

“Finding the Right Balance”

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The views expressed are those of the author and not necessarily those of the FDIC.

Introduction

Over Fourth of July weekend in 1982, I was the officer in charge of lending at the Federal Reserve Bank of Kansas City. Our week had begun with “the phone call” from a panicked banker whose institution was experiencing a serious liquidity problem. The bank’s funding sources, mostly deposits and upstream purchasers of its energy loans, had lost confidence and were running. Then, reminiscent of a scene from the Great Depression, lines had formed outside the bank as depositors demanded their money back, having heard rumors that the institution was in trouble. The Reserve Bank provided some replacement funding through its discount operations with the goal of buying time to determine whether the bank was solvent and, if so, whether it had sufficient collateral to lend against. Ultimately, the bank, Penn Square National Bank, met neither test. It had too little capital and its assets were too distressed to offer any hope of survival. The bank was closed that holiday weekend.

In the end, Penn Square, through its model of originate to distribute, contributed to the largest bank failure in U.S. history at the time with the collapse of Continental Illinois National Bank. However, because Continental was then the fifth-largest U.S. bank and because numerous creditors would have taken significant losses if it had failed, regulators chose to bail it out. Thus began Too Big to Fail as a policy option in the United States.

I tell this story because it illustrates just how little has changed over the past almost 40 years. Events since then have included the S & L crisis, the Mexican Peso crisis, the Asian financial crisis, the Russian financial crisis and failure of Long-Term Capital Management, and, of course, the Great Recession and the Greek sovereign debt crisis. Each crisis has its own personality but what is often ignored is that the fundamental elements almost never change.

The elements include a significant change in monetary policy—a crucial but inherently blunt instrument with far-reaching effects; a significant ramping up of leveraged assets; and management that displays a degree of confidence that repeatedly proves unjustified. On the other side, they too often include supervisors who lack the confidence or are so convinced of management’s talents that they fail to challenge questionable executive behavior.

Another common element of most crises is the aftermath, in which new laws and regulations are enacted with the intent to prevent new crises. But memories are short and with an improving economy, these laws and regulations—which early in the recovery are viewed as essential—are eventually recast as burdensome constraints that need to be eased or ended.

And here we are again. After years of slow recovery, the U.S. economy is booming and the call for regulatory relief is loud. This is the case despite changing monetary policy, increasingly volatile markets, increasing economic leverage, and changing risk profiles of some of our largest institutions. Still, standards of living are on the rise. Indeed, U.S. gross domestic product (GDP) is projected to approach a 3 percent growth rate this year. While in flux, both monetary and fiscal policy are accommodative. As you would expect, the banking industry is an important part of this success, generating \$165 billion of income in 2017, a near record high.

Considering this history, I want to take this opportunity, as I step away from my role at the FDIC, to outline an approach for providing meaningful regulatory relief without undermining the goal of assuring sound banking. The recommendations are founded on my confidence in markets and in their ability to deliver consistent economic growth. But there is a trade-off. Success requires that the rules which remain to assure that markets work include proven prudential standards that are enforced rigorously and complied with consistently. These standards include strong capital and wise constraints on a bank's reliance on the government's safety net. With such a foundation in place, a number of costly administrative rules that create burden with little benefit can be removed or minimized.

Prudential Standards and Success

Today, the U.S. banking industry is better capitalized than that of most other major industrial countries.¹ Better capitalized banks lend more, promote economic growth and financial stability, and provide the necessary confidence for the world to invest in them. In fact, throughout the modern era, the United States has fostered and sustained a strong and highly influential banking system that is the envy of the world. From this strength, U.S. banks are again reporting near-record profits.

As bank profits have grown, so too have their appetite for risk and their dislike for regulations that constrain that appetite. They also are frustrated with rules that impose thousands of pages of administrative processes and unproductive costs onto their operations. The challenge is to eliminate those rules that impose a real administrative burden from those that set performance standards that allow properly gauged and priced risks onto the balance sheet. The former rules create needless barriers to bank competition and fall disproportionately on the different segments of the industry, while long-proven prudential standards promote responsible performance and are key to meaningful deregulation.

With that thought, I would ask the following question: If one of the most common elements of recurring crises is excess leverage; if careful study and analysis by leading scholars suggest that a 15 percent equity-to-assets capital ratio significantly reduces the likelihood of failure with only the smallest of increase in lending cost; and if prior periods show that the market demands 10 percent capital or more when government

guarantees are unavailable, then why shouldn't a capital ratio of 10 percent equity to total assets be the minimum standard for every bank wishing to operate in the United States?ⁱⁱ

The answer I get most often is that insisting on stronger capital levels raises the cost of capital and holds back economic growth. This view is repeated despite the many studies showing the opposite: that stronger bank capital contributes to stronger, more sustainable economic growth through a business cycle.ⁱⁱⁱ

We know that when the business cycle shifts and losses materialize, the absence of capital intensifies the downturn as the market suspects there is not sufficient capital to absorb the shock and it worries about bank insolvency suddenly becoming real. For example, going into the last crisis the largest banks had 3 percent tangible equity capital and their losses in 2008 approached 6 percent. In circumstances like that lenders must pull back, liquidity dissipates at an accelerating pace, and fear gathers momentum. The magnitude of the shock spills over into the broader economy where it can severely affect Main Street. Thus, it is not credible to base public policy on the assumption that unrestrained leverage accelerates economic growth without serious consequences for which ownership, not the public, should be accountable.

Therefore, I caution strongly against eroding the post-crisis capital standards that have contributed to the strength of U.S. banks and the long-awaited recovery of the U.S. economy. Weakening these standards will undermine the long-term resilience of not only the banking system, but the broader economy as well.

For example, reducing the capital requirements of the most systemically important banks by excluding central bank reserves from the supplemental leverage ratio (SLR) is a serious policy mistake. Measures on the table to do so would excuse primarily the custody bank business model from holding as much capital per assets as all other banks. What should be remembered is that custody banks are integral to the financial system, highly interconnected to the capital markets, and relied upon as safe havens in times of stress. How unfortunate that during the last crisis these custody banks were seriously undercapitalized and as confidence in them ebbed, the government found itself supporting them under emergency conditions at levels reaching \$60 billion to \$90 billion a day. These trusted custodians must remain pillars of strength and should be retaining capital, not reducing it.

There also is some effort underway to try to relax the SLR's treatment of initial margin. Because banks that act as a clearing agent for their clients also guarantee their clients' exposures to the various clearinghouses without limit, removing initial margin from the exposure calculation of the SLR ultimately shifts the burden of the guarantee onto the public.

Additionally, it concerns me that the U.S. regulatory agencies have joined the recent Basel Committee agreement that, according to some estimates, could remove as much as \$145 billion of capital from the eight largest banking firms. This is counterproductive. As I noted earlier, the U.S. banking system is stronger than that of any other region. Even with tangible equity at only 6.62 percent of total assets plus the fair value of derivatives, the market has come to rely most heavily on U.S. banks over their less well-capitalized foreign peers. Also, U.S. bank stocks are trading at premiums with an average price-to-book ratio of 1.4. In contrast, foreign banks trade at an average ratio well below 1, a reflection of their lower capital and poorly priced risks.

Should the U.S. banking agencies embrace the Basel standard, the reduction in private capital would necessarily be underwritten by the FDIC, the Federal Reserve, and then the taxpayer. As an example, one bank that received more than \$100 billion dollars of capital and liquidity support in the last financial crisis would be free to reduce its capital by 30 percent under the new Basel accord. The United States should not engage in this race to the bottom.

The second prudential standard that serves to mitigate mispriced risk in the financial system is the Volcker Rule. With the introduction and expansion of the government safety net, a side effect is the issue of moral hazard. For example, in the build-up to the last crisis some banks relied on their insured status to engage in speculative proprietary trading and to organize hedge fund activities. When the crisis erupted, many of the assets had to be repurchased and brought onto their balance sheets, becoming, in effect, part of the bailout. That is why the Volcker Rule was then implemented to contain these practices in the future.

Its purpose appropriately is to limit the use of deposit insurance to fund speculative trading and related activities, and that should not be compromised for any group of banks. With that said, the application of the Volcker Rule can be greatly simplified. Commercial banks should be free to enter into swaps and other derivatives to accommodate loan customers or hedge their own risks. And they should be free to buy and sell government securities and manage their day-to-day liquidity needs. To accommodate this need, I suggest such activities be entitled to a presumption of compliance with zero additional reporting requirements, unless compelling evidence to the contrary is identified during the normal supervisory process.

With meaningful reporting relief in effect the burden would be eased, so rather than carve out exceptions, the Volcker Rule should continue to apply to all banks that benefit from deposit insurance. For the largest banks that engage in market making and trading, there should be the additional requirement that their CEOs attest in their confidence that procedures are in place and tested to assure compliance.

Additional Regulatory Relief and G-SIBs

With strong prudential standards in place, reflecting ownership's greater role in absorbing the risk its banks take on, the opportunity for regulatory relief for the largest firms increases. One candidate for such relief is the living will and its administrative process.

The living will process is cumbersome, political, and misleading. Annual preparation is costly to both bank and regulator. Once written, it provides little new information as it is submitted and resubmitted each year. Most of what is learned is available through the examination process and the annual stress test. Eliminating or extending the reporting cycle would reduce bank and regulatory costs with access to information no less available.

Unfortunately, given the size and scope of these banks' activities and their global reach they remain Too Big to Fail regardless of the paper exercise. And, the living will process may be having the unintended result of institutionalizing that effect. For example, with encouragement from regulators, the largest banking firms have adopted single point of entry (SPOE) as a resolution strategy. This assumes that operating companies remain open through a crisis. Should it be necessary, these companies will have creditors, in the form of Total Loss-Absorbing Capacity (TLAC), to recapitalize the banks and, if needed, they will have access to liquidity from the Treasury. However, this approach also has the effect of signaling that creditors of operating units will be able to get out of their position, which effectively is a bailout. The largest banking firms should be subject to bankruptcy, but the evidence suggests that the living will is unlikely to achieve that goal. Additionally, since SPOE trades process for substance and TLAC substitutes debt for equity capital, these administrative approaches promote bailouts.

The point is that the imposition of administrative rules and regulations that substitute for long-tested and more reliable prudential standards is a poor tradeoff. We can do with far fewer rules if we have a clear expectation that private ownership and substantial private capital, not taxpayer funding, will minimize the likelihood of crisis and its effects should it occur.

Regulatory Relief and Regional and Community Banks

To an important degree, community and regional banks are better positioned for regulatory relief than the largest banking firms. For example, regional commercial banks, even the biggest among them, do not engage in the same breadth of risk activities as G-SIBs. There are more than 5,600 banks in the United States, of which 35 are G-SIBs or their affiliates. Unlike the G-SIBs, the remaining banks have far less than 10 percent trading as a percentage of total assets, and most of them have 8 percent or more equity to assets. That's 95 percent of all U.S. commercial banks.

For these banks I have suggested a substantial list of rules that should be reviewed for elimination or simplification. The list includes the Basel capital calculations and compliance, liquidity rules, and Comprehensive Capital Analysis and Review (CCAR). It also includes rules already under legislative review, such as appraisal requirements, examination cycles, and consumer rules regarding the collection of HMDA data. As described earlier, I also have recommended simplification of the Volcker Rule .

Such changes represent real regulatory relief. They would reduce the demand on bank management's time and strengthen the business of banking within their communities. This is the goal I believe we all seek, and these recommendations provide one possible and solid path toward achieving it.

Conclusion

I want to finish by noting that the failure to better understand the nature and disparate effect of regulations on the industry will be to increase the costs of banking and encourage ever-greater consolidation of the industry. Prudential standards strengthen performance, while administrative procedural rules raise new barriers, increase costs, and discriminate against banks that are less able to absorb those costs. As recently as 1984, the 10 largest banking firms held about 17 percent of industry assets. Today, the eight U.S. G-SIBs own only 20 banks but control about 50 percent of bank assets. Moreover, when all of their financial activities—which include commercial and investment banking, trust activities, trading, and safekeeping—are added together, the individual financial footprint of the four largest banks exceeds U.S. GDP of \$18.6 trillion.^{iv} Their combined footprint exceeds world GDP of \$75.8 trillion by nearly 40 percent. This consolidation story also suggests that Too Big to Fail remains more a factor today than even in 2008 with the advent of that crisis, which serves to further guarantee more consolidation.

A stronger banking industry relying on sufficient private capital to manage through the cycles of the economy will be a freer industry, where management can structure its balance sheet based on its strategic business model rather than government requirements that predefine capital, liquidity, and resolution needs. This would go a long way to returning market discipline. Regulation could focus on prudential standards and less on large-scale government-mandated administrative exercises.

I suspect we will always have a Federal Reserve Bank loan officer getting that dreaded phone call, where the banker on the other end is desperate for help in addressing a liquidity crisis. But I would prefer it be less often than in recent years and from an institution that really only needs help with liquidity, not with solvency and a bailout.

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ⁱⁱⁱ Saad Alnahedh and Sanjai Bhagat, “Impact of Bank Equity Capital on Bank Cost of Capital,” University of Colorado Boulder, Leeds School of Business, 2017, <http://leeds-faculty.colorado.edu/bhagat/Bank-Capital-Lending.pdf>.

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^{iv} Financial footprint of the top 50 U.S. bank holding companies by size compared to all other bank holding companies and U.S. GDP,
<https://www.fdic.gov/about/learn/board/hoenig/finfootprint-bubble.pdf>.

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