Why We Need Glass-Steagall

July 7—*Among U.S. banking circles, one of the most vocal advocates of restoring Glass-Steagall is former Kansas City Federal Reserve President Thomas Hoenig, who currently serves as a director of the Federal Deposit Insurance Corporation. In the U.S. upsurge for the reenactment of Glass-Steagall, centered on Rep. Marcy Kaptur's H.R. 1489, which began after the JPMorgan Chase scandal erupted, Hoenig began to take a more active role. He wrote an op-ed entitled "No More Welfare for the Big Banks," for the June 11 Wall Street Journal. Then, on June 26, he gave an extensive interview to Bloomberg Radio's "The Hays Advantage," hosted by Kathleen Hays and Vonnie Quinn. We excerpt key sections of our transcript of that interview here.*

Kathleen Hays: Tom Hoenig, who was the President of the Federal Reserve Bank of Kansas City, now at the Federal Deposit Insurance Corp. As I said, you started out, as a bank examiner at the Kansas City Fed years ago. You did your dissertation on bank competition, for crying out loud! What is it that's happened over the years to get us where we are now?

Thomas Hoenig: Well, I think you have to start out with why you have the safety net introduced to begin with. It was after the Great Depression and we wanted to protect the payments system, and have people confident in that system. That's why you use deposit insurance. But the trade-off was, if you're going to give them that kind of protection, you're going to give the commercial banking industry that protection, you want to narrow what they do, because you are now subsidizing that industry. And so, you forced out investment banking and high-risk activities away from the banking, as it was conducted prior to that. And so you had commercial banking and you had investment banking completely separate.

Then, over time, because of the stability, they thought, "Well, we don't need to do that, any more." So you brought the high-risk activities back underneath the safety net, by allowing the largest institutions to engage in broker-dealer activities, investment banking activities, and that raised the risk and the markets assumed that they would, in fact, be protected, as they were, and that actually increased the leverage of the industry, weakened the industry, and eventually did lead to excess and the crisis of 2007-2008.

Hays: So basically, it's your view that breaking down the Glass-Steagall wall back in 1998…

Hoenig: 1999.

Hays: 1999. …was a mistake.

Hoenig: Mm-hmm, I do. I thought it was at the time, and I think it is today. And I think events have verified most of what I've been concerned about, in the sense that when you bring high-risk activities underneath a safety net, a subsidy of the safety net, you will, in fact, encourage high-risk-taking speculation; you will encourage leverage at ever greater amounts, because your cost of borrowing's cheaper, and you eventually lead to excess and problems.

Thomas Hoenig, former president of the Kansas City, Mo. Federal Reserve, has repeatedly called for a return to Glass-Steagall: "I think it will be good for business," he said.

Banks: A Force on Capitol Hill

Hays: Did this partly develop, because the banking industry has become a big political force on Capitol Hill?

Hoenig: Well, I think that followed the industry's, over time, becoming larger, more important, more influential, the largest institutions themselves, that followed on. But I think the real issue is, that when you mix commercial banking and high-risk broker-dealer activities, you increase the risk overall, and as a result, you invite new problems. You're going to have problems even in commercial banking itself. But when you now, even deepen that, in terms of the risks that were taken, I think the outcomes are, as proven over and over again, adverse.

Hays: And this is why you're arguing for a Glass-Steagall II?

Hoenig: Yes, I am. Yes, I think it's absolutely necessary to break those back out. And in doing that, you will, I think, reinvigorate the broker-dealer investment banking side of things.

Remember, now, because you put those in the largest, most powerful institutions financially, the barriers to entry are now much greater than they ever were. If you break that out, I think you will reinvigorate the investment banking side, the broker-dealer side of the industry, and I think that will be good for the consumer; I think it will be good for U.S. business, and U.S. capital markets, relative to the rest of the world.

Hays: So, Tom, your recent op-ed, "No More Welfare for Big Banks"—it's basically a call for a Glass-Steagall for today, separating the risky broker-dealer trading activities from basic commercial banking. What exactly are you proposing?

Hoenig: Well, there's a couple parts to it: One is, it would require that you take the broker-dealer activities out of the commercial banking industry, and make [them] separate, again. And in doing that, I think you invigorate the industry, you make it more subject to market discipline. I think you will create a more innovative environment. That's number 1, so, separating them out.

But there is the idea many people bring up from time to time, of shadow banks. So there's two other elements: One is, money markets, which help fund some of the highly speculative activities, and have the appearance of deposits, have to be reformed. Instead of having a fixed amount, like "breaking the buck," as you often referred to, it has a net asset value that changes as the assets of the money market change of wealth. So, if you have a loss, your value declines, like investing in the stock market, that's what it is. And that would bring greater discipline to that market, and no longer have it appear to be a deposit, and put in a position of ending up having to be bailed out, should be we have a crisis.

And number 2, is you have to get rid of—or, not rid of—you have to, then, bring forward a change in the bankruptcy law that would discipline the repo market, which now, you can grab your collateral and run if there's a crisis, and not be put into bankruptcy, and that has to change, as well.

Shadow Banking

Hays: And you're saying that encourages excess risk, especially in the shadow banking system; that's part of your way of making the entire system not too risky?

Hoenig: Right. Because in the shadow banking, you use very short-term deposit-like instruments, called money markets, or repos, to fund your asset purchases that can be longer term. So you are acting like a bank, and the public views you as a bank, and therefore, thinks they're putting their money in a commercial bank, when, in fact, it's a risky proposition to invest in money markets, or other non-bank activities…

Hays: So, won't attempts to scale down U.S. banks be thwarted if large European banks, universal banks, maintain their universal bank structure? Just go over there?

Hoenig: Well, you know, I say this with great care, but I think that's a little bit of a child's argument: "If everyone else is doing it, why can't I?" If you look at Europe today, I'm not sure that's what I want to aspire to. They have their major problems. . . .

Hays: . . .Why are banks allowed to have such huge trading operations, with the incumbent risks, using federally insured deposits? Should this activity put in a separately capitalized, *uninsured* unit, at a minimum, should it be ring-fenced, like the U.K. plans to do, with separate capital requirements, not allowed to use depositors' funds?

Hoenig: . . .I understand the idea. Ring-fence it, take it away, but always in a crisis, the affiliate gets bailed out with the bank, because the bank's so important to the industry, you always bail it out. You *have* to force it into a separate corporation, entirely. This is not something that commercial banking, with access to the safety net, and an implied guarantee to the holding company, should be allowed to do: that's my point.

Ring-fencing is a nice idea. We used to call it, having it in a separate subsidiary of a bank holding company. It does not work, it hasn't worked in history, it won't work in the future. You really need to separate them out completely.