Fed's Hoenig: US Banks Need To Get Back To Core Business

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NEW YORK -(Dow Jones)- The U.S. financial industry needs to get "back to the business of banking," with regulations that promote a more competitive and stabilized landscape, said a regional Federal Reserve president Tuesday.

At a monetary and trade conference in Philadelphia, Kansas City Fed President Thomas Hoenig voiced his support for the Volcker Rule--a clause in the landmark Dodd-Frank financial reform act that prohibits banks from engaging in their own proprietary trading and involvement with hedge funds and private equity funds.

Instead, Hoenig said banks should be limited to their core business of taking deposits and extending loans. Other fee-based services such as underwriting securities, asset management and advisory services should also be allowed, he said.

Riskier activities that should be restricted include trade-related operations, ranging from propriety and customer trading, to brokerage and market-making services, Hoenig said. Trade as a means to make money is inherently risky, especially with a bank's funding source being long-term in nature misaligned with the short-term stakes in trading.

"Trading is an adversarial zero-sum game," Hoenig said in his speech. "The trader's gains are the losses of the counterparty, who is oftentimes the customer."

The U.S. financial system was able to reach this stage of complexity because the public safety net has been cast wider and wider through the years, Hoenig added. The industry went from 14,000 highly competitive commercial banks in the late 1980s, to a highly-concentrated environment where the five largest financial institutions control assets worth nearly 60% of U.S. gross domestic product.

"As risks intensified and new crises emerged, this safety net was continually expanded...to ensure systemically important institutions didn't bring down the economy," Hoenig said. "This process inevitably led to the picking of winners and losers--not through competition and performance, but through bureaucracy."

Hoenig added that the fear of U.S. banks losing competitiveness versus foreign lenders or fleeing to operate abroad would be an "unfortunate" but questionable outcome to the tougher U.S. regulation.

In fact, the regional Fed president supported extending the reform efforts to crack down on the shadow banking system as well. Hoenig suggested marking the net asset share value of money market mutual funds to market. That would give a more accurate reading on value of the short-term funding provided to shadow banks.

Furthermore, to prevent repo runs in the shadow banking system, bankruptcy law should be revised to eliminate the automatic stay exemption for riskier mortgage-related repo collateral.

"The proposal...will not take all risks out of the financial system," Hoenig said, but it will improve its stability "by clarifying where the risks reside...It also will promote a more competitive financial system."

Hoenig, who is a non-voting member of the Federal Open Market Committee, has been vocal in his concerns about inflation and the need to raise interest rates.

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