

“A Market-Based Proposal for Regulatory Relief and Accountability” -- Remarks by FDIC Vice Chairman Thomas M. Hoenig, Presented to the Institute of International Bankers Annual Washington Conference, March 13, 2017

## **Introduction**

Promoting economic strength and sustainable growth is a common objective of nations around the world, and the shape of the financial landscape in which this can best be achieved is rightly subject to fierce debate. As we contemplate the paradigm here in the United States, we have two distinct choices. One is to preserve the system that emerged from the most recent financial crisis. The other is to reshape and reinvigorate the banking system by ending too-big-to-fail, enhancing competition, and rebuilding trust in our financial firms.

As memory of the financial crisis of 2008 fades, we must remain vigilant. We all know that this event was not the only one of its kind. Indeed, the United States has experienced 14 major banking crises dating back to 1837. I have been on the front line for at least three of them in the 40-plus years that I have worked in bank supervision. While the reasons behind each crisis have been different, each has caused serious harm to individuals and the economy. It does not matter what politician or party is in office or whether new technology is put in place to better inform the industry, banks will inevitably come under stress and some will fail—and a truly capitalistic system should allow them to do so. Rather than try to prevent bank failures, our goal should be to prevent the consequences of failures from requiring public bailouts and instead allow private owner equity to absorb the shocks.

The Dodd-Frank Wall Street Reform and Consumer Protection Act was enacted in response to the most recent crisis. While well intended, its many and complicated regulations are burdensome for all banks, but especially smaller banks. The legislation also has served to enshrine too-big-to-fail for the largest, most complex universal banks, providing them with a powerful competitive advantage.

Today I will outline an alternative approach to better address the challenge of too-big-to-fail, regulatory burden, and competitive equity. The proposal would not reduce the ability of a universal bank to conduct any of its current portfolio of activities, whatever they might be. It would, however, partition nontraditional bank activities into separately managed and capitalized affiliates to return the safety net back to its original scope and purpose. The proposal also would require greater owner equity at risk for large, complex, universal banks, as defined in the accompanying term sheet. With these conditions in place, too-big-to-fail would be well on its way to being addressed, and a true opportunity for regulatory relief for these largest banks would be provided. We could pare back the thousands of pages of rules that inhibit bank performance and level the competitive playing field without undermining the stability of our financial system and economy.

## **A Proposal for Accountability and Regulatory Relief**

### *Partition Bank Activities and Preserve the Safety Net*

A major feature of this proposal is more effective use of the bank holding company business model. It would require large, complex, universal banks to separately capitalize and manage their traditional commercial banking activities and their nontraditional activities, such as investment banking.<sup>1</sup> While this model allows for many of the synergies of commercial and investment bank activities, it also serves to return the safety net to its original purpose—that of protecting the payments system and the depositor—and reduce the associated moral hazard.

This approach would also provide a far more competitive environment among investment banking firms as they serve our economy. Over time, as the safety net has been allowed to cover expanded activities conducted within commercial banks, the investment banking operations affiliated with insured banks gained a noticeable competitive advantage over noninsured competitors. Data show that for nonbank financial service providers, such as independent broker-dealers not affiliated with an insured bank, tangible equity measures 8 percent of assets, whereas many nonbanks that are affiliated with an insured bank operate with substantially less capital measuring about 5 percent of assets.

Under this proposal, traditional banking activities generally found in an insured depository institution and nontraditional banking activities, such as investment banking, would each be structured under one or more separately capitalized intermediate holding companies of a financial holding company (FHC). And each intermediate holding company that houses nontraditional banking activities would become a separate affiliate, separately capitalized and separately managed from the insured bank. In addition, each intermediate holding company would be structured in a manner that would make it a “resolvable” entity that could withstand the normal bankruptcy process.

### *Capitalization*

A nontraditional intermediate holding company would be capitalized using tracking shares issued by the ultimate parent. This is a relatively common practice used by commercial firms to separate a key franchise in one operating division from new or riskier activities in another. Tracking shares are generally a separate class of stock of the holding company that give economic rights to a discrete set of assets—in this case the shares of the intermediate holding company. This would allow management to unlock value in each line of business while insulating the insured depository institution from potential losses.

### *Resolvability*

The nontraditional intermediate holding company would also be subject to independent liquidity requirements designed to eliminate or limit access to the public safety net and to ensure that, if it

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<sup>1</sup> This is similar in concept to John Vickers’s proposal adopted in the UK.

were to be fully separated from the financial holding company, it could continue to operate and function on its own in the market and be resolvable through normal bankruptcy. To protect the insured bank, transactions with affiliates would be subject to stricter 23A and 23B requirements where, for example, quantitative limits would be tied to the capital stock and surplus of the member banks as well as the capital stock and surplus of the intermediate holding companies.

The ultimate parent company and its affiliates should be constrained in the amount of debt funding they provide to the nontraditional intermediate holding company. I would suggest a limit of 20 percent of aggregate liabilities, with external market sources providing 80 percent of the remaining debt funding.

### *Governance*

As with any prudentially regulated entity, the ultimate responsibility for safety and soundness rests with the board of directors and senior management. To ensure that this responsibility is not compromised and that accountability does not become fractured, internal oversight would need to be reformed so there is the appropriate separation of management across the affiliated entities and that an adequate control structure is established and maintained. Each intermediate holding company would have its own board of directors. And each financial holding company would be required to have an independent general internal auditor responsible for the audit function of the company in its entirety and who reports directly to the board of directors. In addition, management would no longer be allowed to serve on the boards of directors.

### *Tangible Equity and Leverage Ratio*

No proposal to strengthen the system and provide for relief from the burdens of regulation can occur without first bringing capital to levels that the market would otherwise demand if there were no safety net.<sup>2</sup> For the largest, most complex banks, as defined in the accompanying term sheet, my proposal would require, over time, a minimum capital level of 10 percent tangible equity to assets (recognizing only payment netting for derivatives). As I have suggested elsewhere, such a level of capital provides a deeper industry buffer against the contagious panic that causes systemic failure when any one large banking firm fails, making bankruptcy more feasible.

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<sup>2</sup> After nine years since the most recent crisis, taxpayers -- not the market -- continue to carry the burden of the ultimate risk of loss, and yet taxpayers receive no dividend for their capital-at-risk. Using a 10 percent tangible equity at risk target and considering banks' current level of tangible equity, I have estimated that the public's investment in the top 10 U.S. bank holding companies and their insured depository institutions is equivalent to more than \$400 billion.

While my proposal would set the level of capital for the insured bank, the level for nontraditional intermediate holding companies and the entities housed underneath it could be further examined and calibrated. For example, the capital requirements for an intermediate holding company housing broker-dealer activities would become sized based on the market's expectations and perception of risk as access to the public safety net would be confined. However, in setting the minimum requirement, it should not be less than what broker-dealers not affiliated with banks currently hold.<sup>3</sup>

As you know better than anyone, there is significant opposition to raising capital especially for the large, complex, universal banks. Primary arguments are that doing so would hamper lending and that current capital requirements are already too burdensome and have been a drag on the economy. These assertions are incorrect. Data show that a higher level of tangible equity in banks does not curtail lending, but promotes it.<sup>4</sup> Capital does not remain idle. Along with debt, capital is a primary source of funding for lending. As tangible equity grows from retained earnings, lending and earnings continue to grow. As capital levels have increased since 2009, albeit too little, loans have increased by \$2.1 trillion, or 4 percent a year on average, and bank earnings have continuously improved.<sup>5</sup> Further, studies document that insured banks with higher levels of tangible equity are more likely to lend through economic cycles, including a downturn, which helps sustain economic growth over the long term.<sup>6</sup>

The consequences of inadequate capital are equally well documented. If you recall, in 2008 the largest banks held tangible equity capital to assets of only 3 percent on average. Even with a taxpayer bailout, they experienced losses equal to 6 percent of their assets. Today tangible equity among the largest firms is approximately 5.75 percent of tangible assets<sup>7</sup>. While this is an improvement, it continues to fall short of covering losses similar to 2008. If the solvency of one of these banks is called into question, the contagion of panic will follow. These firms remain too big to fail.<sup>8</sup>

### *Transition*

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<sup>3</sup> One form could be the enhanced supplemental leverage ratio and another simpler and more direct form would be to recognize only payment netting for derivatives (as contemplated by IFRS). I prefer this approach because it more truly reflects the risks inherent in derivatives activities that cannot be offset or netted away.

<sup>4</sup> Shin, Hyun Song, "Bank Capital and Monetary Policy Transmission," panel remarks at the ECB and Its Watchers XVII conference, Frankfurt, April 7, 2016, <http://www.bis.org/speeches/sp160407.pdf>.

<sup>5</sup> Federal Reserve Y-9C data

<sup>6</sup> Pogach, Jonathan, "[Literature Review on the Macroeconomic Impacts of Capital Requirements](https://www.fdic.gov/about/learn/board/hoenig/2016-05-12-lr.pdf)," FDIC, <https://www.fdic.gov/about/learn/board/hoenig/2016-05-12-lr.pdf>.

<sup>7</sup> Semi-Annual Update of the Global Capital Index: <https://fdic.gov/news/news/speeches/spsep2016.html>

Implementation of the approach I am proposing contemplates a three-year period to restructure and separate the nontraditional banking activities and a multi-year period to meet enhanced capital requirements.<sup>9</sup> These periods could be subject to change after further examination, with the primary goal of ensuring that services to the economy are not disrupted and credit intermediation is continuous.

### **Sustaining Investment Banking for the Long Term**

This proposal recognizes that investment banking is an essential element of the economic success of the United States, and its intent is to buttress this success. Through the booming 20th century and during the era of Glass-Steagall, investment banks underwrote companies that helped to build the modern economy and became part of the national fabric. Such companies provided jobs and security to millions of Americans and were a genuine source of national pride. Today that tradition continues with much needed capital and funding integral to startups like Facebook, Netflix, and Uber, companies that many couldn't imagine living without and that are truly indicative of American entrepreneurship in the 21st century. The proposal outlined here acknowledges the vast changes the financial industry is experiencing. These recommendations will foster the business of investment banking and promote entrepreneurship, but also will provide a more level competitive playing field among and between commercial and investment banks, and they will do so without harmfully expanding the federal safety net and the moral hazard it sometimes invites.

### **Regulatory Relief for FHCs Engaged in Nontraditional Banking Activities**

If the banking industry were to structure itself as I have outlined, and with sufficient tangible equity at risk, then the opportunity for a significant reduction of regulatory requirements would become possible; much more than the 2-for-1 called for by the new Administration. All banks—including the largest, most complex, universal banks—could be relieved of the costs and burdens of risk-based capital and liquidity requirements. Dodd-Frank Act Stress Testing (DFAST), the Comprehensive Capital Analysis and Review (CCAR), Title II and Living Wills, and other requirements mandated under section 165 of the Dodd-Frank Act could be simplified or eliminated.

Moreover, banks would get relief from the Volcker Rule. It would not be eliminated, but the burdens of it would be dramatically reduced. Speculative proprietary trading would still be prohibited, but through the use of trader mandates rather than through the complexities of the current rule. An insured bank would be prohibited from owning or sponsoring a private equity or hedge fund, but the separately managed and capitalized affiliates would be able to do so with

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<sup>9</sup> The scope of application does not apply to banking organizations in which the primary business purpose is to provide custodial services. However, I also suggest that closer examination be undertaken to tailor the proposal to custody banks to fit their business model accordingly.

proper controls in place and assurances that the safety net was appropriately confined and risk adequately capitalized.

### **Regulatory Relief for Traditional Banks**

This proposal for nontraditional banks could be adopted separately or in tandem with the regulatory relief proposal for traditional banks that I announced in April 2015.<sup>10</sup> The community and regional banks that qualify under that framework would continue to do so.

### **Conclusion**

Regulatory relief for the banking industry is a goal worth pursuing. This is especially the case for regional and community banks saddled with burdensome and complex rules disproportionate to their simpler traditional business model. Regulatory relief for the largest firms is also needed, although their circumstances are more complex. They engage in a much broader set of activities than traditional banks. They rely on extreme leverage to fund themselves when compared with most other banks and nonfinancial companies. Over time they have come to control a disproportionate share of the nation's banking and financial assets and as a result have become too-big-to-fail. Dodd-Frank legislation, with its many and more complicated regulations, was enacted to address this problem, but it imposes a heavy cost burden on the industry and its results have been mixed at best.

We need regulatory reforms, but they must be grounded in capitalism that permits failure and improves economic efficiency and growth while maintaining the safety and soundness of the economic and financial system overall. We can best achieve these goals if the largest banks were to partition their commercial and investment banking activities and also hold tangible equity capital at a level where bank owners—not the taxpayer—cover the cost of inevitable failures.

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

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<sup>10</sup> Regulatory relief recommendations for traditional banks, April 2015 - <https://www.fdic.gov/about/learn/board/hoenig/relief.html>