# Banking Safety Net Makes Wall Street Dangerous

By Thomas M. Hoenig
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Given calls for breaking up the largest banks and placing the nonbank broker-dealer activities in separate companies to successfully compete without public support, it is fair to ask, "Will they remain too big to fail?"

The short answer is no. Structured correctly and without a government backstop, the market would demand stronger capital and safer asset growth. This in turn would enhance the ability to place them into bankruptcy instead of the arms of the taxpayer, should they run into trouble.

To achieve this result, however, we must return the safety net – deposit insurance and Federal Reserve credit – to the purpose for which it was intended and economically justified, and we must reform parts of the shadow banking system to end its reliance on the same government support.

The safety net was designed to safeguard the retail consumer and to assist solvent commercial banks in meeting the liquidity demands so essential to the functioning of our national payments and clearing system. While the safety net meets these goals, it also creates the well-recognized moral hazard problem in banking: creditors worry less about getting their money back, so they pay less attention to a financial firm's condition and capital levels and they have less to lose should it fail. This results in a subsidy for insured banks in the form of reduced capital cost and funding advantages.

This moral hazard problem intensifies not only as firms become larger but as the scope of protected activities expands. The more activities that are brought within the subsidy of the safety net of commercial banks, the more incentive and ability management has to leverage the firm and gamble for higher returns. Subsidizing noncore banking activities such as underwriting, proprietary trading, market making, and derivatives encourages firms to bring these business lines onto their balance sheets using more debt, most of which is very short term. The effect is to make the financial system increasingly fragile, and it becomes proportionately more difficult to allow these firms to fail. Thus, while these activities are crucial to the success of a market economy, there is no rationale for the public to subsidize them.

For decades the principle of limited subsidy was understood and practiced. The Glass-Steagall Act kept commercial banks and the government safety net separate from investment banking and broker-dealer activities. Just as importantly, investment banks were kept separate from the payments system and from funding their activities with insured deposits. Investors and creditors understood the risk and rewards for each type of firm and demanded capital and returns commensurate with those risks. When commercial banks failed, they were taken into receivership by the FDIC and the payments system was protected. When investment firms failed, they were placed into bankruptcy. The effects of financial failures on the economy were contained.

This system served the United States from the Great Depression until 1999, a period of relative financial stability. So, what happened?

In 1999, the passage of the Gramm-Leach-Bliley Act officially ended the separation of activities. Large commercial banks expanded into a host of trading and investment bank activities that were easily funded using the public backstop. Investment banks like Lehman Brothers and other broker-dealers became bank-like firms – shadow banks – funding and leveraging themselves with overnight repos, asset-backed commercial paper and other deposit-like instruments. The two structures became one large, highly complex and leveraged system, and the perception that the safety net covered the blended structure became reality.

Thus, to realistically address the problem of too-big-to-fail, these activities must again be separated. Commercial banking companies should be confined to operating the payments system and engaging in lending and traditional activities that follow from this basic role. Such a restructuring would strengthen management teams' attention to these services, allow the market and supervisors to better assess the banks' condition, and give resolution a higher likelihood of success.

At the same time, placing broker-dealer activities outside of the safety net will reduce the direct risk to the taxpayer and lower the multibillion dollar subsidy that economists now estimate these activities currently enjoy. Broker-dealers would be free to engage in proprietary trading, market making, underwriting and all related activities. But under the statutory changes I am suggesting, they would not be allowed to issue short-term liabilities secured by longer-term assets to fund growth. Firms that run into trouble would be far more likely to be resolved through bankruptcy. Under this structure a large broker-dealer would fail without a sustained impact on the economy, as was the case when Drexel-Burnham failed in 1990.

The increased capital and limits on size that follow the removal of the subsidy would result not only in a more stable broker-dealer industry, but also a more innovative, competitive and successful one. Those are the goals we seek to achieve.

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