# Bank Regulation, Monetary Policy, and Economic Inequality: A Lethal Combination and a Cure


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- Economic inequality is not only a structural force underlying social- and fiscal-policy woes, but also the direct result of U.S. monetary and regulatory policy. Evidence for this is how bad it got how fast after 2010.
- Failing to reduce economic inequality where possible quickly increases family hardship, slows growth, increases financial-crisis risk, and fans the flames of already-ferocious populist anger. An industry viewed as a big part of the inequality problem could be "reformed" in ways that pose existential challenges to established business models.
- The industry can lead the way to action reversing financial-policy inequality. Even easier, it can take up three pro-equality innovations: an Equality Bank, Eye-Bonds, and enhanced product design.

Thank you, Kieran, for inviting me again to address the leading group of larger-bank counsel. When I was with you last year, I touched only in passing on the question of economic inequality and financial policy.[1] Karyn was among those who came up to me later to express strong interest in moving forward and I've very much enjoyed working with both of you to explore the issues I'll discuss this morning. As an analyst, I can draw attention to what I think is the most pressing challenge in post-crisis financial policy; as institutions and an industry, you can do a lot to address it.

As I'm sure you know, the U.S. is the least equal advanced democracy in the world by all of the measures I think robust and, what's less well-recognized, it's become starkly less equal in just the past eight years. I've been looking very hard at these issues for a forthcoming book and what strikes me the most as I dive deeply into this problem is the disconnect between economic reality and the thinking of top U.S. economic policy-makers. As recently as August, Chairman Powell continued the longstanding Fed argument that economic inequality is awful but also everyone else's fault.[2] Rising labor non-participation rates, stagnant wages, sharply lower median net worth, widely-unaffordable housing, scant mortgage credit for riskier borrowers, and tens of millions at risk of losing what little they have after only one unexpected auto-repair bill are just a few of the reasons the U.S. is neither as prosperous as the Fed thinks nor as willing to believe that private finance works for the public good. A recent Fed staff paper attributes a good deal of this to equality-blind monetary policy.[3] The longer it continues, the greater the political risk not just for the Fed, but also the rest of us.

Time is not on the side of reasoned discourse, nor does the nation appear to be in the mood for it. That's why I'd like this morning to discuss several concrete action steps that would make a meaningful difference. I won't spend our time this morning going more deeply into the reason I think the economic inequality problem is not only so profound, but also so deeply intertwined with monetary and regulatory policy. A short discussion may be found in remarks I gave earlier this year at the Federal Reserve Bank of New York[4], with a more global perspective to be had in a talk I gave at the Chicago Fed shortly before the 2016 election[5] warning of the link between populism and post-crisis policy. Things haven't gotten any better, as you well know. So, what can we do?

## Three Ideas

Before turning to the structural threat inequality poses to each of your companies, let me suggest a few concrete actions that would make a difference and are quicker both to contemplate and, with your help, to construct.

First is what I'm calling the "Equality Bank." Since an *American Banker* op-ed on this a while back,[6] I've heard from several of you and others in the industry about ways to move forward. I'll describe the idea now so all of you can think about ways to move forward at your own bank or as a group.

An Equality Bank is essentially a special-purpose charter that offers products or services that by dint of current rules, the economics of the product, or risk-management considerations are problematic for individual banks but serve low-and-moderate income households and other engines of bottom-up growth at reasonable rates of return. One way to do this is through bankers' banks as described in my op-ed. Another is through a special-purpose national charter. As I've noted elsewhere,[7] the OCC has described its special-purpose fintech bank as subject to rules akin to those for national banks, but the substance of the policy statement shows considerable agency discretion and regulatory latitude. Using this to make equality-enhancing products viable business propositions for individual banks or bank consortia is a way to go as long as risk management and regulatory-arbitrage issues are carefully considered from the get-go. Finally, very large banks have options through the financial holding company charter both for equality-enhancing products and investments. How about merchant banking for small manufacturers using some of the analytical and securitization tools developed by online marketplace lending?

A related idea with far-reaching equality impact are "Eye Bonds." Bipartisan legislation (H.R. 6421) has recently been introduced to provide a limited federal guarantee to financial instruments backed by biomedical-research projects ready to move from basic science to patient treatments and cures. More information on the bill is available at [www.eyebonds.com](http://www.eyebonds.com) as well as in a recent *Wall Street Journal* article.[8] Importantly, the idea behind Eye Bonds is not only to craft a pilot program to speed treatments and cures for blindness and other severe vision impairment; it's also to use this pilot to pioneer a new "Bio Bond" market. You all know that "green bonds" went from zero just a few years ago to a $220 billion global market after the first World Bank guarantee. Why not do the same for treating the diseases and disabilities that afflict all too many?

Is there an equality angle to Eye Bonds? You bet! As discussed elsewhere in more detail,[9] blindness keeps about seventy percent of affected adults from gainful employment. I can tell you that it's not the lack of eyesight that's the equality barrier – it does significantly challenge many individuals and lead far too many employers to discount their skills. We often think of economic inequality in terms of race, gender, education, and ethnicity. But, disability is perhaps the most profound barrier to economic opportunity. Census Bureau data[10] show that when taking account of all Americans and not just those considered to be "labor force participants," less than 36 percent of all working-age Americans with a disability were employed in 2016 compared to almost 77 percent for those without a disability.

And, finally, there's CRA, small-dollar lending, and many specific issues already before you. Several banks here have done great work innovating in the community-development and LMI-banking arenas. However, much of this is still specialized and confined to community-banking units. With the radical transformation of finance already upon us due to giant fintech platform companies and their ability to reach deeply into the retail market,[11] I think it's time for high-priority thinking about what your banks can really offer. The "sandboxes" many regulators contemplate are already being eclipsed by sophisticated jungle gyms erected by Amazon, Google, and foreign platform companies. I suspect one-off product improvements – useful as they are to targeted markets – overlook a far larger strategic challenge with equality and market-stability risks beyond those we've seen so far.

## Inequality and Franchise Value

We haven't time this morning to go into detail on the structural reasons why post-crisis monetary and regulatory policy have done so much so fast on their own to make U.S. income and wealth equality so much worse. Suffice it now to say that many of these policy problems are also strategic challenges for U.S. banks. This is due not only to the way in which inequality makes regulated financial intermediation less profitable, but also the result of heightened crisis risk for which big banks will be blamed even if this time they're innocent.

My suggestion thus is that you add economic inequality to the suite of social- and public-policy problems each of you already assesses for others in senior management and the board. You've all done fantastic work on specific regulatory and legislative questions in the wake of the 2010 and global reform initiatives, but much of this is still at the relatively technical level. Beyond issues such as the dollar threshold at which rules should apply and the specifics of these rules lie far-reaching structural questions about which companies will continue to engage in financial services for whom and at how much profit.

In considering the inequality landscape, I would suggest looking not only at specific financial-policy questions, but also at the broader public debate. Some of this lies behind calls to reinstate Glass-Steagall, to break up big banks, to provide a guaranteed national income, to allow the Fed to enter the banking system still more directly as a deposit-taker, to limit capital distributions, and even to redesign private-corporation charters. Each of these ideas and many others have their problems, but all of them result from a fundamental truth: America is enormously unequal, the financial industry writ large is making this worse, and the public wants something new that politicians are increasingly likely to give them at your bank's expense.

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[1] Karen Petrou, "The Road to Intermediation is Paved with Ruins: Equifax and the End of Banking as We Know It" (speech, Washington, D.C., October 5, 2017), available at http://www.fedfin.com/images/stories/press_center/speeches/Karen%20Petrou%20Remarks%20Prepared%20for%20the%20Conference%20of%20Counsel.pdf.

[2] Jerome Powell, "Monetary Policy in a Changing Economy" (speech, Jackson Hole, WY, August 24, 2018), FRB, available at https://www.federalreserve.gov/newsevents/speech/powell20180824a.htm.

[3] Isabel Cairó and Jae Sim, *FRB Finance and Economics Discussion Working Paper 2018-048: Income Inequality, Financial Crises, and Monetary Policy*, (May, 2018), available at https://www.federalreserve.gov/econres/feds/files/2018048pap.pdf.

[4] Karen Petrou, "The Inexorable Will of the Financial Market: Profit Imperatives and Financial-Policy Design" (speech, New York, NY, March 1, 2018), available at http://www.fedfin.com/images/stories/press_center/speeches/Karen%20Petrou%20Remarks%20Prepared%20for%20Distinguished%20Speaker%20Lecture%20Federal%20Reserve%20Bank%20of%20New%20York.pdf.

[5] Karen Petrou, "Income Inequality: The Battlefield Casualty of Post-Crisis Financial Policy" (speech, Chicago, IL, November 3, 2016), available at http://www.fedfin.com/images/stories/press_center/speeches/Income%20Inequality-The%20Battlefield%20Casualty%20of%20Post-Crisis%20Financial%20Policy_Speech.pdf.

[6] Karen Petrou, "How to Build a More Equal Bank," *American Banker BankThink*, July 3, 2018, at https://www.americanbanker.com/opinion/how-to-build-a-more-equal-bank.

[7] Karen Petrou, "What's missing from the OCC's fintech charter" *American Banker BankThink*, August 7, 2018, at https://www.americanbanker.com/opinion/whats-missing-from-the-occs-fintech-charter.

[8] Christina Rexrode, "The Woman Who Has a Plan for Wall Street to Help Cure Blindness," *The Wall Street Journal*, August 18, 2018 at https://www.wsj.com/articles/the-woman-who-wants-wall-street-to-fund-a-cure-for-blindness-1534600800.

[9] Karen and Basil Petrou, "Seeing One Way Out," *Economic Equality Blog*, July 19, 2018 at https://economicequality.blog/2018/07/19/seeing-one-way-out/.

[10] United States Census Bureau, "Employment Status by Disability and Status Type, Universe: Civilian noninstitutionalized population 18 to 64 years," *U.S. Census Bureau, 2016 American Community Survey 1-year Estimates*, (2016), available at https://factfinder.census.gov/faces/tableservices/jsf/pages/productview.xhtml?pid=ACS_16_1YR_B18120&prodType=table.

[11] Karen Petrou, *The Crisis Next Time: The Risk of New-Age Fintech and Last-Crisis Financial Regulation*, (September 6, 2018) available at http://www.fedfin.com/info-services/issues-in-focus?task=weblink.go&id=456.