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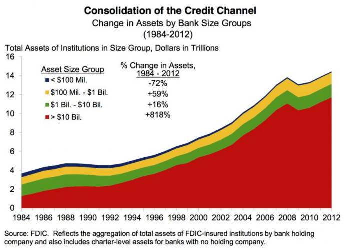
Beware of Oligopolies in Banking

By Kerry Pechter *Thu, Mar 13, 2014*

"I suspect that 2014 will prove to be a critical juncture for determining the future of the banking industry and the role of regulators within that industry," said the vice chairman of the FDIC in this speech, delivered on February 24 to a business group in Arlington, Va.



The United States is in its sixth year following the financial and economic crisis of 2008, and we are just about to start our fourth year since the enactment of the Dodd-Frank Act. Enormous energy has been expended in an attempt to implement a host of required reforms. The Volcker Rule has been implemented, and more recently a rule requiring foreign bank operations to establish U.S. holding companies has been adopted.

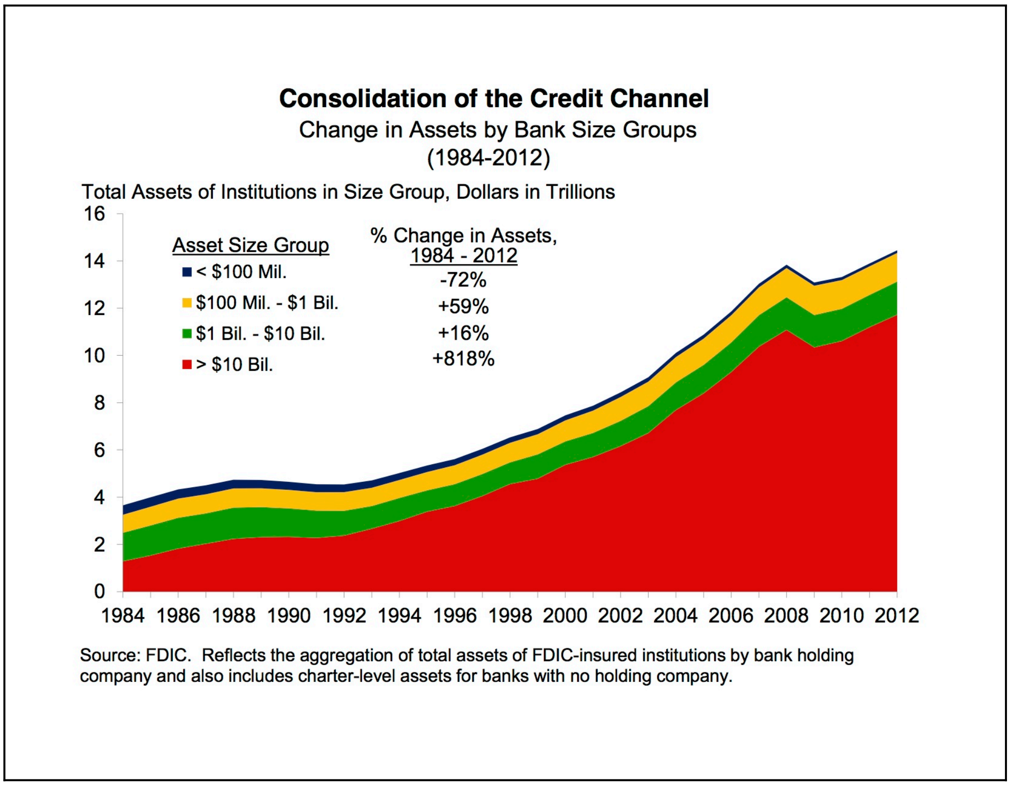
While these are important milestones, much remains undone and I suspect that 2014 will prove to be a critical juncture for determining the future of the banking industry and the role of regulators within that industry. The inertia around the status quo is a powerful force, and with the passage of time and fading memories, change becomes ever more difficult. There are any number of unresolved matters that require attention:

- This past July the regulatory authorities proposed a sensible supplemental capital requirement that is yet to be adopted. This single step would do much to strengthen the resiliency of the largest banks, since even today they hold proportionately as little as half the capital of the regional banks. The Global Capital Index points out that tangible capital to asset levels of the largest firms average only four percent.
- The largest banking firms carry an enormous volume of derivatives. The law directs that such activities be conducted away from the safety net, and we are still in the process of completing what is referred to as the push-out rules.
- Bankruptcy laws have not been amended to address the use of long-term assets to secure highly volatile short-term wholesale funding. This contributes to a sizable moral hazard risk among banks and shadow banks, as these instruments give the impression of being a source of liquidity when, in fact, they are highly unstable. The response so far has required that we develop ever-more complicated bank liquidity rules, which are costly to implement and enforce, and leave other firms free to rely on such volatile funding.
- Fannie Mae and Freddie Mac continue to operate under government conservatorship, and as such they dominant home mortgage financing in the United States.
- Finally, among the more notable and difficult pieces of the unfinished business is the assignment to assure that the largest, most complicated banks can be resolved through bankruptcy in an orderly fashion and without public aid. Congress gave the Federal Reserve and the FDIC, and the relevant banking companies, a tough assignment under the Title 1 provisions of the Dodd-Frank Act to solve this problem. It requires making difficult decisions now, or the die will be cast and the largest banking firms will be assured an advantage that few competitors will successfully overcome[1].

The persistence of 'Too Big To Fail'

I want to spend a few more minutes on this last topic, as it remains a critical step to a more sound financial system.

The chart titled Consolidation of the Credit Channel shows the trend in concentration of financial assets since 1984. The graph shows the distribution of assets for four groups of banks, ranging in size from less than $100 million to more than $10 billion. The chart shows that in 1984, the control of assets among the different bank groups was almost proportional.



Also, within each group if a single bank failed, even the largest, it might shock the economy, but most likely would not bring it down. Today this distribution of assets is dramatically different. Banks controlling assets of more than $10 billion have come to compose an overwhelming proportion of the economy, and those with more than a trillion dollars in assets have come to dominate this group. If even one of the largest five banks were to fail, it would devastate markets and the economy.

Title I of the Dodd-Frank Act is intended to address this issue by requiring these largest firms to map out a bankruptcy strategy. This is referred to as the Living Will. If bankruptcy fails to work, Title II of Dodd-Frank would have the government nationalize and ultimately liquidate a failing systemic firm.

While these mechanisms outline a path for resolution, success will be determined by how manageable large and complex firms are under bankruptcy and whether under any circumstance they can be resolved without major disruption to the economy. This is a daunting task, and increasing numbers of experts question whether it can be done given current industry structure. Two impediments are most often highlighted to organizing an orderly bankruptcy or liquidation for these firms.

First, it is not possible for the private sector to provide the necessary liquidity through "debtor in possession" financing due to the size and complexity of the institutions and due to the speed at which crises occur. There simply would be too little confidence in bank assets and the lender's ability to be repaid, and too little time to unwind these firms in an orderly fashion in a bankruptcy. Under the current system, it would have to be the government that provides the needed liquidity, it is argued, even in bankruptcy to avoid a broader financial meltdown.

Second, when a mega banking firm goes into bankruptcy, capital markets and cross-border flows of money and capital most likely would seize up, intensifying the crisis, as happened following the failure of Lehman Brothers, for example. International cooperation is critical in such circumstances, and it would be ideal if creditors, bankers and governments acted calmly and rationally in a crisis. It would be ideal also if all contracts were honored and if collateral and capital were free to move across borders. But, experience suggests otherwise. Panic is about panic, and people and nations generally protect themselves and their wealth ahead of others. Moreover, there are no international bankruptcy laws to govern such matters and prevent the grabbing of assets, sometimes known as ring-fencing.

This raises the important question of whether firms must simplify themselves if we hope to place them into bankruptcy. This is no small question, and it must be addressed.

A further sense of the importance of these unresolved issues can be gained by working through the annual report of any one of these largest firms. These reports show that individual firms control assets close to the equivalent of nearly a quarter of U.S. GDP, and the five largest U.S. financial firms together have assets representing just over half of GDP.

The reported composition of firm assets represents a further challenge in judging their resolvability, as it is opaque and the relationship among affiliate firms is sometimes unclear. A host of assets and risks are disclosed only in footnotes, although they often involve trillions of dollars of derivatives that are not shown on the balance sheet. Inter-company liabilities are in the hundreds of billions of dollars and if any one link fails, it can initiate a chain reaction of losses, failure and panic. And should crisis emerge, liquidity is sought through the insured bank, not through the provisions of bankruptcy. One failure means systemic consequences.

These conditions mean "too big to fail" remains a threat to economic stability. They necessarily put the economic system at risk should even one mega bank fail. And they allow these mega banks to operate beyond the constraints of economies of scale and scope, and provide the firms an enormous competitive advantage — all of which is antithetical to capitalism.

Structural change, subsidarization and capital

These observations are not new to the financial system, and they have sparked a broadening debate on what action might be taken to better assure that bankruptcy is the first option for resolution. Potential actions include some of the following:

First, simplify the corporate structure of the mega banks that now dominate the financial system. There is mounting evidence of the benefits that would flow from such an action. Market analysts and economists[3] have pointed to increased value and greater economic stability that would flow from such restructuring. Commercial banking is different than broker-dealer activities, and studies show that requiring banks and broker-dealers to operate independently would serve potentially to improve the pricing and allocation of capital, and to increase value.

Second, as the Federal Reserve recently required for foreign banks operating in the United States, governments should require global banking companies to establish separate operating subsidiaries within each country. This subsidarization would give greater clarity to where capital is lodged globally, and it would serve to assure that banks within each country have capital available at foreign affiliates to absorb losses on a basis comparable to that jurisdiction's domestic banks. Subsidarization also would lead to greater recognition of the risks on firms' balance sheets, causing more capital to be held globally and thus contributing to greater overall financial stability and availability of credit.

Those who object to this concept suggest that such a requirement interferes with capital flows and would actually reduce available credit. However, subsidarization would require that capital be aligned with where assets reside, and it would identify for markets and authorities the capital available to absorb losses should it be needed. It provides far more transparency than the current structure. Such transparency would encourage a more responsible use and allocation of capital and resources. It ends the charade that markets are open and safe, only to see them suddenly shut down and ring fenced, with devastating effect, when the inevitable crisis occurs.

Conclusion

It is fundamental to capitalism that markets be allowed to clear in an open, fair manner and that all participants play by the same rules. A situation whereby oligopolies that evolve into institutions that are too big to fail, and are so significant and complex that should they fail the economy fails, is not market economics. To ignore these circumstances is to invite crisis.

Thomas M. Hoenig, vice chairman of the Federal Deposit Insurance Corporation, delivered this speech to the 30th annual Economic Policy Conference of the National Association for Business Economics, in Arlington, Va., February 24, 2014.