Ending the Government Subsidy
Thomas M. Hoenig, Vice-Chairman, Federal Deposit Insurance Corporation

The government safety net of deposit insurance, central bank loans, and ultimately taxpayer support provides a multibillion dollar subsidy to firms that engage in both commercial and investment banking. This government backstop means that they have cheaper access to funding and face less discipline from the market. The subsidy, in turn, creates incentives to take excessive risk directly through risky investments and greater leverage. For example, they can cover – and even double-down -- on their trading positions by using insured deposits or central bank credit that comes with the commercial bank charter. Their competitors that don't affiliate with a commercial bank have no such access to the safety net and its subsidy, and thus no such staying power, putting them at an enormous competitive disadvantage and eventually leading to consolidation. While trading and investment banking activities are important to the success of an economy, there is no legitimate reason to subsidize them with access to the safety net. Furthermore, the excessive risk and greater industry consolidation that is brought about by the subsidy has created a more fragile economy and, therefore, greater risk for the American taxpayer.

The safety net's protection should be limited primarily to those commercial banking activities for which it was originally intended: stabilizing the payments system and the intermediation process between short term lenders and long-term borrowers. That is, it should be confined to protecting activities essential to a well-functioning economy.

Vice Chairman Hoenig is calling for statutory changes to place noncore financial activities such as proprietary trading, market making, and derivatives outside of the commercial bank – and thus outside of the safety net. Broker-dealers would be free engage in these activities where they would be subject to the forces of market discipline and have greater incentives to innovate and thrive.

None of these reforms would be effective unless the shadow banking system is also removed from the safety net. Therefore, Vice Chairman Hoenig is calling for requiring that money funds represent themselves for what they are: uninsured investments, the value of which changes daily. And he is calling for disciplining the repo market by subjecting repo lenders that accept mortgage-related collateral to the same bankruptcy laws as other secured creditors.

Confining the safety-net to what it was intended will not eliminate crises. But it will allow the economic system to handle them, and it will return the financial services industry to a simpler, more competitive and pro-growth footing.