

Testimony Before the Joint Economic Committee  
United States Congress

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Madam Chair Maloney, Vice Chair Schumer, ranking members Brady and Brownback, and members of the committee. Thank you for the opportunity to testify at this hearing.

The United States currently faces economic turmoil related directly to a loss of confidence in our largest financial institutions because policymakers accepted the idea that some firms are just “too big to fail.” I do not.

Despite record levels of expenditures, we have not seen the return of confidence and transparency to financial markets, leaving lenders and investors wary of making new commitments. Until confidence is restored, a full economic recovery cannot be achieved.

When the crisis began to unfold last year, and its full depth was not yet clear, substantial liquidity was provided to the financial system. With the crisis continuing and hundreds of thousands of Americans losing their jobs every month, it remains tempting to pour additional funds into large firms in hopes of a turnaround.

However, actions that strive to protect our largest institutions from failure risk prolonging the crisis and increasing its cost. Of particular concern to me is the fact that the financial support provided to firms considered “too big to fail” provides them a competitive advantage over other firms and subsidizes their growth and profit with taxpayer funds.

Yes, these institutions are systemically important, but we all know that in a market system, insolvent firms must be allowed to fail regardless of their size, market position or the complexity of operations. In the rush to find stability, no clear process was used to allocate TARP funds among the largest firms. This created further uncertainty and is impeding recovery.

We have options that could provide a more successful outcome, but there are several hard steps to be taken. Here are two:

First, we must “triage” systemically important financial firms based on their current condition. For those that are well-capitalized, we move on. Those that are viable but need more capital either raise it privately or seek government assistance, with the taxpayer put in the senior position and the government determining the circumstances of the senior managers and directors.

Second, nonviable institutions must be allowed to fail and could be put into a negotiated conservatorship, as was done in 1984 with the holding company Continental Illinois.

Such actions serve to ensure that when public funds are used, and they may well be needed, management and shareholders bear the full cost of their actions before taxpayer funds are committed. It would give the public confidence in the process and mitigate the need for the government to micromanage institutions.

Such a resolution process is equitable across all firms, has worked in the past, and favors taxpayers. Past experience also suggests this approach is much less costly than the alternative of not recognizing losses and allowing forbearance, as Japan initially did with its problem banks during the “lost decade” and as the United States initially did with thrifts in the 1980s.

As we look to the future, we will turn to the matter of regulatory reform. It is critical that we correctly diagnose the cause of this crisis. The structure of our regulatory system is neither the cause nor the solution. These “too big to fail” institutions are not only too big, they are too complex and too politically influential to supervise on a sustained basis without a clear set of rules constraining their actions. When the recession ends, old habits will reemerge. Thus, we should focus on defining the supervisory framework and operational rules that over the decades have provided the best outcomes no matter the complexities and dynamics of the market. For example, history has shown that strong limits on leverage ratios work.

Finally, the structure of the Federal Reserve System also is not the problem, as has been recently suggested. It would be a sad irony if the outcome of a crisis initiated on Wall Street was to result in Wall Street gaining power at the expense of the other parts of the country. The 12 regional Federal Reserve Banks that make up the Federal Reserve System were established by Congress specifically to address the populist outcry against concentrated power on Wall Street. Its structure reflects the system of checks and balances that serves us well at all levels of government, and it is the reason I am here today able to express an alternative view.

I look forward to your questions.