

LEVERAGE AND DEBT: THE IMPACT OF TODAY'S CHOICES ON TOMORROW

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The views expressed by the author do not necessarily reflect those of the Federal Reserve System, its governors, officers or representatives. This text was prepared from a transcript of Mr. Hoenig's remarks.

I want to thank the Kansas Bankers Association for inviting me here today and for giving me the opportunity to speak on what I consider to be increasingly important challenges confronting our economy in the coming months and years. The challenges are focused around the common theme of debt and leverage as it impacts the banking industry, government, business and consumers. How we address these challenges will also affect how the Federal Reserve conducts monetary policy as we emerge from this recession and beyond.

I'll start by focusing on the banking industry and the challenge of too-big-to-fail. The matter of a resolution process for failed large banks must be addressed before the financial system can be fully healed and functional. Then I will speak on the broader issue of debt, federal government, business and consumer, and the challenges it presents for policy. These topics are important because, as citizens, we have some very difficult choices before us that will impact us and future generations.

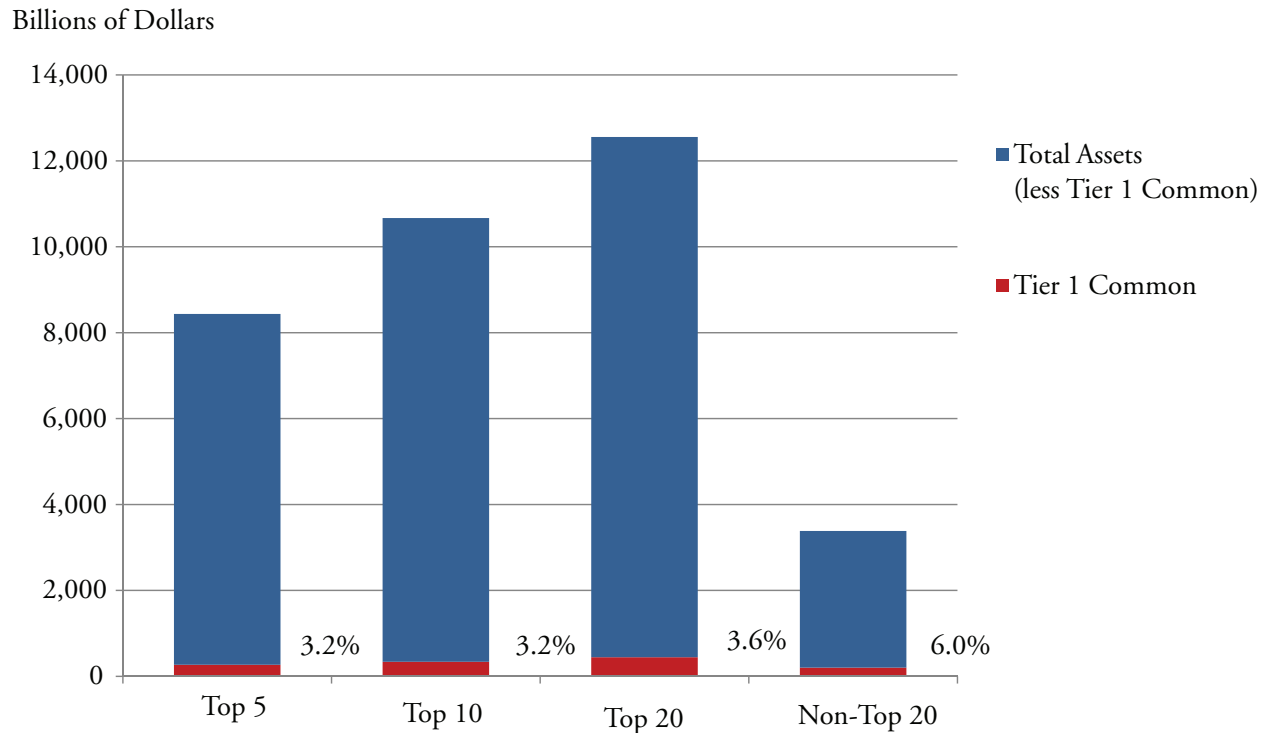
Throughout my presentation, I will share a number of charts that illustrate the magnitude of debt and leverage in the economy.

### **The advantages of too-big-to-fail**

Chart 1 is a picture of leverage in the banking system and illustrates the enormous advantage of being too big to fail. For example, at the end of the first quarter of this year, the 20 largest financial institutions in the United States controlled more than \$12 trillion in assets, supported by more than 3.5 percent equity capital. This chart illustrates how little equity supports that massive amount of assets and risk. The next group of financial institutions, the non-top 20 financial institutions (\$500 million to \$100 billion in assets) has an equity capital ratio of 6 percent—notably higher than that of the largest banks.

Chart 1

### Tier 1 Common as % of Total Assets



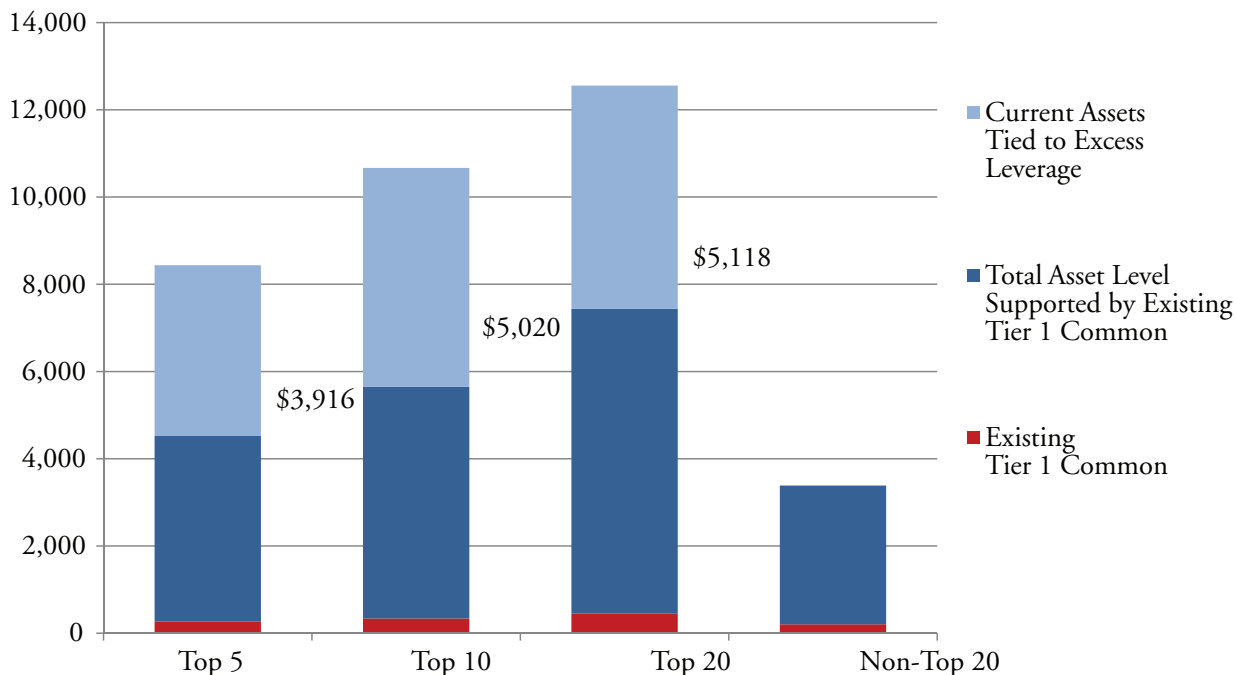
Source: Bank Holding Company Reports of Consolidated Condition [March 2009]  
Notes: Graph includes only BHCs that filed the Y9-C which excludes approximately \$2 trillion in assets.  
Tier 1 Common = Tier 1 Capital less Preferred Stock, Related Surplus and Minority Interest.  
Non-Top 20 includes bank holding companies with \$500 million to \$100 billion in assets.

Assume for a moment that the 20 largest institutions were required either to raise new equity, or to reduce their total assets to meet the 6 percent equity capital ratio. This would require that they raise more than \$300 billion in new capital or, as Chart 2 shows, they would need to shrink in size by \$5 trillion, or some combination of the two options. The numbers in Chart 2 make clear how much of an advantage the larger institutions have over smaller banks, and show the excess leverage the largest banks have accumulated.

Chart 2

**Total Assets Supported by Existing Tier 1 Common Supported  
Assets assumes 6% Tier 1 Common to Total Assets**

Billions of Dollars



Source: Bank Holding Company Reports of Consolidated Condition [March 2009]

Notes: Tier 1 Common = Tier 1 Capital less Preferred Stock, Related Surplus and Minority Interest.

It is no longer conjecture that the largest institutions in the United States have been determined to be too big to fail. They have been bailed out, and proposed legislation allows for that practice to continue. They have an implied guarantee, which affords them an enormous advantage in terms of their use of leverage and their ability to accumulate assets to unprecedented levels.

The large banks have added capital since the end of the first quarter, but they are far short of achieving a 6 percent ratio of equity capital to assets. Ironically perhaps, some proposals being offered would require large institutions to hold more than this level of capital. I would

suggest such proposals are wishful thinking, and will not be achieved. I would be pleased if these largest institutions were held to the same standards as the non-top 20 firms because the community banking system cannot survive if the largest banks continue with their current advantage, and that obviously has significant adverse effects for the financial system as a whole.

There were two pieces of legislation that facilitated our migration toward too big to fail. Chart 3 illustrates the relative growth in position of the largest institutions against the timeline of Interstate Banking and Branching Efficiency Act of 1994, which permitted banks to grow across state lines, and the Gramm-Leach-Bliley Act, which eliminated the separation of commercial banking and investment banking. Since 1990, the largest 20 institutions grew from controlling about 35 percent of industry assets to controlling 70 percent of assets today. This trend will continue unless we take specific steps to end it.

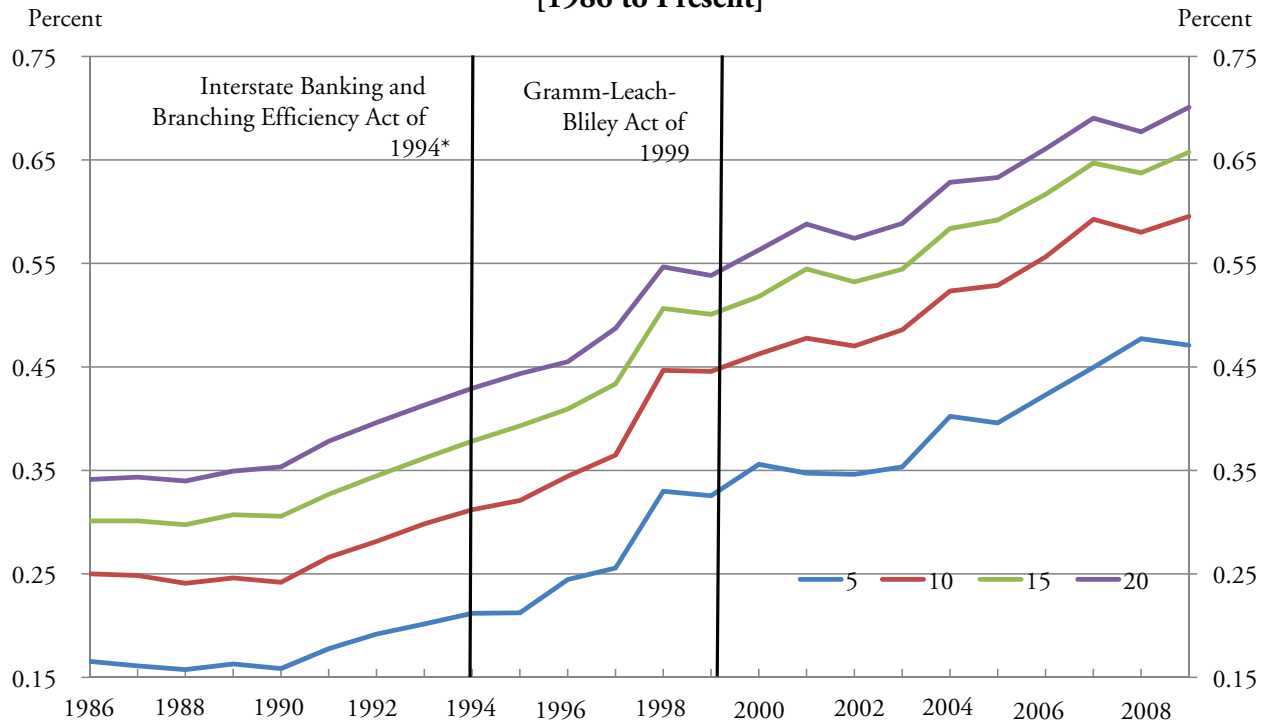
The way we normally address failure in a capitalistic system is to subject any institution, from the largest institution to the smallest, to the same penalties for bad management. To accomplish this, we must pass legislation mandating that institutions that become insolvent, due to liquidity or capital, be taken over in an orderly fashion and placed under a conservatorship or receivership. In such an instance, both the equity holders and long-term debt holders should share the losses before the taxpayer is required to bail out the institution. Taking over the failed institution in an orderly fashion—not a panicked fashion—would protect the franchise and, more importantly, protect the economy from instability.

As I have described elsewhere, a resolution framework can be designed that is fair and much more efficient for the economy. As we have handled the largest institutions through this crisis, they are not market-driven institutions, they are public utilities. This has to change or we

will not retain the dynamic financial system that has made the United States so successful over its history.

Chart 3

**Industry Concentration in Top Bank Holding Companies  
[1986 to Present]**



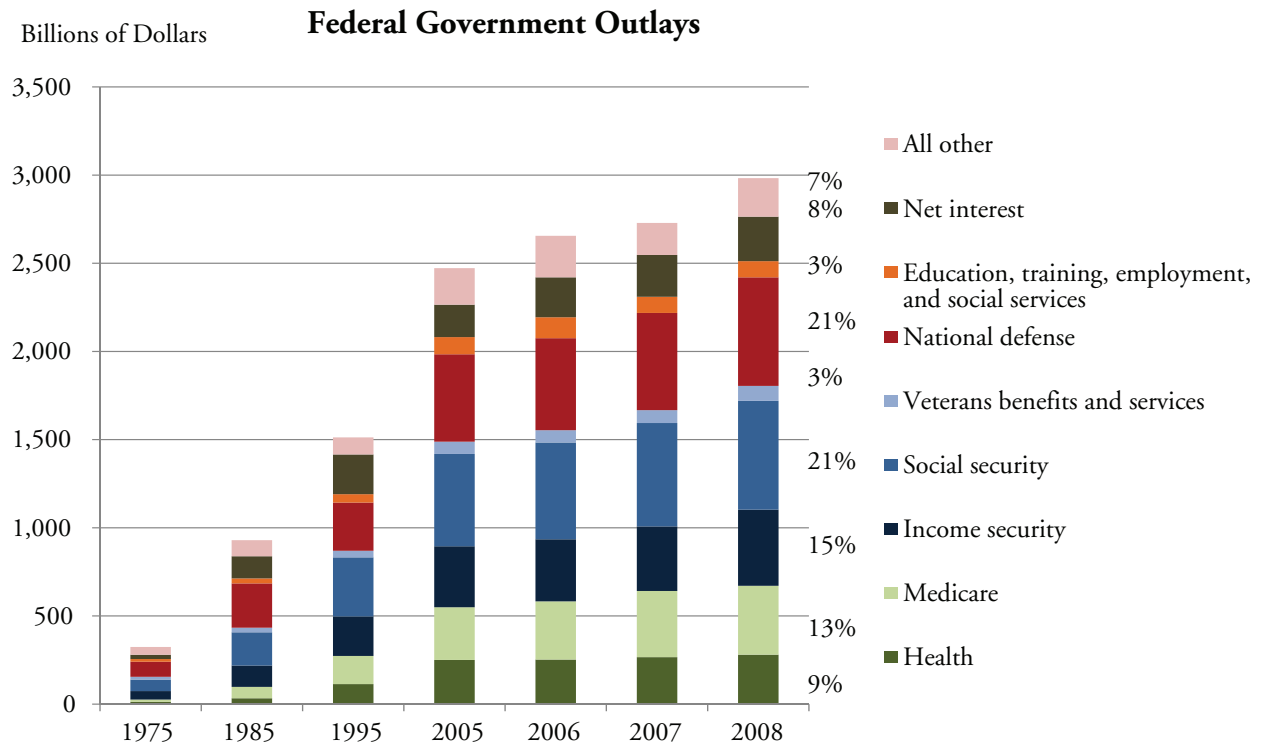
Sources: Bank Holding Company Reports of Consolidated ConditionParent Company Only Financial StatementsConsolidated Reports of Condition and Income  
Notes: \*Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 allowed for interstate acquisitions

**Difficult choices**

While staying with the theme of debt and difficult choices, I am going to turn next to the challenge of the growing debt levels within our economy and the challenges they present for monetary policy makers, starting with federal debt levels.

It is the responsibility of us citizens, through our congressional representatives, to decide how much our government spends and how we allocate those expenditures, which nominally increased to \$3 trillion in 2008 from less than \$500 billion in 1975. Medicare, income security, Social Security and veteran’s benefits make up more than half of government spending. Federal outlays also include national defense, education, interest payments on the debt and other expenditures. These expenditures are substantial, and they may grow further as we set forth on implementing a stimulus package and tackle some very difficult health-care issues. Both these initiatives involve legitimate goals, and it is not my place here to debate the merits or the arguments surrounding them. However, as Chart 4 shows, we need to understand that we, through our government, have already made significant long-term commitments and choices in allocating federal resources.

Chart 4

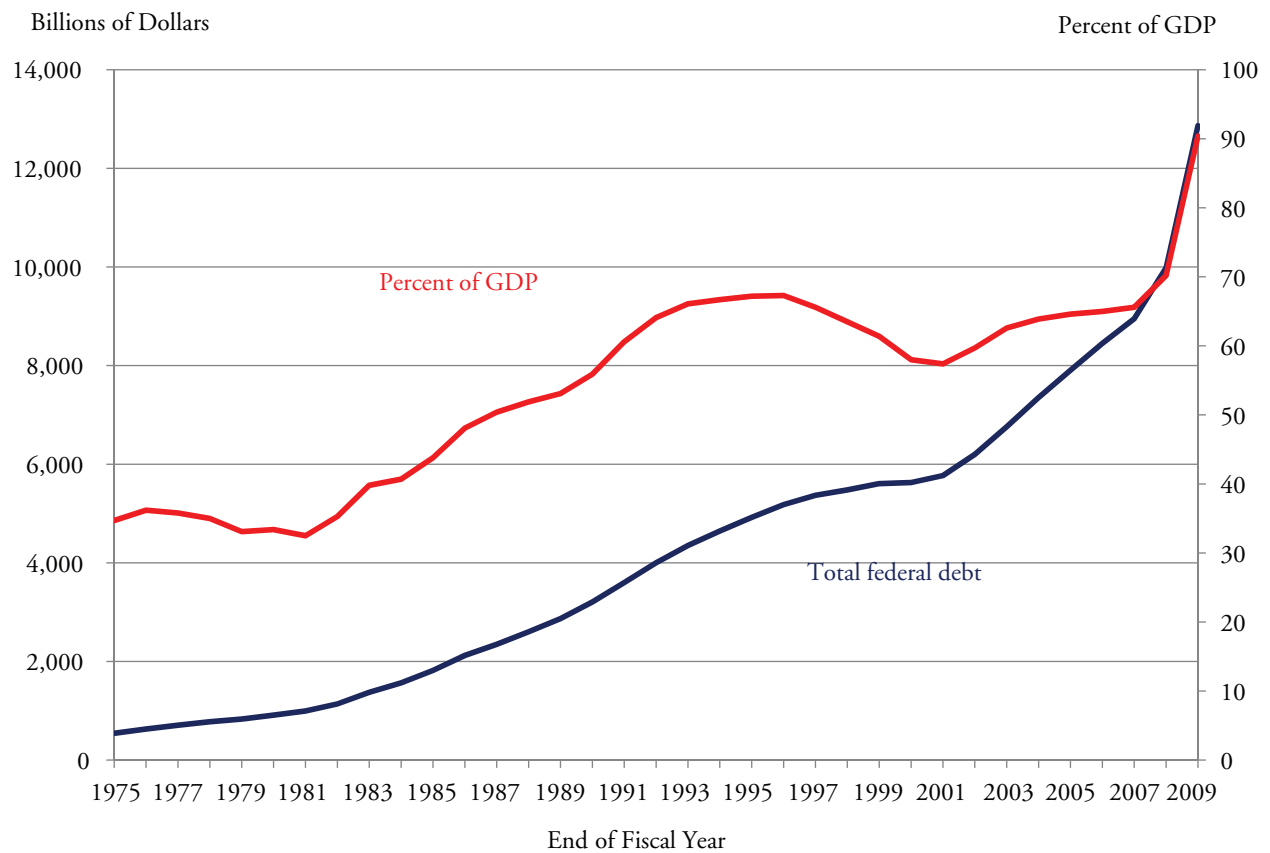


Source: OMB. Data for 1975 is the average for 1974-1976, data for 1985 is the average for 1984-1986, and data for 1995 is the average of 1994-1996. The number on the right is the percent of outlays.

If our government is going to spend a total of \$3 trillion a year, it must obtain the revenues to do so. If we are not willing to tax ourselves, then funds must be borrowed. Chart 5 shows that in nominal terms, the total federal debt has grown from less than \$500 billion in 1975 to approximately \$12 trillion, and over that same period, our debt-to-GDP ratio has increased from 35 percent to 90 percent. We are spending 8 percent of our total federal budget just to make the interest payments on that debt, and that too will only increase.

Chart 5

**Total Federal Debt**



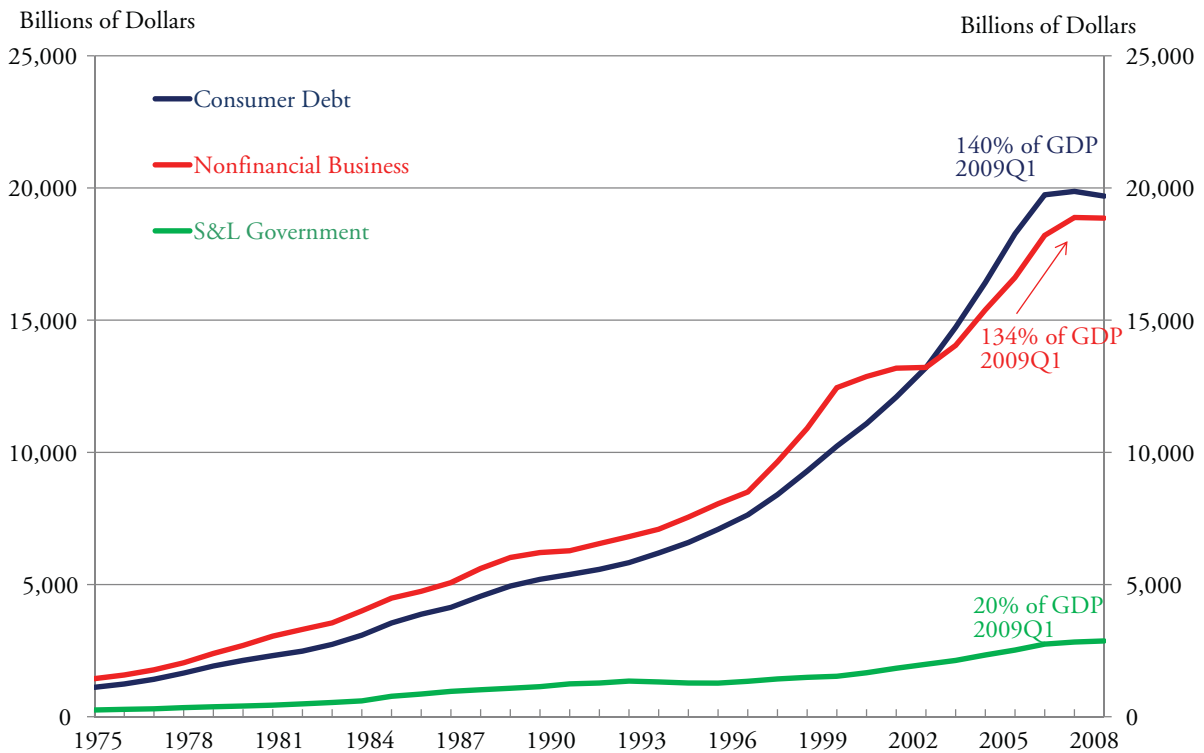
Source: OMB, BEA, calculation.



While our federal debt level is significant, we must consider more than the government's debt as we evaluate the economy. Chart 6 shows that consumer and nonfinancial business debt are each now more than 130 percent of our national income. Consumer leverage has actually worsened as consumer wealth has declined during this recession due to the collapse in housing and the decline in U.S. equity markets.

Chart 6

**Debt**



Note: The source is Flow of Funds. Consumer debt equals the liabilities of the personal sector. Nonfinancial business debt and S&L government debt equals the liabilities of these two sectors.

In an environment where debt is large and growing, low interest rates are preferred by nearly everyone: the government, bankers and bank customers. The desire for low interest rates will put incredible pressure on the Federal Reserve and the central banks of the world to keep rates low. Since Paul Volcker broke the inflationary cycle of the late '70s and early '80s, Chart 7

shows that there has been a sustained downward movement of the federal funds rate—which affects interest rates broadly—and this has encouraged the use of debt to finance a broad range of purchases. Consequently, we are carrying more debt than we have carried in most of our history, and the pressure to keep rates low is only going to increase as the economy begins to recover from this recession.

Chart 7

**Federal Funds Rate**

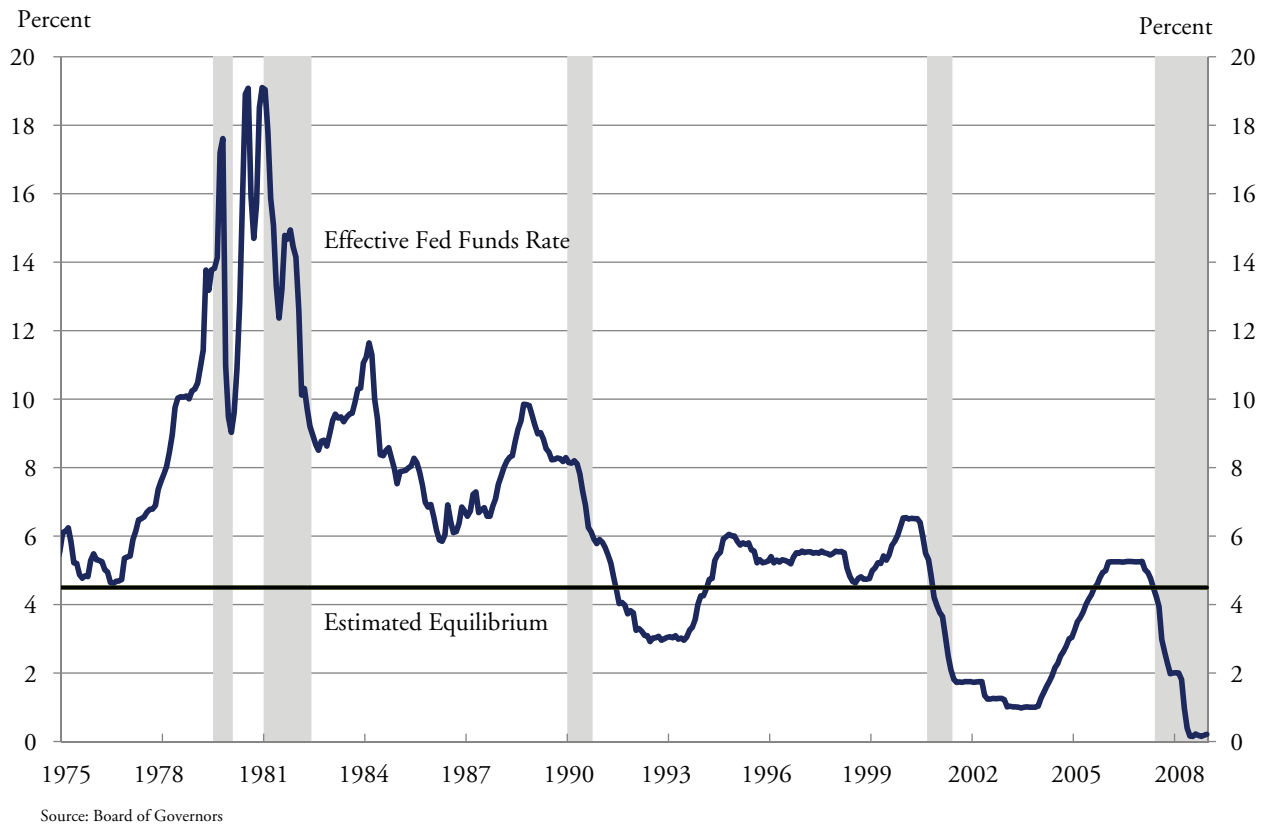
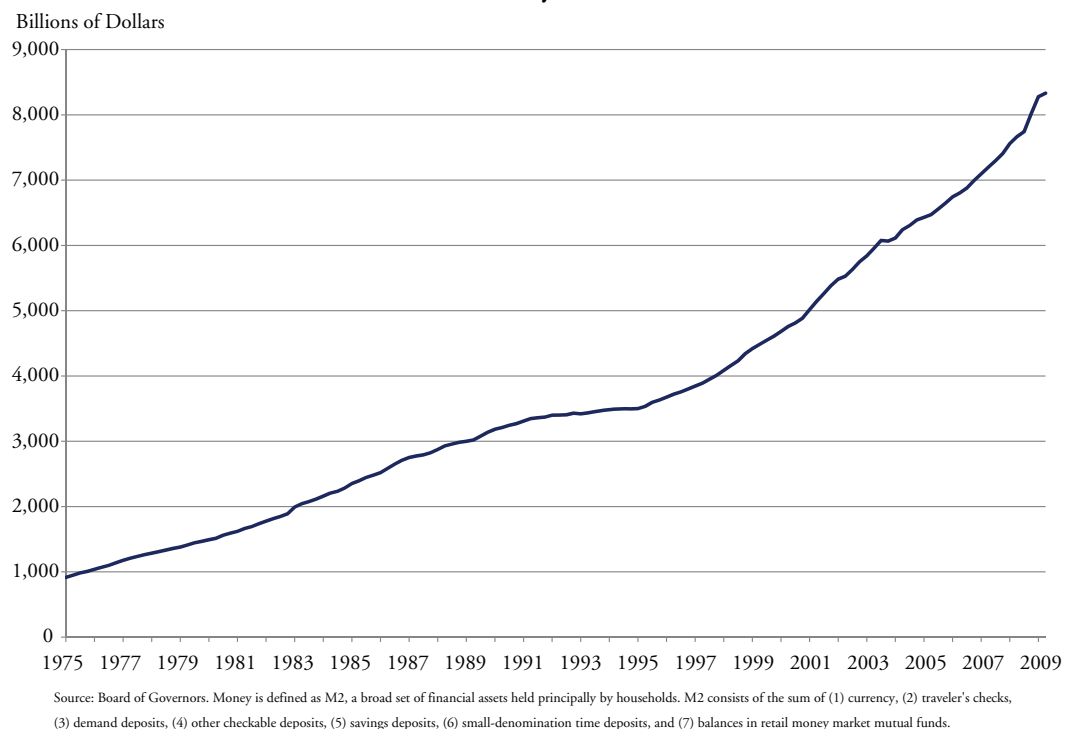


Chart 8 shows that low interest rates have coincided with a growing level of money in the economy, which the Federal Reserve defines as M2. Chart 9 suggests further that this growth in money over these past several decades has had a staggering effect on the consumer price level. Since the founding of the Federal Reserve some 95 years ago, the consumer price level index has

risen to a level of 2200 from a level of 100. That's an astonishing increase in the general price level, and it represents a significant reduction in the purchasing power of the dollar over time. These are matters that demand our attention as we make choices involving both fiscal and monetary policy.

Chart 8

**Money**

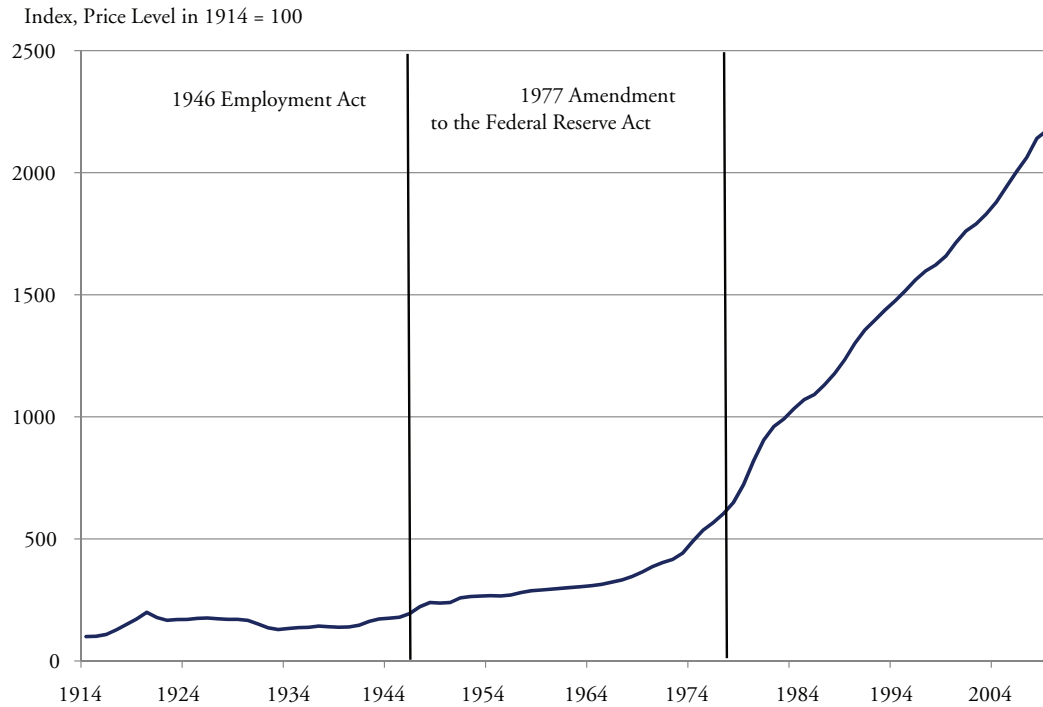


In considering these charts and the matters of policy, we should be aware of two pieces of legislation that I suggest influenced their contours: the 1946 Employment Act and the 1977 Amendment to the Federal Reserve Act. The 1946 Employment Act established as a national priority a goal of low unemployment. Low unemployment is a worthy goal and one that I share, but it cannot be achieved by systematically keeping interest rates low. In 1977, Congress passed the Amendment to the Federal Reserve Act—also called the Humphrey-Hawkins Act—which

called upon the Federal Reserve, as the central bank of the United States, to pursue a dual mandate of promoting long-run stable economic growth and stable prices.

Chart 9

**Consumer Price Index**



Though I am convinced we can achieve both mandates, I also am convinced that both are only possible if the first priority of the central bank is to achieve stable prices. Understandably, however, many prefer that the emphasis be on growth and low unemployment. Although the Federal Reserve is insulated from politics, it is not isolated from politics, as you can observe by the frequent congressional testimony of Ben Bernanke and past chairmen. The Federal Reserve System is accountable to Congress for achieving the dual mandate, and the data suggest it has given important deference to the growth objective.

## **Recession and recovery**

These issues provide context for the monetary policy choices that lie ahead. Based on the data we are receiving today, it would appear that we are at the bottom of the recession. The data are mixed, which is usually a sign that we are at the bottom. However, these mixed data also make it difficult to determine just how firmly or quickly we will emerge from the recession. Given the large amounts of consumer, business and government debt that will influence events going forward, I suspect we're going to recover slowly. The recovery will be assisted by the fiscal stimulus and an accommodative monetary policy, but it most likely will be slowed by the extensive rebalancing of the economy that has yet to occur.

In this environment, one of the Federal Reserve's major challenges will be how to pull back its highly accommodative monetary policy without undermining the recovery and not igniting inflationary expectations. We learned in the Great Depression and with the Japanese experience that we have to pull back gently. At the same time, however, we also learned from the great inflation of the '70s that we have to be resolute in pulling excess stimulus back or risk greater consequences in the future. We are going to be walking the "knife's edge" for some time to come.

In considering this challenge it is important also to realize first that more than half of the current fiscal stimulus package has yet to be spent, so we have yet to see its full effects. In addition, monetary policy remains exceptionally accommodative and will provide significant stimulus into 2010 and beyond.

Focusing more narrowly on monetary policy, the excess reserves in the banking system now exceed \$800 billion; they were less than \$8 billion when this recession started. The balance sheets of the Federal Reserve Banks have increased from \$900 billion to more than \$2 trillion in

less than two years. As we become more confident that we are at the bottom of the recession and are moving into recovery, we must become more resolute in systematically reducing our balance sheet and raising interest rates to levels we might all agree are more in line with the economy's long-run growth path. Moving from zero to one percent, for example, is not a tight policy. I don't know what the neutral rate is, but I am certain it isn't zero.

If the monetary stimulus does not come out, the price level trend shown earlier in Chart 9 will only worsen. As a reminder of what that might imply, you need only study the early '80s when high inflation undermined our economic system. Paul Volcker's efforts to bring inflation down then were not without cost and required that the country suffer through a recession nearly as bad as the one we hope we are exiting now.

## **Conclusion**

If the government, the banks and consumers address the difficult issues of debt and the Federal Reserve begins to remove the significant stimulus in an orderly fashion, then we will come out of this recession without an inflationary hangover. Noninflationary growth will follow, new wealth will be generated, and we will continue to be the strongest, most successful economy in the world. But in the short run, these actions will involve painful choices, and it is the responsibility of citizens like you, and policymakers like me, to consider the impact of today's choices on tomorrow. We must choose well.