“Financial Markets and Accountability: A Better Way Forward”
-- Remarks by FDIC Vice Chairman Thomas M. Hoenig,
Presented to the
Conference on Systemic Risk and Organization of the Financial System,
Chapman University,

Orange, California

May 12, 2017

Introduction

Notwithstanding the experience of 2008, the U.S. financial system remains heavily subsidized, increasingly concentrated, and, despite a host of new efforts to safeguard the system, it continues to be vulnerable to inevitable financial shocks. I have long argued that we need an organizational model that would turn the industry back toward capitalism. Such a model should enhance the role of markets, allow for failure, and reduce reliance on intrusive regulations. Most importantly, it should improve bank and economic performance.

To that end, I recently introduced “A Market-Based Proposal for Regulatory Relief and Accountability.” Among its goals are addressing too-big-to-fail, enhancing financial stability, and returning the safety net to its original purpose of depositor and payment system protection. My proposal would require the largest banks to hold more capital, and it would partition nonbank activities away from the safety net. Importantly, it also would create a more level playing field between insured and noninsured financial firms, thus enhancing competition.

My remarks today are intended to provide some additional perspective on that proposal by discussing the forces driving change within the industry and speculating on what they might mean for the future of banking and long-term economic growth. I will conclude by outlining how my proposal is the preferable alternative for addressing too-big-to-fail, strengthening the financial system, and providing regulatory relief—all without compromising the public’s interest.

Forces of Change

For decades, until at least the late 1990s, the American banking industry was composed of firms with a range of specialties and sizes, but all with a similar business model that relied heavily on intermediation—that is, taking deposits and making loans. The industry also was highly competitive with assets nearly evenly distributed among the various types of banks: money center, regional, and community.[1]

In more recent years, the largest banks have become disproportionately larger, and their activities within the safety net have become far more extensive than those of most other financial firms. In thinking about the industry’s evolution toward this new order, four forces of change have, in my estimation, been most influential: technology and financial engineering, legislation, ownership structure, and of course the financial crisis of 2008.

Technology and Financial Engineering

As in all industries, technology has fundamentally altered the way banks operate. Tremendous developments in computing power, data collection capabilities, and communication methods have changed the supply chain for lending and how banks manage both sides of their balance sheets. Since operational efficiencies increase with scale, these advances have also encouraged industry consolidation, as the largest institutions gain the advantage in capturing deposits, payments, and lending markets.

Technology also has enabled the largest banks to engage in financial engineering, which facilitates product development and extends their business profile while also substantially increasing product complexity and risk. Short-term wholesale funding instruments, such as repos, rather than retail deposits now provides significant financing for loans. This change has facilitated growth in products such as leveraged loans and securitized assets. It also has driven growth of derivatives and other short-term trading activities, all of which have contributed to a dramatic increase in on- and off-balance-sheet leverage among the largest, most systemically important banking firms.

Legislation of the 1990s

Another force of change that helped shape the banking industry was legislation that relaxed geographic, product, and affiliation restrictions on insured commercial banks, opening up markets and opportunities. Two significant laws enacted in the 1990s, when coupled with technological advances, accelerated institutional growth and changed the banking landscape by allowing for more product expansion and geographic reach during the past few decades.

First, the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 removed most of the interstate banking restrictions that had been in place to address industry concentration and supervisory concerns. The enactment of Riegle-Neal led to an acceleration in consolidation within the industry as banks merged across state lines to take advantage of economies of scale and to access new markets.

Next, the Gramm-Leach-Bliley Financial Services Modernization Act of 1999 broadened the markets for commercial banking by formally removing barriers that prevented bank holding companies and their insured banks from owning other financial service providers, such as investment banks and insurance companies. Allowing the activities of these non-commercial banking businesses to be subsidized with direct and indirect access to the federal safety net dramatically changed the competitive and cultural dynamics of commercial and investment banking and potentially set the stage for, as some call it, the “financialization” of our economy.[2]

Ownership Structure and Corporate Culture

Following Gramm-Leach-Bliley, commercial and investment banks began a series of significant mergers that affected the combined industries in a profound way.

Investment banks originally were formed as partnerships, where owners were liable for all of the firm’s debts. When the New York Stock Exchange relaxed its rules to permit joint stock corporate ownership in 1970, over time it became an attractive opportunity for the investment banking industry to grow and expand its business model. Investment banks that converted to public companies altered the incentives of owners and management, increasing appetite for risk and leveraging balance sheets. The further effect of combining insured commercial banks and investment banks under Gramm-Leach-Bliley magnified these outcomes. In the end, there was a profound change in industry culture that further changed the competitive dynamics among firms. As universal banks formed and matured, and with increasing support from the expanding safety net, the largest banks were increasingly drawn away from relationship banking and lending and toward the higher risk-return model of the broker-dealer-investment bank focused on trading and other fee-based income.

Financial Crisis of 2008

Of course a pivotal force of change was the financial crisis of 2008 itself, out of which came more than new legislation. The effect of the crisis on the U.S. economy, the numerous bank failures, and the government's response in addressing those failurdramatices accelerated industry consolidation and altered its structure and direction in ways that will have lasting effects. JPMorgan Chase acquired Bear Stearns with government assistance, and subsequently acquired Washington Mutual after it failed. Wells Fargo acquired Wachovia. The government injected capital into Citibank, thus bailing it out. Bank of America purchased Countrywide and Merrill Lynch, and later also received extraordinary government assistance. After the failure of Lehman Brothers, regulators allowed two remaining investment banking firms, Goldman Sachs and Morgan Stanley, to become bank holding companies, providing them explicit access to the federal safety net. In short, the crisis and government's reaction to it quickly and dramatically changed the composition and structure of the U.S. financial system.

The crisis altered the industry's structure in other ways as well. Between 2008 and 2014, there were 507 bank failures and 1,576 private mergers, mostly among community banks; and practically no chartering activity. Among regional and community banks, this trend toward consolidation continues nearly a decade after the crisis.

The Dodd-Frank Act

The most recent force of change is the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, enacted in response to the crisis. The law created mechanisms intended to better control the risk profile of the largest financial institutions and end too-big-to-fail. In pursuing these goals, Congress chose regulatory control over structural change.

While some structural changes were introduced, such as the Volcker Rule limiting insured bank proprietary trading and hedge fund activities, there has been little appetite in the United States for breaking up banks or separating activities from the safety net within existing corporate structures. Instead, new regulations have sought to define risk-based standards for allocating capital and liquidity within a firm, while other regulatory tools such as living wills and orderly liquidation have sought to end too-big-to-fail.

Notably, Dodd-Frank reflects a loss of confidence in markets, placing greater emphasis on solutions that rely less on the market system while ceding more authority to individual regulators. This shift will almost certainly reshape the industry in the years to come.

Concentration of Resources

Without question, the landscape of banking has been altered by the combination of technology, legislation, and crisis. Looking back, the four largest U.S. banking firms in 1992 held roughly 14 percent of total industry assets. Today, the four largest banking firms hold 42 percent of total industry assets. Further, assets of these four largest are now approximately $7 trillion, an amount equal to 38 percent of U.S. gross domestic product. To add further perspective, the 20 largest banks today hold more than 60 percent of industry assets.

These institutions have come to dominate the economy and financial markets in other ways as well. Following the Great Depression, the financial sector's share of U.S. corporate profits rose only gradually for decades, reaching 23 percent in 1999, the year Gramm-Leach-Bliley was enacted. The financial sector's share surged after 1999, exceeding 30 percent of total corporate profits in four of the next five years, and stood at 28 percent in 2016. This migration of income from the real economy into the financial sector serves to confirm the "financialization" of our economy.

Some argue that we should not be concerned with these data because they represent less concentration in the U.S. banking industry than elsewhere in the world. However, the rest of the world is not the United States, which has thrived on small business and entrepreneurship and which, since its founding, has distrusted concentrated power. This wariness is particularly acute when it is perceived to be the result of power concentrated in a select few who influence the rules of the game.

Whether one views these forces of change as positive, negative, or indifferent, it is inarguable that they have transformed banking in the United States, giving us systemically important financial institutions, or SIFIs, that dominate the industry and increasingly dominate our economy.

The Future of Banking

Turning to what these forces and related trends portend, I would begin with the observation that the largest U.S. banking firms will dominate the industry well into the future. They also will certainly lead global banking. Having said this, I worry that there are forces in play that will adversely affect their performance and the economy more generally.

For these banks, the safety-net subsidy has been institutionalized, but at a cost in which regulatory oversight and control might impede the firms' ability to adapt to change. Regulators insist on promoting one-size-fits-all solutions for capital, liquidity, and resolution strategies in an effort to control the risks these banks pose to the broader economy. We can observe this tendency with debt being a central feature of Total Loss-Absorbing Capacity (TLAC) requirements, regardless of a bank's business model. Similarly, living wills increasingly reflect regulators' preference for a single-point-of-entry strategy for resolution. Finally, the global regulatory community insists on pre-weighting assets for these firms when judging the adequacy and allocation of equity capital and liquidity positions.

This more intrusive regulation also creates its own barrier to entry into this segment of the industry, which can stifle innovation among firms and reduce choices for customers. Such developments will themselves become a drag on long-run economic growth. For example, as the financial industry has become more concentrated, the average annual pace of real GDP growth has declined in each of the past three economic expansions, from 4.3 percent during the expansion of the 1980s to just 2.1 percent during the current expansion. While many factors influence economic growth, the effects of regulation and market structure cannot be ignored.

The industry will also be influenced by the development of the so-called shadow banking industry, where nonbank firms pursue opportunities outside the bank regulatory construct. Some of these firms will undoubtedly become influential and perhaps systemic. However, developments here are not easily anticipated; their effects will depend on how large a role they eventually play within the economy and on how prepared the banking industry is to absorb the shocks when one experiences stress or fails.

Implications for Regional and Community Banks

If the above outlook for the largest segment of the industry is correct, then the stakes have been raised for regional and community banks as engines of economic growth. These banks, already critical to job creation through their lending to small- and mid-sized businesses, will see increased opportunities for lending and increased pressure to merge and expand their scale and footprint as they seek success.

Regional banks will continue to diversify their services to meet customer demand and successfully compete at the edges of the SIFIs' business domain. At the same time, they will be drawn to consolidate. Just how quickly and to what degree is less certain. The market and regulatory barriers to entry into the realm of the largest and most powerful of the banking firms are substantial. It is unlikely that even the largest regional banks will gain a sufficient share of the payment systems or provide the broad investment banking services necessary to threaten the dominance of SIFIs.

Smaller community banks most likely will operate in the same way as in the past, although they will continue to narrow their business model to focus more on real estate and small business lending. Banks using this model have performed well in the post-crisis period despite the effects of near-zero interest rates. Indeed, community bank loans have grown by more than 8 percent annually for the past three years and outpaced U.S. economic growth in 2016 by three times. Community banks most likely will build on this model that provides a good source of income. However, such a business model carries its own risk associated with concentrated assets, as witnessed by the more than 500 regional and community bank failures following the last crisis.

Finally, regulatory oversight will also play a greater role in shaping the future of regional and community banks. Regulatory costs are proportionately greater for these institutions, as they have fewer assets over which to spread costs. Such burden encourages further consolidation, all of which will affect the competitive vibrancy of the industry.

Overall, reliance on the regulatory path in pursuit of safe banking continues a long trend within the United States. The result has been and will continue to be an industry less influenced by the market and more influenced by regulators whose primary focus is on containing the risk and cost to the safety net, perhaps resulting in an inevitable slowing in economic growth.

An Alternative Path to Consider

The forces of change that I have outlined here beg the question of how best to proceed now that we are nearly a decade past the start of the last crisis and have had time to reflect on the responses and results. Should we back away from heavy reliance on regulation? Can we outline an industry structure that would better balance market forces and sound banking while promoting more rapid but sustainable economic growth?

To that end I recently offered a proposal[3] in which universal banks would partition their nontraditional activities into separately managed and capitalized affiliates. The safety net would be confined to the commercial bank, protecting bank depositors and the payment system so essential to commerce. Simultaneously, these protected commercial banks would be required to increase tangible equity to levels more in line with historic norms, and which the market has long viewed as the best assurance of a bank's resilience.

Under this proposal, the largest, most complex financial holding companies would not be required to divest their current portfolio of activities such as that of the broker-dealer. The firms would be allowed to continue operating these businesses and benefiting from the synergies of common ownership. But they would be required to place the operations in a separately capitalized operating unit that, as such, would be insulated from the insured depository. To partition these activities effectively would require establishing an intermediate holding company capitalized through the issuance of tracking shares tied explicitly to the economic performance of its nontraditional subsidiary, such as the broker-dealer. This is a practice increasingly employed among commercial firms with operating units that differ in composition and performance.

There would be other safeguards as well; for example, limits would be placed on the amount of debt the ultimate parent company could downstream to subsidiaries and on affiliate transactions with the insured depository. Such a structure would necessitate independent market-driven capital and liquidity requirements, and it would provide far greater transparency and better pricing of risks among operating units. Taken together, the intermediate holding company's stakeholders would require that it be appropriately capitalized and able to function on its own.

While the proposal would inhibit the intermingling of funding and operations between affiliates, which is advantageous during good times, it would provide far greater advantages during bad times. Most importantly, over the business cycle, it would provide for more stability and more consistent economic growth. Additionally, such a structure would facilitate resolution using bankruptcy, with less likelihood of precipitating multiple failures or a crisis. These advantages offer a real opportunity for significant reductions in regulatory burden, including, for example, the elimination of risk-based capital and liquidity, the Comprehensive Capital Analysis and Review (CCAR), Dodd-Frank Act Stress Testing (DFAST), Title II and Living Wills, and parts of the Volcker Rule, among others.

Finally, this alternative approach is intended to be supplemented with strong supervision that reemphasizes the importance of management and examiner judgment in gauging safety and soundness, which currently has been substituted for prescriptive rules and regulations reliant upon backward-looking regulatory estimation and the use of complex models.

Conclusion

As I observed at the start of my remarks, the U.S. financial system remains heavily subsidized, increasingly concentrated, and less competitive than at any time in recent history. And it continues to be highly vulnerable to unexpected financial shocks. As we again attempt to address these unresolved issues, we have an opportunity to better balance regulation and markets and to improve industry performance, innovation, and economic growth.

Under the proposal I offer, we could achieve many of these outcomes. Not surprisingly, however, the most vocal criticisms of the proposal come from those who benefit most from the safety net's rich subsidy. I respect the right of those who oppose such a solution and encourage them to speak out. Indeed, the American public should insist that regulators and the industry give their full attention to and engage in an open discussion of the implications of the current state of the industry, its growing power and influence in Washington, and its long-run effects on growth and jobs for our economy. This is nothing less than a discussion about the future of capitalism and economic opportunity for our country.

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

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[1] Consolidation of bank assets, 1984-2013.

[2] May 10, 2010 letter to Senator Cantwell and Senator McCain.

[3] Term Sheet for proposal on Regulatory Relief and Accountability for Financial Holding Companies Engaged in Nontraditional Banking Activities.