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Mr. Aaron Klein & Members of the Financial Regulatory Reform Initiative
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Dear Members:

Thank you for taking the time to meet with me last week. You raised good questions, and I enjoyed the conversation and the exchange of views. As we work through the extensive issues following from the most recent crisis, it is important to keep in mind the expanded role that the safety net and its multibillion-dollar subsidy play in changing incentives for universal banks, especially the incentive toward greater leverage. We should also consider carefully the demands expected of bank supervision and the protocols around those responsible for its success. Because of the emerging prominence of these critical topics, I want to take this opportunity to share further my perspective.

First, subsidizing two important sectors of the financial services industry – complex banks and shadow banks – with access to the safety net puts the financial system and taxpayers at risk, even with the added protection of Titles I and II of the Dodd-Frank Act. Moreover, regardless of the subsidy, the safety net should be limited primarily to those commercial banking activities for which there is an economic and public rationale for protecting and for which the backstop was originally intended. That includes stabilizing the payments system and the intermediation process between short-term lenders and long-term borrowers. To expand the safety net and its related subsidy to an ever greater list of activities around trading and derivatives is to encourage ever more speculative behavior and to risk repeating results global markets experienced in 2008.

Relatedly, there is abundant evidence that the safety net and its systematic extension, explicit and implied, encourages leverage and discourages equity as a principle means of funding financial and economic growth. This is best understood using the simple measure of tangible assets to total tangible capital, as reflected in the table I shared with you during our meeting. For example, just prior to the last crisis, this ratio for some large firms exceeded 40 to 1. Today, for the largest eight U.S. bank holding companies this ratio equals 17 to 1 under GAAP accounting standards and nearly 28 to 1 using international (IFRS) accounting standards. Without the safety net, historical experience tells us this ratio would be between 8 and 10 to 1.

The presence of the safety net has played an important role in enabling this trend toward leverage, but I would be negligent if I failed to point out that also contributing to this trend is regulators' reliance on the highly complex and opaque Basel risk-weighted capital measures and standards. There is a clear indication that large financial firms have successfully managed their risk weighted assets to as little as one-half of their total assets, making it appear as if they increased their capital buffer when in fact they have managed their way to dangerous levels of leverage that will serve only to worsen the inevitable financial shocks that will fall upon the industry.

Reintroducing a simpler but more useful tangible capital measure and establishing a capital level that history tells us would exist if there were no safety net would do much to strengthen both individual firms and the industry. With such capital standards in place, bank management could then allocate resources in a manner that better balances the drive for return on equity with the discipline of having greater amounts of tangible equity at risk. Behind this tangible measure we could use a simplified risk-weighted measure as a check against excessive off-balance sheet assets or other factors that might influence firms' safety.

On the matter of bank supervision, I am aware that you are proposing consolidating the number of supervisors responsible for the largest banks. I am concerned that such an approach fails to recognize the legitimately differing but equally important interests of the Treasury as administrators of the TARP bailout, the FDIC as insurer and guarantor of bank liabilities, and the Federal Reserve as ultimate liquidity facility. Carrying out these responsibilities requires that each agency understand the risks within these firms that they ultimately are required to backstop. I suggest that rather than ignore what each agency brings to the table in assessing the risks these firms are taking, regulators instead should be required to develop an interagency bank examination program for the largest institutions. At the moment, targeted reviews and stress tests are used to assess the condition of these largest, influential firms. While this is helpful, reestablishing systematic and rigorous examinations of the largest banks and bank holding companies is the way to best understand the real risk profile of both individual firms and financial markets. Of course, whatever structure you put in place requires the leadership of the agencies to act to discipline these firms when their risk appetite exceeds sound principles of risk management.

Finally, our conversation also considered the implications of requiring debt as part of a single-point-of-entry approach to Title II resolution. The overall level and composition of debt and equity is an issue that deserves significant thought and discussion as we settle upon the best resolution scheme under both Titles I and II. We should keep in mind that if the largest firms assert, as they currently do, that they have too much capital to deploy, they will systematically strive to substitute debt for equity within their capital structure, once again contributing to a more leveraged and fragile U.S. financial system.

I appreciate your thoughtful consideration of these issues and welcome any further questions or discussions you might want to have.

Sincerely,

[Signed]

Thomas M. Hoenig