



FEDERAL RESERVE BANK *of* KANSAS CITY

February 19, 2010

The Honorable Michael F. Bennet
United States Senator, Colorado
702 Hart Senate Office Building
Washington, DC 20510

The Honorable Michael O. Johanns
United States Senator, Nebraska
404 Russell Senate Office Building
Washington, DC 20510

Dear Senators Bennet and Johanns:

I write to express my views on financial regulatory reform to you as members of the Senate Banking Committee from within the Tenth Federal Reserve District. As you know, I share the public's frustration with the handling of the largest financial institutions during the crisis. For that reason, I have been a strong public advocate of financial regulatory reform to improve outcomes in the next crisis. A decade of deregulation weakened the standards and financial restraints that had long been part of the oversight framework. During this time, key leaders in the Administration, Congress, and the regulatory agencies – including the Federal Reserve – advocated less regulation. Now is the time to carefully and appropriately correct those mistakes.

True financial reform will improve the regulatory framework. No agency or set of agencies can be effective without a set of clear, understandable, and enforceable rules in place. For financial institutions, this means a return to firm rules encompassing capital and leverage standards, liquidity requirements, and loan-to-value limits and similar underwriting standards to manage lending exposures. Ending too-big-to-fail must be non-negotiable in financial reform so that the rules apply to institutions of all sizes and market discipline is strengthened. Steps must also be taken to prevent organizations that are part of our payments system from taking on excessively risky activities and thus increasing the threat to financial stability. The Volcker Rule that is now being debated provides a good starting point for this discussion.

Requiring equitable treatment among financial institutions – largest to smallest – does not constitute punishing the big banks. The argument that reining in the largest banks is anti-business is nonsense. Firm rules, resolution authority, and reduced risk are merely methods of making sure that all financial institutions are held accountable for performance. This financial crisis has shown the levels to which risk-taking and leveraging can go when our largest institutions are protected from failure by public authorities. A stable and robust financial industry will be more, not less, competitive in the global economy. Finally, equitable treatment of financial institutions will end the enormous, taxpayer-funded competitive advantage that the largest banks enjoy over the regional and community banks all over the country.



The Senate's financial regulatory reform proposal is not yet available, but I am concerned about its content based on recent news media accounts and statements made by key senators. All accounts report a greatly reduced role for the central bank in banking supervision. It is reported that the Board of Governors in Washington will become a member of a systemic risk oversight council and that this role might be a substitute for the Federal Reserve's current role in the regulation of state-chartered banks and bank holding companies. I have further concerns about the chairmanship of this council by the Treasury secretary when recent secretaries have had very close ties with the largest Wall Street firms that pose the greatest systemic risk. Other reports have the Federal Reserve keeping supervisory authority over only the largest banks. My view, based on 37 years of experience at the Federal Reserve both in banking supervision and in monetary policy, is that these "fixes" are focused on the wrong issues. These actions would also have the unintended consequence of continuing to favor the largest institutions and undermining the thousands of non-Wall Street banks that reliably serve small businesses and Americans every day.

The consolidation of regulators will not improve outcomes. Though I wish that effective supervision were as simple as shuffling responsibilities around, pinning our hopes on a systemic risk council and a consolidated super-agency would be a mistake. Further, a systemic risk council will include the Federal Reserve chairman with likely collaboration from the New York Fed, based on its proximity to most of the largest financial institutions. However, the other 11 regional Reserve Banks, designed by the Federal Reserve's congressional founders to check the concentration of power on Wall Street and in Washington, would certainly play a reduced role – and most likely no role at all – in the well-being of the financial system across the country. The supervision of state-chartered member banks provides the Federal Reserve with its depth of experience regarding details about banking operations and management, and its oversight of bank holding companies provides a breadth of knowledge and insight regarding industry trends and activities. It is a striking irony to me that the outcome of the public anger directed toward Washington and Wall Street may lead to the further empowerment of both Washington and Wall Street in regulating financial institutions.

It is important to remember that the number of regulators did not cause the financial crisis. Each of the federal banking regulators has a legitimate role in supervision; they do not exist as some accident of history waiting to be corrected. At the Federal Reserve, supervision and the financial insight it provides are critical to the System's monetary policy function and to other responsibilities, such as lender of last resort and the payments system. For the Federal Deposit Insurance Corporation, supervision helps provide knowledge and support for its deposit insurance mandate. Through its supervision of national banks, the Office of the Comptroller of the Currency provides a federal chartering option to bankers and helps to give the Treasury Department and federal government a better understanding of financial markets. This system of banking supervision balances the needs of the world's largest, most dynamic economy with protecting the public interest. A consolidated agency would negate many benefits the current system offers.



I believe that neither a systemic risk council nor a consolidated regulatory super-agency will improve financial regulation. The financial crisis has enveloped many countries, including a large number with some form of super-agency. The United Kingdom, for example, has placed all its financial supervision into a single agency outside of the central bank, but the outcome was as bad – or worse – than that of the United States. Moreover, the United Kingdom suffered notably during the crisis from poor communication among this super-agency, the Bank of England, and the Finance Ministry. Today, the United Kingdom is discussing moving banking supervision back into its central bank based on its experience in the recent crisis.

The Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency can supervise the commercial banking industry well when Congress confirms that better regulation with clear standards is in fact the goal. We understand that the problem extends beyond commercial banks. The Senate's efforts to address broader issues related to derivatives and resolution authority will help strengthen the entire financial system in meaningful ways, not just the commercial banking system. A systemic risk council may be a good addition to other specific reforms but should not be considered an adequate role for the Federal Reserve absent the supervision of state-chartered member banks and bank holding companies.

For your reference, I have enclosed two documents that provide important details and rationale for the central bank's hands-on role in banking supervision. As always, I am available at any time to discuss these and any issues of concern to you about the Federal Reserve and the regional Reserve Banks' role in serving our nation's interests.

Sincerely,

A handwritten signature in black ink, which appears to read 'Thomas M. Hoenig', is written over a horizontal line.

Thomas M. Hoenig
President

Enclosures

c: Tenth District Senators
Tenth District Directors
Tenth District State Banking Associations
Tenth District State Banking Commissioners

The Federal Reserve's Critical Role Supervising Bank Holding Companies and State-Chartered Member Banks

The Federal Reserve's supervision of bank holding companies and state-chartered member banks plays an important role in the Federal Reserve's ability to effectively fulfill its central banking responsibilities.

Financial disruptions can occur outside of the largest institutions

Lost in the attention in this crisis to the large and "systemically important" institutions is the fact that serious economic and financial disruptions can occur – and have occurred – in other parts of the financial system. These disruptions can have a substantial impact on the national economy. As a result, the Federal Reserve must have a comprehensive view of the financial system and matching supervisory responsibilities if it is to achieve all of its central banking objectives.

This lesson was learned in the 1980s as individual institutions and segments of the market which would not characteristically be viewed as systemic threats served as a source of significant problems and market disruptions. A prime example of this was Penn Square National Bank, a relatively small bank located in an Oklahoma City shopping center. Before its failure in 1982, Penn Square sold more than \$2.1 billion in energy loan participations to 88 banks, including eight of the top 50 banks in the country.

Most notably, more than \$1.1 billion of Penn Square's loans were sold to Continental Illinois. Substantial losses on these loans resulted in a major hit to Continental Illinois' capital, as well as to its reputation, and were a significant factor in its eventual resolution as a bank deemed "too big to fail." Another heavy buyer of Penn Square loans was Seattle First National Bank, which, shortly thereafter, lost access to market funding and was then taken over under a special Washington State failing-bank law. While Penn Square National Bank was supervised by the OCC, the Federal Reserve had oversight of its holding company, which proved very helpful when it had to make the decision not to extend the discount window funding that would have kept the bank open.

Supervisory insights matter in assessing commercial real estate today

A current example of the Federal Reserve's supervisory insights playing a critical role is in commercial real estate (CRE). CRE is having an important influence on how the economic recovery proceeds both nationally and within the Kansas City Federal Reserve District. It is imperative that the Federal Reserve understands whether banks will be in a position to play a strong supporting role. In this type of lending, we are talking not about the largest banks, but primarily community and regional banking organizations.

Currently, banks with less than \$20 billion in total assets have more than a 53 percent share of bank CRE lending. The decline in CRE markets is resulting in a significant deterioration in the condition of many of these banks.

For example, since year-end 2005, noncurrent CRE loans as a portion of all CRE loans have jumped from .54 percent to 5.84 percent for banks in this group. Declining credit conditions in construction and land development lending – an important piece of CRE lending – have been even more severe, with noncurrent ratios in this lending reaching 13.25 percent at community and regional banks. Without an active role in the supervision of state member banks, the Federal Reserve would not have detailed insights into CRE markets and the knowledge needed to understand possible threats and disruptions to both the economic recovery and banking.

Supervision knowledge was important in the crisis of the 1980s

The Federal Reserve had similar experiences during the collapse of the energy, real estate, and agricultural economies in our District in the 1980s. Again, the best and most accurate sources of information about these events came from bank examiners and state member banks. These sectoral collapses were regional in nature, and Reserve Banks in the affected regions were able to make vital contributions to FOMC discussions and System discount window and supervisory operations because of their unique perspective.

Reserve Banks and their examination staffs also played a role in helping to address other regional problems, such as the Ohio thrift crisis and a similar crisis among industrial banks. In particular, several Reserve Banks, including Kansas City, sent examiners to help review the solvency of Ohio thrifts and reopen the viable institutions.

The 1980s also demonstrated the importance of the central bank's supervisory role in other ways. At the regional level, Reserve Banks were forced to make numerous quick and critical decisions at the discount window. These decisions involved judging which institutions faced liquidity problems and which faced solvency problems; the quality of collateral that institutions in distressed markets were offering; and whether there were broader liquidity problems that needed to be addressed in each District.

It was of enormous benefit during this period to have discount window staff with previous supervisory experience and a resulting knowledge of how banks operate and are funded. Also, Reserve Banks had skilled examiners who helped with decisions on acceptable collateral and the condition of prospective borrowers. In fact, examiners were used in a number of cases to review loans and securities offered as collateral and then to safeguard the collateral. Without a trained and experienced examination staff, we would not have been able to make fully informed decisions on our discount window lending. The same conclusions can be drawn from our discount window lending following 9/11 and during the current crisis.

Central Bank is the Government's Bank: Knowledge and Credibility are Critical

These are not the only examples of how a role in banking supervision is important in carrying out the central bank's responsibilities. Reserve Bank presidents and personnel benefit greatly from having contact with local bankers and other bank supervisors. These contacts provide a wealth of information on regional and community banks and on financial and economic conditions. It would be nearly impossible to have access to such information without a Federal Reserve role in supervision. Furthermore, such contacts are essential in handling financial crises, because trust and ongoing relationships with other supervisors and banks are a necessary part of forming appropriate supervisory and central banking responses.

It is important for the Federal Reserve to have a good understanding of banks of all sizes and types because it is called upon to write and implement a wide variety of regulations for all institutions. Without a comprehensive view of the banking system, neither the Federal Reserve nor any one agency could perform this function in a manner that is equitable and appropriate for all banks. In this regard, it must be acknowledged that a limited supervisory role would open the Federal Reserve to accusations of favoring one part of the financial system over another. This type of criticism would weaken the central bank's overall credibility.

A limited supervisory role was certainly not in the minds of the congressional founders of the Federal Reserve nearly a century ago.

Banking, democracy and the critical balancing of power

Both the financial crisis and the way it was handled by policymakers have generated substantial anger and frustration with our nation's financial system. Many, including me, believe there are important questions about how a nation that believes so strongly in capitalism can intervene to protect some who assumed excessive risk simply because of their size and "interconnectedness," while smaller firms are allowed to fail.

These are issues about how our markets are structured and function as well as several of the values Americans hold deeply, including fairness and honesty. In a nation where many of us are disgusted to see steroids taint the sports record books, the idea that the most powerful financial firms play by a different set of rules to similarly bolster their performance is an outrage. In many regards, it might seem that finding a way to avert the rules has become the true national pastime.

Despite the frustration many feel, I believe it is important to recognize that the arrogance and mistaken ideals of a few—albeit a very powerful and influential few—do not represent the broad population. And so, as we look at the financial crisis, it is important to point out that most bankers—in fact, almost all—play by the rules, are proud to serve their communities, and are perhaps the most dismayed about the crisis and how it was handled. Bankers, especially those at the community banks, are not the bad guys.

This is a reality that has seemingly been lost in the current national discussion about our financial system. Similarly lost have been the reasons why Congress, when it created the Federal Reserve nearly a century ago, made a point of involving both bankers and the government in the oversight of our nation's central bank in such a manner that each balances the other. This balance is the Federal Reserve's real strength, and it is unfortunate that discussions about our financial system and the Fed's structure are happening in an era where opinions

are largely shaped by sound bites—which are by design incomplete. Conducting much of this review at only a superficial level is not only tragic, but also dangerous for our national economic well-being over the long term. Politics is a short-term game, while decisions about monetary policy and how we regulate our financial institutions have substantial and far-reaching implications.

The most fundamental element to protecting our nation's democratic values is balancing power. The Federal Reserve, as an institution, is accountable to the Congress, which created it; the administration, which appoints its chairman and governors; and the public, which it serves.

With this column, I would like to answer some of the most frequently asked questions about our nation's central bank and address some of the more widely held misconceptions on a full range of topics. In discussing these points, I think it will also illustrate not only how power and responsibility are distributed throughout the Federal Reserve, but also why it is so important to our nation.

Bankers do not control the Reserve Banks

The Fed's Congressional founders recognized the dangers of giving the government direct and sole control over the printing of currency. Because the public, including bankers, did not trust the politicians with the printing press, one-third of the seats on each board responsible for the oversight of the 12 Federal Reserve Banks are held by bankers. Bankers within each Federal Reserve District were given the opportunity to elect several local directors. However, two-thirds of the directors on



a Reserve Bank's board are not permitted to be bankers.

While the public did not trust politicians, the politicians also recognized the risk in giving control to bankers. At the time of the Fed's founding, the nation had already made two attempts at a central bank, and neither one was successful because they were privately held institutions. To block private interests from controlling the central bank, a government agency known today as the Board of Governors was created and given broad oversight for the entire System. The governors are appointed by the president of the United States and confirmed by the U.S. Senate. Among their numerous responsibilities: The governors appoint one-third of the directors of each regional Federal Reserve Bank, including both the chair and deputy chair of each board.

With this structure, the Federal Reserve has the most grassroots, representative structure of any federal entity, because the Washington-based Board of Governors, a federal agency, has the benefit of 12 regional Reserve Banks that are located on "Main Streets" all over the United States.

Director elections and appointments are a model of public/private accountability in government

Congress included provisions in the Federal Reserve Act governing director eligibility and selection, in addition to requirements that dictate the makeup of regional Reserve Bank boards. Reserve Bank directors meet legal requirements and practices that guide their eligibility and conduct. They are held accountable by law. They come from diverse backgrounds within every region of the country and every sector of the economy: business, industry, consumer, labor, agriculture and banking. The Federal Reserve Board recently strengthened its rules to address Reserve Bank director eligibility in light of changes in the status of affiliated financial firms as occurred during the

financial crisis, such as when investment banks quickly became bank holding companies.

Each Reserve Bank has nine directors:

- Three directors of each Reserve Bank board are appointed by the Board of Governors, the government agency. These directors are prohibited from any involvement in banking, including stock ownership, and are the only directors eligible to be chair and deputy chair.

- Three directors, who may not be bankers, are elected by bankers from within their respective Federal Reserve district. These directors have no reporting responsibilities to any banks.

- Three directors who are local bankers within the region are elected by their peers. Regulations mandate that smaller banks must hold two of these seats. Often in the Tenth Federal Reserve District, all three banking positions are held by individuals affiliated with community banks.

Federal Reserve Bank stock is owned by state-chartered member banks and all federally chartered banks. These bankers do participate in elections and may serve as directors. The percentage of stock they are required to own, and the dividend paid on that stock, is prescribed by law, thereby eliminating any incentive or reward to benefit from Reserve Bank operations.

Directors receive only travel reimbursement for meetings and a modest stipend. There is no meaningful monetary incentive to serve as a director.

A recent example of a director conflict that may be the source of public concern involved Stephen Friedman, former chairman of the Federal Reserve Bank of New York who was also the former chairman, and a large shareholder, of Goldman Sachs.

There are a few points about Mr. Friedman that may not be widely known, but are a matter of public record:

- Mr. Friedman was not elected by bankers to serve on the Federal Reserve Bank of New York's board. He was, in fact, appointed to his position at the New York Fed by the Board of Governors in Washington.

- Mr. Friedman later became ineligible for Federal Reserve service when Goldman Sachs was made a bank holding company as approved by the Board of Governors in Washington.

- Mr. Friedman, however, was allowed to continue to serve on the New York Fed board under a waiver of the rules that was granted by the Board of Governors in Washington. He resigned from the position in the spring of 2009.

Directors have no role in banking supervision.

As the central bank, the Fed plays a role in banking supervision. The bankers on Reserve Bank boards provide valuable insight on banking conditions and the general economy but are prevented by strict controls from any involvement in the Bank's supervisory role. There is no conflict.

Though Reserve Bank directors have important oversight responsibilities for the operation of their respective Bank, they have absolutely no role in banking supervision. By law, the Board of Governors, a government agency, is responsible for the supervision of banks, and any information or discussion related to supervisory issues moves directly between the regional Reserve Banks' staff and the Board in Washington. The Federal Reserve supervises all bank holding companies, so it is a misnomer that directors can put their own firm under Fed supervision for favorable treatment. If a bank director wants to convert his or her bank to Fed membership, the Board of Governors in Washington must act on the proposal and other agencies comment. When a Reserve Bank director who is a banker comes under a supervisory action, he or she typically resigns from the Reserve Bank's board.

Reserve Bank directors have no role in the Federal Open Market Committee's (FOMC) monetary policy vote

The Federal Reserve has important protections in place to keep the banking community from becoming intertwined with monetary policy votes.

All Reserve Bank directors play an important role in the monetary policy process by providing economic and financial industry data that helps a Reserve Bank president understand current conditions. However, directors play no role in dictating how that president votes on the federal funds rate.

Reserve Bank directors, including bankers, do vote on the discount rate, which is the rate at which the Federal Reserve lends funds to financial institutions, but the rate must be ratified by the Board of Governors before it takes effect. Therefore, there is full control over the rate charged by the Federal Reserve Banks to the banking industry. In my view, there is extreme risk of some group or sector attempting to assert influence if this structure is put under greater political control.

Reserve Bank presidents have a vote on the FOMC and appropriate political checks and balances are associated with their position

Political appointees have the majority vote on the FOMC. However, in designing the Fed's structure, Congress nearly a century ago recognized that it was important for views from a wide range of the public to contribute to important decisions. One of the most common complaints about any government agency or initiative, without regard to topic or political party, is that it is created entirely "inside the Beltway" and not connected to the concerns of the rest of the nation. The Fed's structure addresses this issue very directly.

When the modern FOMC was formed some 20 years after the Fed's creation, this design was also reflected in its structure, with the Federal Reserve governors given a majority (7-5) of the FOMC's voting seats. To suggest that only government appointees should be allowed to vote is, frankly, extremely dangerous from a policy perspective for many reasons. However, the suggestion that government appointees are somehow free of other conflicts and considerations compared with the Reserve Bank presidents is

false. One need only look to the U.S. Treasury and the various connections held by Goldman Sachs to see that, ultimately, any government appointee is a private citizen with a background and perhaps some concern about the opportunities in their future. The real question is: Are adequate protections in place to mute any influences these individual “private citizen” concerns might have?

It could be argued that the Bank presidents are far more insulated from financial interests than any elected or appointed official who can step directly into their post from the private sector. An examination of the current 12 regional Federal Reserve Bank presidents shows that six have come to their position after lengthy careers at the Fed, having moved up through the ranks. This means that their activities and personal investments have been heavily restricted for much—and in some cases all—of their professional lives. Three Bank presidents have come to their positions at the Fed after extensive careers in academia. The remaining three presidents have backgrounds in banking and finance, but have also either held other posts within the Federal Reserve, or have spent time in public service or academia.

- Reserve Bank presidents, though chosen by their boards of directors, may be vetoed by the Board of Governors. That is, they may be prevented from serving if they are unsuitable, regardless of their selection by Reserve Bank directors.

- Reserve Bank presidents undergo an annual review. This review involves both the Board of Governors and the local board of directors.

- Reserve Bank presidents must be reappointed to their jobs every five years by their Banks’ boards of directors.

The Fed is transparent and accountable to Congress and the public through a variety of independent audits

The Federal Reserve does undergo a wide range of audits and reviews involving the Board

of Governors, the Government Accountability Office, the Treasury, an independent outside auditor and an internal auditor. Finally, the Fed is directly accountable to Congress, and Federal Reserve officials testify before Congress regularly.

The author of the so-called “audit the Fed” amendment has played down these numerous reviews in seeking support for his initiative. Congressman Ron Paul’s goal is not a review of the central bank but, as is evidenced by the title of his most recent book, to “end the Fed.” For those who see that as a desirable outcome, it is important to note that our nation was without a central bank for eight decades. Even a quick review of U.S. economic history shows this was a period of recurring financial crises as the nation wrestled with, among other problems, the pitfalls created by an inelastic currency whereby liquidity issues, rather than being addressed, could quickly bring about near economic collapse. Additionally, without elasticity, credit could be unavailable to smaller banks that serve the broad population and tightly controlled by the largest institutions.

The Federal Reserve’s structure was specifically crafted by Congress to limit the influence of financial and political interests on the nation’s central bank. It is the direct result of the nation’s populist movement and the desire to carefully balance competing interests. It is a structure that Congress has repeatedly supported. If anything, the events of the past year have convinced me that this delicate balance is at least as important—if not more—as it was when the Fed was created nearly a century ago.



THOMAS M. HOENIG, PRESIDENT
FEDERAL RESERVE BANK OF KANSAS CITY

The book “[The Balance of Power](#),” summarizes the Federal Reserve’s political history. Read it online at KansasCityFed.org.