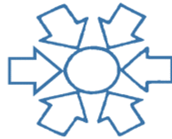
The Inequality Under-Belly of "Sound" Consumer Finance



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KEY POINTS

- Rules that change profit incentives change consumer finance in ways almost always unanticipated by policy-makers and all too often destructive to household income preservation and wealth accumulation.
- Over-simple solutions to predatory or risky practice are likely to exacerbate economic inequality. All short-term loans are not "payday" products and all subprime mortgages are not risky.
- When business incentives and effective regulation still quash equality-enhancing financial products, it's time to change the risks through innovative policy action to realign incentives and equality. Legislation creating a federal guarantee for investments in faster treatments and cures is one example of a policy solution; Equality Banks are another.

It is a pleasure this morning to join so distinguished a panel. You have asked me to answer two high-priority questions: is it possible to offer sound consumer-finance products to higher-risk consumers and what policy changes would increase the odds that this would actually happen? Each of these questions warrants a book – indeed, I'm working on one. Still, I'll keep my remarks brief now to promote discussion among the panel and with so expert an audience.

Analytical Errors

As we have learned over and over again as carefully-crafted rules wreak unintended consequences, rules that may well look good on paper and even seem to solve for pre-crisis failings will backfire if policy incentives do not align with market-dictated demands for bank return on equity. As I've said in other contexts,[1] banks are not philanthropic institutions. Given this, is it a surprise that, as all of the post-crisis rules kicked in and interest rates stayed ultra-low, that many banks transformed retail finance into wealth management even as non-banks supplanted regulated institutions in mortgage finance and other products once considered banking's bedrock. Let me describe just two well-intentioned post-crisis consumer finance rules with wholly unintended equality effects resulting from altered bottom-line incentives.

The first is the Durbin Amendment. Interestingly, a recent Federal Reserve Bank of Kansas City paper pushing for Fed dominance in faster payments argued that the Durbin Amendment shows why the Fed must take a stern hand with banks.[2] It seems to think that the benefits afforded to merchants under the Durbin Amendment accrue to shoppers without offering data to substantiate this. However, another one from the Fed[3] looks at the actual empirical impact of both the Durbin Amendment and related credit-card fee restrictions. As a recent TCH/BPI study showed,[4] these laws cost banks a whole lot of fee income. Reflecting this, the Fed paper observes that consumer gains on the card-fee side were more than offset by losses related to sharp reductions in free checking accounts for low-balance – i.e., lower-wealth – households. Only about half the free accounts one would expect to find at banks are now on offer due to cut-backs directly attributable to the Durbin Amendment. Even when free checking accounts are still available, minimum balances to get them have gone up at least fifty percent.

Incentive alignment is at least as interesting in mortgage finance, especially given all the talk of ensuring that this occurs when Congress enacted Dodd-Frank's risk-retention requirements. In its own context, the securitization construct makes sense. But, put it in context with another Dodd-Frank provision – the qualified-mortgage (QM) rule – and you not only confirm the hard equality lessons of the Durbin Amendment, but also reinforce the critical importance of considering each rule in the broader context of other incentives dictating asset and liability allocation.

After the essential equalizer of receiving a "living return" – i.e., real return leading to meaningful family savings, there is nothing more important for family wealth accumulation and inter-generational mobility that a sustainable – i.e., affordable – mortgage. Post-crisis monetary policy makes living returns impossible on low-balance savings accounts, meaning that wealth accumulation depends on low down payment mortgages. Taking into account also the sharp spike in student borrowing, a sustainable equality-enhancing mortgage is thus almost always one with a high debt-to-income (DTI) ratio.

The QM rule penalizes high-DTI mortgages, but a regulatory exception waives this barrier for loans sold to the GSEs, FHA, or VA. This might seem like a sensible equality exception, but the combination of the high-DTI loophole and non-bank profit-maximizing incentives instead led to a sharp spike in high-risk

loans, many of them for cash-out refinancings now on the federal government's hands. Almost 15 percent of FHA's 2018 book was cash-out refis which combine with other risk factors – e.g., an average credit score of only 670 – to show why only thirteen percent of FHA loans are now originated by banks with capital at risk if loans go bad. A new study from the Federal Reserve[5] finds a sharp drop in the volume of high-DTI loans for lower-income households outside of those sold to FHA and VA because GSE-underwriting standards limit their high-DTI exposure and banks are unwilling to hold these loans on portfolio because loans above a 43 percent DTI violate the QM rules. In short, a sound high-DTI loan a bank would be willing to make to a first-time homeowner violates the rules, but nothing stops lenders – especially nonbanks – from originating high-DTI loans to vulnerable borrowers at the height of what may well prove a house-price bubble. So much for borrower protection, not to mention taxpayer risk.

Simple Solutions and Complex Problems

In addition to failing to anticipate business consequences or consider one rule in the broader policy context, post-crisis policy has been distinguished by failed efforts at simple solutions for complex problems. This is particularly true in the standardized approach to retail-finance capital charges which sets capital by checking the box, not looking at the layers and product characteristics that actually differentiate sustainable equality finance from predatory or high credit-risk activity. I know we are all pushing for greater adoption of the standardized approach, which is warranted in many ways by the procyclicality and other problems embedded in the advanced approach.[6] But, let me lay out two examples that show why over-simple leads to inequality.

First to payday lending or, more politely put, small-dollar, short-term finance. The OCC has and the FDIC may soon authorize insured depositories to get back into a business made still more critical to lower-income households by long years of negative interest rates on small savings accounts. The over-simplified anathema in which prior regulators held payday lending has fortunately given way to a more nuanced understanding of the product. But, even so, banks won't be able to offer it if current capital regulation fails to recognize the collateralized nature of most short-term, small-dollar loans and the risk protections built into new bank regulation. Back to my incentive point: banks may well want to offer sustainable small-dollar loans, but they won't enter a business if they can't make money at it. Uneconomic capital rules mean that they may not be able jump the profit hurdle for loans that can keep vulnerable households away from the hard choice between predatory loans or sharp reductions in household spending on food, medicine, heat, or other essentials.

Second, let's look at subprime mortgage lending, the root of all evil to judge by post-crisis policy. But, are the low credit-score borrowers disproportionately found in low-and-moderate income households the problem? A recent paper from the Federal Reserve Banks of Atlanta and New York shows that mortgage risk is actually higher for prime loans than for subprime loans once you take loan purpose into account.[7] A purchase-money mortgage – the most critical wealth-equality product – was found to be less risky than prime loans made to borrowers who, while they may have said the loan was for their home, actually used it to buy a second home or even a third or fourth one with which the borrower planned to play "flip this house." Current capital rules don't make this important distinction, let alone the many others needed also to differentiate cash-out refis – high-risk products – from high-DTI mortgages for first-time home buyers.

You'll note that I'm not suggesting that capital rules be written to meet social-welfare objectives. We already cook the capital books too much for political purposes – see the statutory change recently made

to high-risk commercial real estate. What I am saying is that unnecessary simplicity in the standardized approach leads to unintended inequality effects. I am sure banks could handle a more nuanced standardized format and I know U.S. economic inequality would be the better for it.

Action Options

Sometimes, though, business incentives do not fit with prudential requirements even if banks are generous and regulators recalibrate equality-critical standards. This leaves two choices: do nothing or reduce risks to fit into the prudential and business framework so that equality-enhancing financial services are prudent, sustainable, and readily available throughout the business cycle.

I'll close with two policy options. The first may be found in H.R. 6421, bipartisan legislation authorizing a limited federal guarantee to back up to a billion dollars in bonds aimed at speed treatments and cures for blindness.[8] If this pilot program works as we hope, then it will lead the way to a class of financial instruments we call BioBonds to speed treatment and cures across the spectrum of disease and disability. Nothing is as economically debilitating as a health problem and of course nothing destroys a family's well-being as much as a loved one's suffering. We tried hard to structure BioBonds to make them viable near-term investments for institutional investors, but found that the only way to innovate in this arena is with a limited federal guarantee. This of course changes the risk equation and, with it, the rules of the game.

Going farther, we can construct banking charters that are expressly focused on equality-essential deposit, payment, and/or loan services. I've sketch out two ways to do this: a bankers' bank[9] and/or a special-purpose national charter akin to the fintech one now on offer from the OCC.[10] Several of you have suggested other exciting options such as a merchant-banking subsidiary taking equity in equality-focused ventures. I think this is a particularly fruitful approach to establishing a new way to fund start-up small businesses. Sustainable mortgages are critical to U.S. wealth equality and inter-generational mobility. But, because small businesses are the most effective employment engine, especially for lower-skilled individuals, they are the best way to boost income equality. What if one large bank or a group of them took small equity stakes in business ventures brought to them through community-development organizations or similar groups? This is a high-risk business with high-cost capital rules, but diversified positions would cross-subsidize these risks in ways that might even get a bit of regulatory relief.

I look forward to your questions about how to enhance equality banking, eliminate regulatory obstacles, and design new delivery models. We know all too well the cost to national prosperity and political stability of our all-too-unequal economy. I know you all have your hands more than full on the policy front, but solutions to economic equality offer not only social-welfare rewards, but also new products for new customers in new markets.

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[2] Fumiko Hayashi, "Faster Payments in the United States: How Can Private Sector Systems Achieve Public Policy Goals," *Federal Reserve Bank of Kansas City Research Working Paper 15-03*, 9 (June, 2015), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2623620.

[3] Mark D. Manuszak and Krzysztof Wozniak, “The Impact of Price Controls in Two-sided Markets: Evidence from US Debit Card Interchange Fee Regulation,” *FRB Finance and Economic Discussion Series No. 2017-074*, 5 (July, 2017), available at https://www.federalreserve.gov/econres/feds/files/2017074pap.pdf.
[4] Francisco Covas, "The Record Profit Canard Continued: A look at bank performance in the post-crisis period," *Underwritings: The BPI Blog*, (July 27, 2018), available at https://bpi.com/what-kevin-costner-can-teach-us-about-bank-profits-and-regulation/.
[5] Aurel Hizmo and Shane Sherlund, “The Effects of the Ability-to-Repay / Qualified Mortgage Rule on Mortgage Lending,” *FRB FEDS Note*, (November 16, 2018), available at https://www.federalreserve.gov/econres/notes/feds-notes/effects-of-the-ability-to-repay-qualified-mortgage-rule-on-mortgage-lending-20181116.htm.
[6] Federal Financial Analytics, *The Value-Add of Advanced-Approach U.S. Capital Requirements: A Marginal Cost-Benefit Analysis*, (June 14, 2017), available at http://www.fedfin.com/info-services/issues-in-focus?task=weblink.go&id=369.
[7] James Conklin, W. Scott Frame, Kristopher Gerardi, and Haoyang Liu, "Villains or Scapegoats? The Role of Subprime Borrowers in Driving the U.S. Housing Boom," *Federal Reserve Bank of Atlanta Working Paper 2018-10*, (August, 2018), available at https://www.frbatlanta.org/-/media/documents/research/publications/wp/2018/10-villains-or-scapegoats-the-role-of-subprime-borrowers-in-driving-the-us-housing-boom-2018-08-28.pdf.
[8] For more information, see http://www.eyebonds.com/.
[9] Karen Petrou, “How to build a more equal bank,” *American Banker*, (July 3, 2018), available at https://www.americanbanker.com/opinion/how-to-build-a-more-equal-bank.
[10] Karen Petrou, “What's missing from the OCC's fintech charter,” *American Banker*, (August 7, 2018), available at https://www.americanbanker.com/opinion/whats-missing-from-the-occs-fintech-charter.