No More Welfare for Banks

By: Thomas M. Hoenig
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I have a proposal to strengthen the U.S. financial system by simplifying its structure and making its institutions more accountable for their mistakes. Put simply, my proposal would help prevent another 2008-style crisis by prohibiting banking organizations from conducting broker-dealer or other trading activities and by reforming money-market funds and the market for short-term collateralized loans (repurchase agreements, or repos). In other words, Glass-Steagall for today.

Those opposed to taking these actions generally focus on two themes. First, they say that if Glass-Steagall—enacted in 1933 to separate commercial and investment banking—had been in place, the crisis still would have occurred. Second, they argue that requiring the separation of commercial banking and broker-dealer activities is inconsistent with a free-market economy and puts U.S. financial firms at a global competitive disadvantage. Both assertions are wrong.

Advocates of the first argument say the crisis was not precipitated by trading activities within banking organizations but by excessive mortgage lending by commercial banks and by the failures of independent broker-dealers, such as Lehman Brothers and Bear Stearns.

This assertion ignores that the largest bank holding companies and broker-dealers were engaged in high-risk activities supported by explicit and implied government guarantees. Access to insured deposits or money-market funds and repos fueled the activities of both groups, making them susceptible to the freezing of markets and asset-price declines.

Before 1999, U.S. banking law kept banks, which are protected by a public safety net (e.g., deposit insurance), separate from broker-dealer activities, including trading and market making. However, in 1999 the law changed to permit bank holding companies to expand their activities to trading and other business lines. Similarly, broker-dealers like Bear Stearns, Lehman Brothers, Goldman Sachs and other "shadow banks" were able to use money-market funds and repos to assume a role similar to that of banks, funding long-term asset purchases with the equivalent of very short-term deposits. All were able to expand the size and complexity of their balance sheets.

While these changes took place, it also became evident that large, complex institutions were considered too important to the economy to be allowed to fail. A safety net was extended beyond commercial banks to bank holding companies and broker-dealers. In the end, nobody—not managements, the market or regulators—could adequately assess and control the risks of these firms. When they foundered, banking organizations and broker-dealers inflicted enormous damage on the economy, and both received government bailouts.

To illustrate my point, consider that if you or I want to speculate on the market, we must risk our own wealth. If we think the price of an asset is going to decline, we might sell it "short," expecting to profit by buying it back more cheaply later and pocketing the difference. But if the price increases, we either invest more of our own money to cover the difference or we lose the original investment.

In contrast, a bank can readily cover its position using insured deposits or by borrowing from the Federal Reserve. Large nonbank institutions can access money-market funds or other credit because the market believes they will be bailed out. Both types of companies can even double down in an effort to stay in the game long enough to win the bet, which supersizes losses when the bet doesn't pay off. The Federal Deposit Insurance Corporation (FDIC) fund and the taxpayer are the underwriters of this private risk-taking.

This leads to the second criticism of my proposal—that breaking up the banks is inconsistent with free markets and our need to be competitive globally. The opposite is true. My proposal seeks to return to capitalism by confining the government's guarantee to that for which it was intended—to protect the payments system and related activities inside commercial banking. It ends the extension of the safety net's subsidy to trading, market-making and hedge-fund activities. This change will invigorate commercial banking and the broker-dealer market by encouraging more equitable and responsible competition within markets. It reduces the welfare nature of our current financial system, making it more self-reliant and more internationally competitive.

Capitalism will always have crises and the recent crisis had many contributing factors. However, the direct and indirect expansion of the safety net to cover an ever-increasing number of complex and risky activities made this crisis significantly worse. We have yet to correct the error. It is time we did.

Mr. Hoenig is a director at the FDIC. His proposal, "Restructuring the Banking System to Improve Safety and Soundness," is at www.fdic.gov.