banks and their retail customers. For the same reason, higher-risk investment banking and broker-dealer activities were forced out of commercial banks and away from the safety net. These restrictions were codified into the Glass-Steagall Act in 1933.

For several decades, this structure coincided with relative stability within the financial system. However, with this stability, market players, academics and others began to argue that the separation between commercial and investment banking was unnecessary and that the market would be more competitive and consumers better served if investment and commercial banks were allowed to compete directly. This view eventually became law as part of the Gramm-Leach-Bliley Act of 1999.

While competition might have increased temporarily, the unintended consequence was to extend the safety net to an ever-greater number and range of activities and financial firms. This extended a rich subsidy that encouraged leverage and facilitated management's reach for ever-higher return on equity -- something that would have been far more difficult and unsustainable without the safety net's subsidy.

The result is to reward those managers who gamble and win the day. And, of course, it is left to the public too often pay the bills when banks lose. Also, it has become an imperative that to compete successfully requires getting access to the safety net. All this has had the additional perverse effect of leading to ever greater concentration within the industry. Diversification may have been the intent, but a more concentrated and vulnerable market has been the result. It didn’t take a decade for the industry to leverage-up, increase in size, and engage in activities that eventually contributed to the crisis of 2008.

Also, given the complexity of the market structure that evolved with the help of the safety net, in extreme circumstances, governments feel increasingly compelled to provide some form of extended financial safety net to a greater share of the financial market.

One lesson we should take from the recent crisis is that the market's structure should be simplified and the safety net should be narrowed to what it was originally intended to cover. If we fail to accomplish this objective, we are on our way to making these firms ever more concentrated and eventually public utilities.

Restructuring to Reinvigorate the Economy

At a minimum, the Volcker Rule needs to be implemented as a step toward this objective. However, we would do well to go further than the Volcker Rule and move the broker-dealer and trading activities out of the banks and into separate corporate entities (see Hoenig and Morris 2012).

With this action, you redefine the coverage of the safety net and provide opportunity for greater market discipline and, in time, greater financial stability to a broad range of financial activities.

In its simplest terms, this broader proposal would narrow the public safety net to the purpose for which it was intended. This would involve commercial banking narrowly defined: the payments system that transfers money around the country and the world, and its related intermediation process of transferring funds from depositor to borrower. Commercial banks with the protection of the safety net would again be restricted from engaging in higher risk and return activities such as trading, creating derivatives, or other broker-dealer activities that do not need government protection to function effectively. However, banks would continue to do trust and wealth management, and underwrite new issues of stocks and bonds, as those activities are similar to the intermediation process by bringing new capital to commercial firms.

These reforms cannot be effective unless the shadow banking system is also removed from the safety net. The proposal thus 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 Role of Shadow Banks and the Need for Reform

It is sometimes argued that the recent crisis was related more to shadow banks outside the safety net than to commercial banks under the net. Lehman Brothers is cited as just such a case. However, Lehman was a commercial bank in the most important sense. Around the same time as the passage of the Gramm-Leach-Bliley Act in 1999, Lehman and similar shadow banks began to issue short-term liabilities – such as repos – to fund longer-term assets, just as banks use demand deposits. Many repos were overnight instruments and were not subject to the same rules as other liabilities should the firm fail. Furthermore, major investors in the repos were money market mutual funds, which were not marked to market on a daily basis, and most consumers considered them to be demand deposits.

These deposit-like instruments were promoted to be perfectly safe and, over time, shadow banks like Lehman leveraged themselves and built complexity and size around these instruments. In time, given the extent of their presence in the market, a view formed that the government would protect creditors, and the moral hazard problem thus worsened. Moreover, when the government attempted to step back from this guarantee with Lehman, the market collapsed and no other large financial firm was allowed to fail. The government confirmed the market's perception that these shadow banks and commercial banks were no different.

Also, I would note that when TARP funds were released to nine of the country's largest financial firms on October 28, 2008, they were distributed according to size and complexity and included both commercial and investment banks. Too-big-to-fail became institutionalized, and included commercial banks and an ever larger group of firms thought to affect the stability of the economy.

Effect on Competition

Finally, there is concern that limiting the safety net to commercial banking and simplifying the structure of the largest banks to exclude trading and related broker-dealer activities will adversely affect the competitive position of U.S. institutions in the global market. There is also concern that such steps would adversely affect regional and smaller banks as they would have to compete more directly with the narrowly focused mega banks.

Before we conclude that simplifying the system would undermine our international competitive position, we should consider the history of banking in the U.S. We have a long tradition of financial institutions competing on a global basis and doing so successfully under the model similar to that proposed here. The largest commercial banks under the umbrella of the safety net would remain mega banks and hold scale capable of offering payments services and loans of any size to firms that operate

globally. U.S. broker-dealers and investment banks have long offered specialized capital market services that are competitive and second to none in the world.

Only recently have we changed the model and made the safety net a requirement for any broker-dealer to compete against the largest banks that operate within its protections. The too-big-to-fail subsidy has provided an enormous competitive advantage to these largest, most complex firms. They hold far less tangible capital than regional or community banks. This gives them an advantage over smaller banks in pricing loans. They dominate any loan market they choose to enter as they have broader, deeper and better priced access to capital and credit.

Similarly, some believe that the largest banks minus their trading and other broker-dealer activities would compete more directly with regional and smaller banks, thus driving them out of the market. I find it difficult to accept this as a reason to leave the largest banking companies as subsidized conglomerates.

This argument would have you believe that although these largest banks can take market share from whomever they please, for some reason they have chosen not to compete with regional and smaller banks. It would seem that only if they were forced to do so, would they compete with these smaller banks. This is untrue. Witnessing the consolidation of the industry over the past two decades makes the argument seem almost nonsensical. I speak to regional and community bankers regularly who express enormous frustration that the largest banks are pricing them out of their own market, not because of scale but because of subsidy.

Robust competition and innovation have been the hallmark of U.S. financial firms' success. Making the safety net a requirement for success hardly enhances the competitive outcome. If these largest firms are required to compete with comparable capital requirements, if they are not too-big-to-fail, if their holding companies can be taken into bankruptcy and their banks resolved as other banks are, then the regional and smaller banks can compete on a level playing field and will be less subject to the whims of the largest firms. Neither the largest nor the smallest financial firms should be afraid of direct competition within a set of fair, transparent and uniformly enforced regulations.

Conclusion

We need to rethink how we can best move our financial and economic systems forward in a competitive and productive direction. To do this, we must eliminate too-big-to-fail and reduce the associated taxpayer subsidy by narrowing the explicit and implied government guarantees.

This requires reforming the financial structure. A safety net only for commercial banking activities provides stability to critical financial infrastructure. Separating broker-dealers from commercial banking and the safety net will make them more responsive to the discipline of the market. This simpler financial structure will also strengthen the

supervisors' ability to place bank holding companies and trading houses into bankruptcy and banks into resolution should they fail, and thus make them more accountable for their actions.

Reconfiguring the financial system would accomplish many goals. It would level the competitive playing field. It would invigorate the capital markets by removing the disparity between investment firms inside the safety net and their competitors that are outside. It would strengthen the economy -- not by preventing crises, but by stabilizing the system so that when crises do arise, faltering firms and not the public are held accountable. In turn, the stability would provide a true foundation for the industry and the economy to thrive through innovation and competition instead of through protections and subsidies.

Can this done? As I have noted elsewhere, the actions of two presidents stand out as our country determines how to define the structure and role of the financial system going forward. 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 coincided with decades of relative economic stability and financial growth.

For our future economic stability and financial growth, we should make the choice to reform the system. Big is not bad. Big and subsidized is bad.

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

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