FEDERAL RESERVE BANK of KANSAS CITY

May 10, 2010

The Honorable Senator Maria Cantwell
511 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Senator John McCain
241 Russell Senate Office Building
Washington, DC 20510

Dear Senators Cantwell and McCain:

After the collapse of a large segment of the American banking system and its contribution to the Great Depression, Congress passed several laws designed to assure that the United States would not experience such turmoil again. The Federal Reserve Act was enhanced and the Federal Deposit Insurance Act was adopted to place an expanded safety net around commercial banks, recognizing their importance to financial and economic stability. Congress also passed the Glass-Steagall Act with the specific intention to limit or prohibit commercial banks' exposure to activities judged to hold risks incompatible with this safety net.

The Gramm-Leach-Bliley Act of 1999 removed several key provisions of Glass-Steagall, ratifying a growing consensus that it was no longer necessary to impose such a separation of commercial and investment banking. To me, it seems hardly a coincidence that less than a decade after its repeal, our nation suffered the most significant financial and economic turmoil since the Glass-Steagall Act was put in place in 1933.

We have come full circle. With the most recent financial crisis, we are reminded that commercial banks are the primary intermediary of the payments system and the trusted guardians of depositors' funds, and that this role is critical to the nation's financial and economic stability. It therefore necessarily follows that commercial banks should not be "high- rollers," especially when risk taking is subsidized and enabled by the public purse. They should not be investment banks. Thus, I support current efforts to restore the principles underlying the separation of commercial from investment banking firms.

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In making this statement, I acknowledge those who argue that the entirety of the crisis cannot be attributed to the repeal of Glass-Steagall and the passage of Gramm-Leach-Bliley. As financial markets have developed, some investment banking activities have become natural extensions of commercial banking and have helped banks provide a broader and more competitive package of services to their customers and diversify their revenues. These services include securities brokerage activities and standard underwriting activities for revenue bonds, corporate debt and equity, and high-quality asset-backed securities. I also would agree that some long-standing activities allowed for commercial banks actually contributed to the crisis. Subprime mortgaged-backed securities were at the heart of the crisis and, for the most part, were instruments that banks could buy and sell under their traditional powers to hold investment grade securities. The fact is that like all crises, this one can be attributed to a failure of management to understand the risks they were taking on and to ignoring the signs of increased risks within the financial industry.

That said, the crisis most certainly reflects the harsh reality that the activities and cultures of the more protected commercial bank and the more highly risk-oriented investment bank have become closely intertwined. Investment banking activities change the incentive structure and the culture in banking organizations to encourage more of a trading-based, risk-taking environment – much like we have seen in recent years. Moreover, the leverage supporting these activities magnify the risks to both, which is incompatible with the protections and subsidies that come from having access to the safety net.

Consequently, I have long supported the position for reinstating Glass-Steagall-type laws to separate the higher risk, often more leveraged, activities of investment banks from activities tied to the nation's payments system and related role of trusted intermediary of the commercial banking system. Experience tells us that so long as investment and commercial banks mix high-risk activities with those that are afforded government protections, then inevitably, elevated risk, financial vulnerability, and unstable markets will be the result. Most tragically then, we find it necessary, inevitably, to bail out undeserving firms.

The Volcker Rule represents a good starting point for the discussion. It offers the opportunity for a systematic review to define those institutions that by their franchise should have access to the safety net from those that should not. We cannot continue down a path in which the incentive for a financial firm is to become so large or so complicated that when a fatal mistake is made, we are all too frightened to allow its failure.

Financial reform is essential to address these issues. Unfortunately, the debate has been far more political than analytical. The ideas that surrounded Glass-Steagall, FDICIA, the Monetary Control Act, and interstate banking were subjected to critical analytical scrutiny, and lawmakers had some idea, albeit imperfect, of what needed to be done. A substantive debate is necessary if we are to determine and agree upon what approaches will be effective, while preserving a profitable, competitive, and innovative financial system that supports rather than jeopardizes the U.S. economy. To proceed without considering the ramifications and unintended consequences of leaving investment banking comingled with commercial banking is a prescription for failure.

Sincerely,

Thomas M. Hoenig
President