FedFin Daily Briefing

Tuesday, February 2, 2021

# FRB-NY Staff Report: Ultra-Low Rates Increase Racial Inequity

A Fed team responsible for ground-breaking equality research on Friday released an FRB-NY staff report empirically reinforcing the link between ultra-low rates and racial inequity demonstrated by an array of research also discussed in Karen Petrou's forthcoming book. This will surely increase Democratic pressure on the Fed to assume a "racial-equity mandate" (see FSM Report **FEDERALRESERVE58**). Looking at distributional data instead of the averages on which Fed arguments so far rely, this paper quantifies the earnings and portfolio effects of ultra-low rates over five-year periods for Blacks and whites, assessing these factors up to the most recent wave of 2019 Fed data. It thus reexamines the longstanding FRB and FOMC view that low rates promote income equality via employment that is most beneficial for low-wage workers and thereby improves racial equity. However, this conventional argument – frequently also deployed by the FRB to defend unconventional policy – does not, as this paper demonstrates, address wealth equality. In addition to large income gaps (median Black wages are 58 percent of white median wages), the typical Black household has only eleven percent of a comparable white household's wealth, attributed here to different asset portfolios that benefit very differently from accommodative policy. Blacks hold substantially fewer financial assets and thus have gained far less from financial-asset valuation increases since 2010. Further, the median Black household not only owns no stock, but also does not own a home. Interestingly, even when Black and white households own a home, capital gains related to home ownership are disproportionately enjoyed by whites. In fact, the paper finds that Black wealth equality is now about where it was in the 1950s, following the path of black home ownership which also dropped after 2008 below rates not seen before the civil-rights era.

Buttressing the Fed to some extent, accommodative policy is found to lead to larger employment gains for Blacks, but Black employment gains are small compared to white wealth gains. Previous research demonstrated that two percentage points in wealth share equals 14 percentage points of total annual household income, making it clear that any labor income gains due to ultra-low rates are more than offset in terms of equality by the distribution of wealth gains.

# FRB-PHIL Staff Study: Capital Buffer Draws Raise Lending if Dividends are Stopped

A new staff paper from the Federal Reserve Bank of Philadelphia updates much prior research on the link between capital requirements and lending to assess conditions unique to downturns – i.e., now. Using an existing model that seeks to account for factors such as current banking-industry concentration and the fact that sound banks hold excess capital, the paper adapts the model to capture the FRB's COVID stress scenario and recent actions to encourage banks to use their capital buffers. As previously noted, both the FRB and FSB have prioritized policies to encourage buffer drawdown under stress. This paper's conclusions may encourage them to do so via more stringent dividend restrictions.

Simulating an end to the 2.5 percent capital conservation buffer and assuming this equals a one percentage point drop in a bank's capital buffer leads to a projected overall lending increase of 0.5 percent in 2021, but big banks in fact drop their lending in order to pay dividends and avoid recapitalization costs resulting from loan losses. A minor increase in rates at big banks that continue lending is attributed to the increase in small-bank lending along with a reduced rate of small-bank failures. Revising the model to assume big-bank dividend restrictions leads to almost four times as much overall lending. The paper notes that its models assume numerous simplified assumptions and thus that its conclusions are only suggestive.

# BIS Expands Call for Entity-Based BigTech Financial Services

Following calls from BIS head Agustín Carstens for entity-based BigTech regulation, the BIS's Financial Stability Institute today issued an "occasional paper" laying out how best to do so. Noting that BigTech is increasingly active across the spectrum of banking, investment management, and insurance products, this paper urges entity-based rules focusing on entity-based risks such as those to competition, operational resilience, resolvability, and others that may threaten financial stability but are not subject to activities-based standards. Payment-system services are particularly concerning due to the limits of activity-based rules in a complex BigTech entity. The paper does not reject the benefits of activities-based rules to ensure competitive equity in key areas (e.g., AML compliance), but argues that additional, idiosyncratic BigTech and perhaps also fintech risks require the addition of entity-based standards. The paper includes a taxonomy of activities and the ways that may be best covered by activity, entity, and/or mixed standards, clearly laying a platform for additional BIS work sure to guide the FSB's planned inquiries into fintech and BigTech later this year.

## Recent Files Available for Downloading

The following reports and analyses have been sent to retainer clients recently. Copies are also available to retainer clients on the Archives section of Federal Financial Analytics' website: www.fedfin.com or clients may obtain the reports/analyses by e-mailing info@fedfin.com giving the requested item name, firm, and e-mail address. To learn more about *GSE Activity Reports*, click here.

- **GSE-020121:** While it will take time for the swamped Biden Administration to craft U.S. housing policy, elements of it emerged last week during stimulus negotiations, the President's statement, and HUD-nominee Fudge's appearance before Senate Banking.

- **CAPITAL227:** Although the FRB in its proposal indicated that this rulemaking would also begin consideration of the U.S. large-bank capital framework post-COVID, its final rule largely confines itself to aligning stress-test standards with the 2019 tailoring rule and stress capital buffer (SCB) for Category IV banking organizations.

- **GSE-012221:** The failure of yet another Administration and Congress to conquer the conservatorships does not augur well for constructive policy action anytime soon.

- **INVESTOR14**: In this report, we expand on prior forecasts to assess broad financial-regulatory and structure issues under the SEC's jurisdiction under what seems likely: a Chairman Gensler. His will be an activist SEC, one sure to throw broker-dealers, asset managers, and investment funds from the relative comfort of the last four years.

- **GSE-012121**: As forecast following a landmark CFTC-committee report and the Fed's financial-stability assessment, FHFA has now turned to the climate risk that worries them the most: residential real estate.

- **GSE-011521:** Last night, Treasury and FHFA announced an agreement on the GSEs' conservatorship unsatisfactory to all concerned and highly objectionable to many of those on the Hill with the power to change it.

- **GSE-011321:** Setting Senate Banking's agenda yesterday, incoming Chairman Brown highlighted refi inequality as a top committee priority.

- **CRYPTO17:** This interpretive letter (IL) follows an OCC advance notice of proposed rulemaking that suggested a notice-and-comment process before the agency made substantive changes to the digital-currency powers of federally-chartered banks.

- **AML133:** In a cliff-hanger before the end of the 116th Congress, the National Defense Authorization Act was enacted into law with an array of provisions significantly revising U.S. anti-money laundering (AML) and countering the financing of terrorism (CFT) requirements.

- **ELECTION25**: It will take considerable time for Congress to absorb the meaning of yesterday's insurrection not only in institutional terms, but also and more immediately with regard to each Member's thinking about his or her own policy and political agenda.

- **TMARKET**: As we noted earlier (see *Client Report* **REFORM200**), we do not expect U.S. regulators to extend SLR relief (see FSM Report **LEVERAGE23**) after its scheduled March expiration.