Financial Oversight:
It's Time to Improve Outcomes

Remarks by
Thomas M. Hoenig
Director
Federal Deposit Insurance Corporation

AICPA/SIFMA FSA National Conference
New York, NY
November 30, 2012

Introduction

Many remain skeptical of claims that the financial system has been reformed and that taxpayer bailouts are relics of the past. Such skepticism is understandable. For nearly a century, the public has been told repeatedly that stronger regulations and supervision, greater market discipline, and enforced resolution will ensure that financial crises will be less likely, and, should they occur, will be handled effectively.

Despite these assurances, the public remains at risk of having to pick up the pieces when the next financial setback occurs. The safety net continues to expand to cover activities and enterprises it was not intended to protect, resulting in subsidized risk taking by the largest financial firms and fueling their leverage. At the same time, the tolerance for leverage remains essentially unchanged, leaving us in a situation that is little different than before the recent crisis. We can be confident that as time passes, this leverage again will be a problem and the public again will be left holding the bag.

To change this outcome, we must change the framework and related incentives.

Defining the Problem

The structure of the system, the rules of the game, and the methods of accountability are all keys to the success or failure of any market system. They determine incentives and, of course, performance outcomes. As you would expect following this most recent crisis, various commissions attempted to sort out what went wrong and offered remedies to prevent such a crisis from recurring.

But for all this effort, incentives around risk remain mostly unchanged and leave the industry vulnerable to excesses. While there are no perfect solutions, there are actions that, taken together, can more effectively improve outcomes.

First, we must change the structure of the industry to ensure that the coverage of the safety net is narrowed to where it is needed, and stop the extension of its subsidy to an ever-greater number of firms and activities.

Second, we must simplify and strengthen capital standards to contain the impulse for excessive leverage and to provide a more useful backstop to absorb unexpected losses.

Third, we must reestablish a more rigorous examination program for the largest banks and bank holding companies to best understand the risk profile of both individual firms and financial markets.

Narrowing the Safety Net

Commercial banking in the United States has been protected for decades by a public safety net of central bank lending, deposit insurance and, more recently, direct government support. This has been done because commercial banks are thought essential to a well-functioning economy. Their operations involve providing payment services, taking short-term deposits, and making loans. In other words, conducting activities that intermediate the flow of credit from savers to borrowers, transforming short-term deposits into longer-term loans. This funding arrangement requires that the public and business have confidence that they can access their money on demand. The safety net helps provide that assurance.

The intended purpose of this government support is well understood. However, less understood is its unintended consequence: providing banks a subsidy in raising funds. As a result, they are less subject to economic or market forces, and their funding costs are less than that of firms outside the safety net. This subsidy, in turn, creates incentives to leverage their balance sheets and take on greater asset risk.

In the United States, this financial subsidy was greatly expanded in 1999 with the enactment of the Gramm-Leach-Bliley Act (GLB), which eliminated prohibitions that kept banks from affiliating with broker-dealer and securities firms. By allowing such cross ownership, the safety net and, therefore, its subsidy was expanded to more and ever-larger financial firms, conducting ever more complex and risk-oriented activities. Subsidies are valuable, and once given are hard to take away and once expanded are hard to restrict.

Despite repeated assurances following GLB that no firm would be too big to fail, the actions of governments have only confirmed that some firms -- the largest or most complex -- are simply too systemically important to be allowed to fail. Under such circumstances, market discipline breaks down since creditors are confident that they will be bailed out regardless of what the bank does. The deposit subsidy and the lack of market discipline from the consequences of failure create an incentive to take on excessive risk.

Narrowing the safety net, limiting its coverage, and realigning incentives, therefore, must be among the highest priorities following this recent crisis. Governments would be wise to limit commercial banking activities to primarily those for which the safety net's protection was 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 our economic infrastructure.[1]

Trading activities do not intermediate credit. They reallocate assets and existing securities and derivatives among market participants. When they are placed within the safety net, they create incentives toward greater risk-taking and cause enormous financial distortions. Protected and subsidized by the safety net, complex firms can cover their trading positions by using insured deposits or central bank credit that comes with the commercial bank charter. Non-commercial bank trading firms have no such access and no such staying power. The safety

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[1] Director Hoenig's proposal to limit financial activities supported by the public safety net can be found at http://www.fdic.gov/about/learn/board/Restructuring-the-Banking-System-05-24-11.pdf.

net provides the complex organizations an enormously unfair competitive advantage. Thus, while such activities are important to the success of an economy, there is no legitimate reason to subsidize them with access to the safety net.

The mixing of commercial banking and trading activities also changes incentives and behavior within the firm. Commercial banking works within a culture of win-win, where the interests and incentives of banks and their customers are aligned. If a customer is successful, the payoff to the bank means success as well. In contrast, trading is an adversarial win-lose proposition because the trader's gains are the counterparty's losses -- and oftentimes the counterparty is the customer. Trading focuses on the short-term, not on longer-term relationship banking. Culture matters, and as we have seen in recent years, the mixing of banking and trading tends to drive organizations to make short-term return choices.

It is sometimes suggested that had broker-dealer and trading activity been separated from commercial banking, the recent financial crisis would have been just as severe. Lehman Brothers was not a commercial bank, and yet it brought the world to its knees. However, following GLB, just as commercial banks enjoyed the special benefit of the safety-net subsidy, firms like Lehman enjoyed the benefits from the special treatment given to money market funds and overnight repos to fund their activities. They were essentially operating as commercial banks and enjoying an implied subsidy very similar to that of commercial banks. Thus, a fundamental change needed to encourage greater accountability and stability is to correct the rules giving special treatment to money market funds and repos, thereby ending their treatment as deposits.

Market discipline works best when stockholders and creditors understand they are at risk and when the safety net is narrowly applied to the infrastructure for which it was intended.

Capital and Bank Safety

Capital is fundamental to any industry's success, both as a source of funding and as a cushion against unforeseen events. This is especially the case for financial firms, as they are, by design, highly leveraged. But what is the right amount of capital, and how should it be measured and enforced to assure a more stable financial environment?

Basel standards have for more than two decades been the focal point of discussion in defining adequate capital for the financial industry. A new version of Basel standards is out for comment as supervisors struggle to find a system that properly defines capital, appropriately allocates it against risk, and results in a more stable financial system. However, the Basel proposal remains extremely complex and opaque as it attempts to anticipate every contingency and to assign risk weights to every conceivable asset that an institution might place on or off its balance sheet. The unfortunate consequence is ineffective capital regulation due to confusion, uncertainty about the quality of the balance sheet, and added costs imposed on a firm's capital program.

Past attempts at defining the correct amount and distribution of capital have uniformly failed. For example, in 2007 as the financial crisis was just emerging, Basel's measure of total capital to risk-weighted assets for the10 largest U.S. financial firms was approximately 11 percent -- a very impressive level of capital. But the ratio, using the more conservative tangible-equity-to-tangible-assets measure, was a mere 2.8 percent.[2] Had this been the primary capital measure in 2007, it is likely that far more questions would have been asked about the soundness of the industry, resulting in a less severe banking crisis and recession.

Today, this same tangible-equity measure for the largest U.S. banks, while double the 2.8 percent number, remains far below what history tells us is an acceptable market-determined capital level. We should learn from past experience and turn our attention from using a capital rule that gives what in the end is a false sense of security to one that is effective because of its simplicity, clarity, and enforceability. Before the safety net was in place in the United States, the market demanded that banks on average hold between 13 and 16 percent tangible equity to tangible assets -- a far cry from the 2.8 percent held by these largest firms in 2007 or the 6 percent they hold today.

Therefore, as an alternative to the unmanageably complex Basel risk-weighted standards, the emphasis should be shifted to a tangible-equity-to-tangible-asset ratio, of say 10 percent. With this simple but stronger capital base, bank management could then allocate resources in a manner that balances the drive for return on equity with the discipline of greater amounts of tangible equity. Moreover, global supervisors would have a clear benchmark to test against and enforce a minimum level. 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.

Some argue that a high minimum would be too much capital, and would impede credit growth and eventually economic growth. However, this level of capital remains well below what the market would most likely require without the safety net and its subsidy. Recall that because so little tangible capital was available to absorb loss when the last crisis emerged, the industry had to resort to a violent shedding of assets and downsizing of balance sheets as it grasped to maintain even modest capital ratios. The effect of too little capital was far more harmful in the end than the effect of a strong capital framework.

Finally, it should be noted that except for the very largest U.S. commercial banks, most banks are currently near this minimum level for tangible equity. For example, while the tangible equity capital to tangible assets for the 10 largest bank holding companies in the U.S. is 6.1 percent, for the top 10 regional banks with less than $100 billion in assets, it is 9 percent. This ratio for the 10 largest banks with less than $50 billion in assets is 9.4 percent, and for the top 10 community banks with less than $1 billion in assets it is 8.3 percent.

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[2] The measure of tangible equity and tangible assets used here differs from the GAAP measures (which exclude intangible assets such as goodwill) by also excluding deferred tax assets. Deferred tax assets are excluded because they are not available for paying off creditors when a bank fails; that is, they are "going concern" assets but not "gone concern" assets.

Only the largest, most complex banks are too big to fail as evidenced by the capital numbers presented here. When the public and the market are at risk, they demand more -- not less -- capital.

Bank Examinations and Financial Stability

Relying on a single tangible measure as a minimum capital standard begs the question of whether it will assure an adequate capital level for the industry. In other words, under a straight leverage ratio, would banks load their balance sheet with the most risky assets because all assets are weighted equally?

First, such a question fails to recognize that a system that underweights high-risk assets and overweights low-risk assets is even more dangerous. This has been the experience with the Basel system going back almost to its start. Also, a minimum tangible-equity-to-tangible-asset ratio, of 10 percent for example, would bring more tangible capital to the balance sheet than current Basel III calculations.

Second, we need to remember that Basel has three pillars: capital, market discipline, and an effective bank supervision program. Effective bank supervision requires that authorities systematically examine a bank and assess its asset quality, liquidity, operations, and risk controls, judging its risk profile and whether it is well managed. Done properly, therefore, the best way to judge a firm's risk profile is through the audit and examination process.

If, following an exam, a bank is judged to carry a higher risk profile, then the minimum capital, it should be judged inadequate for the risk and capital required. Moreover, in this instance the bank's dividend and capital redemption programs would be curtailed until the adjusted minimum is achieved. For example, a 10 percent minimum tangible capital ratio would be adequate for a 1-rated bank, while a bank whose risk profile is 2 rated might require a higher ratio, say 11 percent, and similarly a 3 rating might require say 13 percent. A bank rated more poorly would be under a specific supervisory action.

Such an approach would most affect the largest banks where full-scope examinations have been de-emphasized in favor of targeted reviews, financial statement monitoring, model validations, and, more recently, the use of stress tests. These activities can be useful, but they are limited in scope and have been adopted because the largest firms are judged simply too large and complex for full scope examinations. However, full exams are doable. Statisticians, for example, have long been designing sampling methodologies for auditing and examining large bank asset portfolios and other operations, providing reliable estimates of their condition, and at an affordable cost.

And finally, commissioned examiners as a rule are highly skilled professionals, able to effectively assess bank risk and to do so in a more thorough manner than a static risk-weighted program. Their success, however, is tied not only to their skills but, as always, to the leadership of the supervisory agency. The examination process, effectively conducted and effectively led,

holds the best potential to identify firm-specific risks and adjust capital levels as needed. In the end, an industry with strong individual firms is a strong industry.

Conclusion

The remarks and suggestions outlined here are not new. We have long been aware of the destabilizing effects of broadening the coverage of the financial safety net to an ever-expanding list of activities. There is a long history of the danger of confusing strong capital with complex capital rules, and of confusing strong supervision with monitoring instead of full examinations.

We would be wise to think beyond added rules to fundamental change. We must narrow the safety net and confine it to the payments system, deposit taking, and the related intermediation of deposits to loans. We must simplify and strengthen the capital standards and then subject all banks to the same standard of measurement and performance. And finally, we must reintroduce meaningful examination programs for the largest firms. These steps, taken together, would do much to assure greater stability for our financial system.