Stop Subsidizing Wall Street

By Thomas M. Hoenig
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Imagine if the United States had an airline industry in which the biggest carriers that fly both domestically and internationally received a larger government fuel subsidy than those flying only domestic routes. Unfair? Yes — and that's exactly how the U.S. financial system works.

The fuel of the largest firms in our financial services industry is subsidized, and the public bears the cost.

Financial firms can borrow money — their equivalent of fuel — more cheaply and with less market scrutiny when they have access to government guarantees of deposit insurance, loans from the Federal Reserve and, ultimately, taxpayer support such as we saw with the Troubled Assets Relief Program in 2008. This safety net was intended to stabilize the financial system by protecting the payments system that transfers money around the country and the world as well as the essential lending that commercial banks provide. But these protections also assure those who lend to banks that they will be repaid regardless of the condition of the bank. Under such circumstances, creditors give the firms a discount on the cost of the funds they borrow.

Things are made more difficult by the fact that the largest financial companies now combine traditional commercial banking with higher-risk activities such as trading so that both their banking and betting activities get access to these government protections and the multibillion-dollar subsidy that comes with them. Using subsidized money to finance the conglomerates' bets encourages ever-higher levels of debt, risk and interconnectedness not attainable or sustainable in a truly free market.

While some suggest that the 2010 Dodd-Frank Act removed all protections and subsidies for these largest firms, there is no evidence to support that assertion. Recently, Attorney General Eric Holder testified before the Senate that there is a reluctance to pursue legal actions against these firms for fear of destabilizing the markets. The subsidy and its effects remain entrenched and continue to distort the free market.

This form of corporate welfare allows the protected giants — those "too big to fail" — to profit when their subsidized bets pay off, while the safety net acts as a buffer when they lose, shifting much of the cost to the public. For example, the conglomerates can cover — and even double down on — their trading positions for extended periods using insured deposits or discounted loans from the Federal Reserve that come with the commercial bank charter. The subsidy often allows them to stay in the game long enough to win the bet, but it supersizes the loss if the bet should finally fall apart.

This system distorts the market and turns appropriate risk-taking into recklessness. The result is a more concentrated and powerful financial sector — and a more fragile economy. The way to return the financial services industry to the free market is by separating trading from commercial banks and by reforming the so-called shadow banking sector. Government guarantees should be limited primarily to those commercial banking activities that need it to function: the payments system and the intermediation process between short-term lenders and long-term borrowers.

Non-banking financial activities such as proprietary trading, market making and derivatives should be placed outside of commercial banks and so outside of the safety net. Trading and investment companies would be free to engage in these activities; they would be subject to the forces of market discipline and have greater incentives to innovate and thrive.

None of these reforms can be effective unless the shadow banking system is also removed from the safety net by ending the subsidy for money-market funds and the short-term institutional loans known as repurchase agreements or "repos." Money-market funds should be required to represent themselves for what they are: uninsured investments, the value of which changes daily. Similarly, repo lenders that accept mortgage-related collateral should be subject to the same bankruptcy laws as other secured creditors. (Details of my proposal can be found at www.fdic.gov/about/learn/board/hoenig/index.html.)

As entitlement reforms are being debated, the subsidy enjoyed by the most powerful players in the financial services industry should not be overlooked. Stronger, sustainable economic growth will stem from successful firms that are the right size and structure to support the economy instead of being dependent on government protection.

It is time to return our financial system to one in which success is no longer achieved through government protections but, rather, through innovation and competition. While trading and investment activities are vital parts of the financial services industry, there is no economic or social rationale for protecting and subsidizing them. Financial services firms are in the business of taking risks. Our country shouldn't attempt to take the risk out of the system. But we should absolutely stop subsidizing it.