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Top Fed Official Supports Restricting Banks' Derivatives Bets, Goes FURTHER Than Obama

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The top fiscal hawk and longest-serving policy maker in the Federal Reserve supports limiting banks' derivatives activities, a potential blow to Wall Street megabanks that use their taxpayer support to trade the kind of risky financial products that nearly brought down the global financial system.

In a letter of support, Federal Reserve Bank of Kansas City President Thomas M. Hoenig endorsed a Senate provision Thursday that would force banks to strip their swaps desks out from their depository institutions, calling it "of utmost importance to our nation's long-term financial and economic stability."

The affected firms would have to move those units, which deal and trade in a type of financial derivative product, into a separately-capitalized institution within the bank holding company, collectively raising as much as a few hundred billion dollars to protect their swaps desks in case their bets go bad. Or, they could disband the activity altogether.

Of the nearly 8,000 banks in the U.S., less than 25 would be seriously affected.

Authored by Senate Agriculture Committee Chairman Blanche Lincoln, the measure is beloved by economists and financial experts like Nobel Prize-winning economist Joseph Stiglitz who wish to purge the riskiest of risky activities from the U.S. banking system. Since

banks enjoy taxpayer-financed protection via federal deposit insurance and access to cheap funds from the Federal Reserve, they shouldn't use that taxpayer support to subsidize risky bets on derivatives, proponents of the measure say.

The explosion of risky swaps, like those sold by AIG, helped cause the worst financial crisis since the Great Depression, resulting in what's now referred to as the Great Recession. The Wall Street-caused crisis led to the loss of about eight million jobs.

Federal Deposit Insurance Corporation Chairman Sheila Bair, Federal Reserve Chairman Ben Bernanke, former Federal Reserve Chairman Paul Volcker and Treasury Secretary Timothy Geithner all have expressed reservations about the provision.

"As you know, commercial banks are the trusted guardian of depositors' funds and the primary intermediary of the national and global payments system -- a role that is critical to our country's financial and economic stability," wrote Hoenig, a noted defender of community banks and an impassioned critic of the nation's current policy of propping up too-big-to-fail megabanks, in a letter obtained by the Huffington Post.

"I have been a long-time proponent of limiting the derivative activities of commercial banks to only those designed to mitigate the institution's balance sheet risk. Accordingly, I support the reinstatement of Glass-Steagall-type laws to separate higher-risk, often more-leveraged, activities of investment banks from the commercial banking system.

"Section 716 appropriately allows banks to hedge their own portfolios with swaps or to offer them to customers in combination with traditional banking products," Hoenig wrote in a reference to the part of the Senate's financial reform bill that compels banks to split their swaps desks from the depository institution.

"However, it prohibits them from being a swaps broker or dealer, or conducting proprietary trading in derivatives. The risks related to these latter activities are generally inconsistent with the funding subsidy afforded institutions backed by a public safety net. Such activities should be placed in a separate entity that does not have access to government backstops. These entities should be required to place their own funds at risk," Hoenig said.

Hoenig is particularly well known for his hawkish views on monetary policy.

Last month before the Financial Crisis Inquiry Commission, Geithner made a veiled reference to the provision when he argued that policymakers should not "simply separate banks from risk."

"[I]n important ways, driving risk-taking into areas with less regulation -- that's exactly what caused this crisis," Geithner said on May 6. Activities such as helping businesses hedge risk with derivatives should not be moved outside of banks, "outside the reach of strong regulation," Geithner said.

Bernanke and Volcker argued against the proposal in separate May letters; Bair expressed her concerns in an April letter.

They all essentially say moving these units outside of banks would court disaster as banks are the best-regulated entities in the nation's financial system.

However, they don't note that the current financial reform legislation compels the Federal Reserve to further examine the nation's largest bank holding companies, looking at all their subsidiaries, affiliates and associated activities.

According to proponents of the legislation in the Senate and in the Obama administration, the overall bill should have the effect of making these separate entities within bank holding companies as well regulated as banks in order to avoid another catastrophic meltdown and subsequent taxpayer-financed recovery.

The financial industry vigorously opposes the measure. Senate Banking Committee Chairman Christopher Dodd is said to be looking for ways to gut the provision before the bill reaches President Barack Obama's desk.

But Hoenig, a native Iowan, reads the provision differently than his counterparts nestled in Washington and Wall Street.

According to his letter, Lincoln's measure would allow banks to continue to hedge against their own risk (such as offering a fixed-rate 30-year mortgage when one's not sure where interest rates will be over the next 30 years) and offer customers similar products in conjunction with "traditional banking products."

All it bans are the kinds of Wall Street activities that historically have not benefited from explicit (or implicit) taxpayer support.

There's speculation that Lincoln's measure will be taken out of the bill given the strong opposition from Wall Street and the Obama administration.

Having an independent voice like Hoenig on board -- one who's argued for breaking up too-big-to-fail megabanks, raising interest rates to avoid another financial bubble, and reining in federal spending to a more sustainable level -- strengthens Lincoln's hand, said one Senate aide involved in the negotiations. "It's an impressive voice to have in her camp."

READ the letter:

Thomas Hoenig on Blanche Lincoln's derivatives measure