THE UNINTENDED CONSEQUENCES OF REGULATORY, FEDERAL RESERVE, AND FISCAL POLICIES
HAVE COMMERCIAL BANKS BEEN HANDED THE SHORT STRAW IN THE AFTERMATH OF THE FINANCIAL CRISIS?

By Rick Buczynski and Robert Kennedy

“Unintended consequences” has recently become a catch-phrase for critics of American economic policy. In this paper, the authors uncover several instances where policies may have had unforeseen and undesirable effects on commercial banks and the general public. They argue that all too often inappropriate data is analyzed, which together with a lack of distinction between causality and correlation, results in both serious policy errors and mixed signals communicated by policymakers and politicians. Misidentifying the true causes of the financial crisis has been a distraction preventing us from dealing with the real challenges. We believe that an outside-the-box bipartisan debate is required.

Elements of this paper, particularly how the housing bust precipitated the recent financial crisis, were presented at a session sponsored by IBISWorld at RMA’s Annual Risk Management Conference in October 2014 in Washington, D.C. There, IBISWorld’s chief economist Rick Buczynski was joined by Richard J. Parsons, author of the 2013 RMA-published book Broke: America’s Banking System, Common Sense Ideas to Fix Banking in America.
WE HAVE MISINTERPRETED THE TRUE CAUSES OF THE FINANCIAL CRISIS, AND HAVE A LONG WAY TO GO

Let’s think back to 2008 and 2009: Suddenly, 8 million Americans found themselves unemployed or underemployed, and in due course millions of households were faced with underwater mortgages. The Fed, using its monetary policy and supervisory tools, acted quickly and with determination to prevent a meltdown of the financial system and permanent damage to the economy. Initially, the common wisdom in the media, the government, and even in the banking industry was that we were dealing with a mess created by large commercial banks and investment firms. Politicians saw the opportunity to punish banks, bankers, and even key government agencies, as evidenced by Henry Waxman’s attack on Federal Reserve Chairman Alan Greenspan in a Congressional hearing on October 23, 2008.¹

The veritable missing link in this discussion, though, is the stagnant wages of the poorest 40% of American households. After being force-fed homeownership through misguided policies and actions, it turned out these households were frankly unable to afford “affordable housing.” For all that went wrong in the run-up to the crisis, if income growth had been stronger, the bubble’s demise would have been limited to a serious but cyclical “pop”—and not the most horrific economic meltdown since the Great Depression.

By promoting homeownership through dubious policies, government officials got it wrong leading up to the crisis. Now, in the aftermath, they are getting it wrong again by addressing symptoms and not causes of the predicament. The unintended consequences of the vast new regulatory regime created by Congress and official rhetoric, combined with

¹. Rick Parsons emphasized this point at the October 2014 RMA Annual Risk Management Conference in Washington, D.C.
the economy’s persistent structural issues, are multifaceted:

- The mess could happen again because of the undying desire of the government to increase homeownership despite the income problem.
- Overregulation\(^2\) is driving up compliance costs for all banks, not just institutions with over $50 billion in assets.
- Although, as of this writing, the U.S. economy is apparently gaining momentum, the recovery has been historically lackluster (perhaps because stimulus efforts have been overly driven by political motivations, rather than serious dialog, debate, and action with long-term, structural improvements in mind).
- There are serious conflicts between the Dodd-Frank legislation, which calls for a return to tighter underwriting standards, and official pleas for banks to open up their lending wallets. Mixed signals pervade.
- Younger people are unable to secure credit either because of low incomes and/or little credit history.

In addition to all this, have we forgotten that we are due for another cyclical downturn, and that global conditions at present pose serious risks? With this in mind, this paper is intended to inform and promote a meeting of the minds among government officials, regulators out in the field, academics, and banks big and small. We are all indeed in the same boat. Let’s keep it from capsizing again. Or even worse: sinking.

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PRE-CRISIS POLICIES: BOOM TO BUST

There are numerous well-researched accounts of the financial crisis, its origins, and how the calamity morphed from a serious but short-lived downturn into the “Great Recession.”

Several government reports, particularly the Financial Crisis Inquiry Committee’s (FCIC) 663-page issuance, provide a comprehensive analysis. The FCIC concluded, “While the vulnerabilities that created the potential for crisis were years in the making, it was the collapse of the housing bubble—fueled by low interest rates, easy and available credit, scant regulation, and toxic mortgages—that was the spark that ignited a string of events…”

While we agree with that basic assertion, we find the analysis of the committee (and others) seriously flawed in many ways, specifically in the failure to distinguish between the symptoms and causes of the disease. This unfortunately renders the committee’s policy prescriptions ineffective at best and destructive at worst. Constructed before the publication of the report, Dodd-Frank’s premises were similarly faulty. The authors of this paper are more in line with the two dissenting statements that appear at the end of the FCIC report, particularly those of Peter J. Wallison of the American Enterprise Institute. It seems abundantly clear that this crisis was rooted in the government’s aggressive affordable housing goals under both Presidents Clinton and Bush—and Congress. To increase home ownership during the 1990s and 2000s, Fannie Mae and Freddie Mac stimulated mortgage lending through dramatically reduced underwriting criteria.

The unintended consequences of such policies reached critical mass in 2008. In the run-up, economic policymakers had underestimated growing imbalances and so failed to introduce preventative measures.

We are not absolving banks, Wall Street’s financial engineers, credit agencies, or subprime lenders from their roles in fomenting the crisis. Nor are we absolving most of the 400+ community banks that failed because of flawed business models and substantial concentrations in residential real estate lending. Still, it is obvious to us that the primary culprits lay inside the Beltway, which the FCIC report tactfully avoids.

**AMERICAN DREAM OR NIGHTMARE?**

In addition to Fannie and Freddie’s role in creating the bubble, in the 1990s banking regulators sought to increase mortgage lending by commercial banks. The idea was to replace the lending of the largely defunct S&L industry. This came in the form of a considerable ramping up of the Community Reinvestment Act (CRA) in 1995, which required banks to quantify their lending to lower-income communities. As noted by Wallison and Edward Pinto in “A Government-Mandated Housing Bubble” (Forbes, February 16, 2009), “As the enforcers of CRA, the regulators themselves were co-opted into this process, approving lending practices that they would otherwise have scorned. The erosion of traditional mortgage standards had begun.”

The jury is still out as to the role the CRA played in the crisis and it continues to be a matter of dispute even within the FCIC report. However, as Richard Parsons observes in his 2013 book *Broke: America’s Banking System, Common Sense Ideas to Fix Banking in America*, in the 30 years following CRA’s 1977 passage, “astute lawmakers came to realize the personal power they gained by leveraging banks for social engineering.

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5. As Parsons points out in *Broke*, the Garn-St. Germain Depository Act of 1982 had the unintended consequence of encouraging deadly concentrations in commercial real estate for S&Ls by allowing them to enter commercial lending.


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And as banks became instruments of social policy, lawmakers also came to see banks as an extension of law enforcement.” We conclude that the political mindset was in place for the federal government’s increased tinkering in the housing market and, in effect, the allocation of credit. The tinkering, by the way, came from both sides of the political aisle.

Added to the equation was a financial system awash in cash and cheap financing, owing to Fed Chair Alan Greenspan’s low interest policies and capital inflows from abroad (the latter was pointed out in Hennessey, Holtz-Eakin, and Thomas’s dissents in the FCIC inquiry).

In the 10 years leading to the Great Recession, housing prices more than doubled, while Americans’ disposable incomes limped along, barely keeping ahead of inflation (see Figure 1).

All the while Fannie and Freddie continued to feed the frenzy. As Wallison and Pinto point out, from 1994 to 2003 “Fannie and Freddie’s purchases of mortgages, as a percentage of all mortgage originations, increased from 37% to an all-time high of 57%, effectively cornering the conventional conforming market… Fannie and Freddie were competing with Wall Street and one another for low-quality loans.”

While Fannie and Freddie did not make all of the subprime and alt-A loans, the fact that they accepted reduced underwriting standards and loan documentation lowered the bar for the rest of the marketplace.

In this context, we find it beneficial to include a table from page 456 of the FCIC report.

<table>
<thead>
<tr>
<th>Entity</th>
<th># of Subprime &amp; Alt-A Loans</th>
<th>Unpaid Principal Amt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fannie Mae and Freddie Mac</td>
<td>12 million</td>
<td>$1.8 trillion</td>
</tr>
<tr>
<td>FHA and other Federal</td>
<td>5 million</td>
<td>$0.6 trillion</td>
</tr>
<tr>
<td>CRA and HUD Programs</td>
<td>2.2 million</td>
<td>$0.3 trillion</td>
</tr>
<tr>
<td>Total Federal Government</td>
<td>19.2 million</td>
<td>$2.7 trillion</td>
</tr>
<tr>
<td>Other (including subprime and Alt-A PMBS issued by Countrywide, Wall Street and others)</td>
<td>7.8 million</td>
<td>$1.9 trillion</td>
</tr>
<tr>
<td>Total</td>
<td>27 million</td>
<td>$4.6 trillion</td>
</tr>
</tbody>
</table>

Table 1 clearly illustrates that government agencies, or private institutions acting on their behalf, either held or guaranteed the bulk of risky non-traditional mortgages (NTMs) that were outstanding at this point; it wasn’t just the private nonbank subprime lenders that were culpable. Plus, keep in
mind that subprime and Alt-A mortgages accounted for half of all mortgages by early 2008—a staggering statistic that was obviously trivialized.

Fannie and Freddie were extremely active in the purchases of NTMs, private mortgage-backed securities (PMBS), and high loan-to-value (LTV) mortgages. This accelerated, coincidentally, during the Fed’s low interest foray.

Figure 2: Government-Sponsored Enterprise (GSE) Purchases of Subprime and Alt-A loans*

(Cumulative since 1997 $Bn)

![Graph showing GSE purchases of subprime and Alt-A loans](source: FCIC Report, data on page 504.

*No data available for Alt-A until 2002. Includes high LTV loans.

After averaging around 64% in the period from 1980 to 1994, the home ownership rate passed 69% in early 2005. This translated into about 16 million more homeowners in the 10-year period commencing around 1994. The government had achieved its goal. Was this desirable? The housing boom sure did provide jobs in the construction industry. But that industry’s strong economic multipliers are short-lived, while the economy was left with millions of long-term loans that turned out to be far from “affordable.”
As home ownership surged in the early to mid-2000s, inflation-adjusted family income largely stagnated for the lowest-earning 40% of households, as shown in Figure 3. After 2005, incomes among the poorest 40% of households actually declined. From 1989 to 2013, annual income of the lowest two quintiles each rose only $2,000, while the middle quintile’s income rose by less than $1,000.

**Figure 3: Mean Value of Before-Tax Family Income* (Thousands 2013 Dollars)**

Source: Survey of Consumer Finances, Federal Reserve Board, September 2014

* Mean and medium are statistically equivalent for these categories.


Figure 4 provides a slightly different perspective of the issues we raise, depicting a timeline of housing-start and homeownership data. (Incidentally, in 1992 Congress authorized Freddie and Fannie to establish affordable housing goals.)

**Figure 4: Timeline of Boom to Bust**

Coinciding with the housing boom was a serious erosion in household finances, as debt servicing rose and savings rates plummeted. This was indeed a house of cards as policymakers clearly missed these worrisome signs.

**Figure 5: Household Debt Service and Savings Ratios (% Disposable Income)**
Figure 6 provides a simplified view of the chain of causality.

**Figure 6: Financial Crisis Chain of Events: Did We All Miss the Point?**

The noxious combination of the government’s aggressive pro-homeownership mandate and the Fed’s low interest rate policy juxtaposed with weak wages, particularly for lower income households, fueled the unintended consequence of the Great Recession. (The writing was on the wall well before the collapse. In fact, RMA/IBISWorld’s forward looking Industry Risk Ratings red-flagged single family housing in early 2005. RMA Statement Studies data showed profits as a percentage of sales for single family home builders dropping to zero in 2008 from 5.8% in 2006.)

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POST-CRISIS POLICIES AND POLITICS:
SLOW RECOVERY TO ANOTHER BUST?

By Rick Buczynski and Robert Kennedy

In this paper, the authors examine post-crisis politics and policies and how their actions could adversely affect commercial banks and the general public. The government continues to execute ineffective policies rather than focusing attention on the fundamental problems underlying the banking and housing industries and the broader economy. Misidentifying the true causes of the financial crisis has been a distraction preventing us from dealing with the real challenges. We believe that an outside-the-box bipartisan debate is required.

Elements of this paper were presented at a session sponsored by IBISWorld at RMA’s Annual Risk Management Conference last October in Washington, D.C. There, IBISWorld’s chief economist Rick Buczynski was joined by Richard J. Parsons, author of the 2013 RMA-published book Broke: America’s Banking System, Common Sense Ideas to Fix Banking in America.
HAVE WE COME FULL CIRCLE ON HOUSING? MIXED SIGNALS?

The policy pendulum has unequivocally swung in the opposite direction, morphing from lax standards and poorly conceived affordable housing policy to overregulation and strictly enforced multifarious compliance. Highly publicized settlements to the federal government claim that banks misleading investors into buying toxic mortgage securities prior to the financial crisis appear to have dampened the mortgage market. Another factor is the Consumer Financial Protection Bureau’s newfound swagger, which has banks of all types and sizes—community and commercial, big and small—worried. Reputation risk is at center stage.

Outstanding home mortgages as of the second quarter of 2014 are the lowest since the third quarter of 2006. This is a much-needed correction. From 1998 to the start of the recession, outstanding mortgages were out of control, doubling during that period. More importantly, the ratio of home mortgage value outstanding to GDP—which hovered around 60% from 1990 to 2000—exploded to nearly 70% just prior to the bubble bursting, as shown in Figure 6. Now that the government has helped create an oversupply of homes, the market needs to work off the excess—region by region, town by town. Weakened housing prices are part of the process. (As an aside, investment firms like the Blackstone Group are buying thousands and thousands of units at bargain prices with the intention to rent—another unintentional consequence of government policy.)

**Figure 6: Home Mortgages Outstanding (Trillions) to GDP (%)**

Source: Federal Reserve Board, Bureau of Economic Analysis
But will the market be allowed to do its important work? A September 7, 2014, Washington Post article by Dina ElBoghdady noted that “housing experts say the government’s push to hold the industry accountable for loose lending practices is unintentionally steering lenders toward the highest-quality borrowers, undermining the institutions’ missions to serve the broader population, including moderate- and low-income families.” Apparently reflecting such concerns, recent government rhetoric seems intent to turn back the clock and loosen standards. From ElBoghdady’s article: “President Obama has appealed directly to the banking industry several times for greater leniency, once in a State of the Union address. Federal Reserve Chair Janet L. Yellen weighed in this summer, lamenting that ‘any borrower without a pretty pristine credit rating finds it awfully hard to get a mortgage, which in turn has slowed the housing market’s recovery.’” More recently, Melvin L. Watt, director of the Federal Housing Finance Agency, made this disturbing comment at the Mortgage Bankers Association Annual Convention: “To increase access for creditworthy but lower-wealth borrowers, FHFA is also working with the enterprises [Fannie and Freddie] to develop sensible and responsible guidelines for mortgages with loan-to-value ratios between 95 and 97%.”

Doesn’t this trouble you? Even a small cyclical decline in the price of a home pushes an LTV ratio to a tipping point.

The mixed message is unmistakable: Dodd-Frank says tighten standards, but the same politicians who orchestrated Dodd-Frank are calling for a loosening of credit standards… Even a small cyclical decline in the price of a home pushes an LTV ratio to a tipping point.

The mixed message is unmistakable: Dodd-Frank says tighten standards, but the same politicians who orchestrated Dodd-Frank are calling for a loosening of credit standards, harking back to the main premise of CRA. Go figure.

Banks are caught between a rock and a hard place: Lend more to lower-income households, relax underwriting standards, AND maintain the underwriting statutes under Dodd-Frank? Regulators who administer policies are marooned in the same bind as bankers, so don’t shoot the messenger.
THE NEW CHALLENGE FOR COMMUNITY BANKS: MORE REGULATION

An October 2014 *RMA Journal* article titled “Regulators Responsive to Community Bank Concerns” clearly demonstrates an unintended consequence of the federal government’s response to the financial crisis. According to a poll mentioned in the article, community bankers now believe that the single most important risk facing their banks is regulatory. These executives are concerned about the uncertainty of how new banking regulations resulting from Dodd-Frank will be applied to community banks. They see not only compliance risk, but also increases in costs managing regulations that should have been targeted at the nonbanks and megathrifts that helped Fannie and Freddie create the housing bubble. We believe many community banks will reduce their mortgage businesses, and consumer lending in general, in order to manage the compliance risk.

The worry is that community banks that have a large share of business in home mortgages may attempt to shift into other lending lines, where they have little or no institutional knowledge. Is this the intention of government policy? This possibility puts one in mind of the Garn-St. Germain Act of 1982. It was intended to revive S&Ls—burdened by holdings of low interest fixed rate mortgages—by opening the door to commercial lending. Unfortunately, as Parsons writes in *Broke*, “The biggest problem with the legislation, although it was not really known at the time, was just how difficult it would be for the S&Ls to attract top commercial lending talent.” At the end of the day operational risk management seems to dictate success and failure.10

LEST WE FORGET: THE DIRECT AND INDIRECT COST OF COMPLIANCE

As mentioned above, for community banks, the most severe unanticipated consequences are found in the Dodd-Frank Act. A couple of papers from the Mercatus Center\(^\text{11,12}\) remind us that while DFA was meant to focus on larger banks, these regulations have had an outsized impact on community banks. These institutions have fewer executives, staff, and revenues to absorb compliance costs than larger banks. A survey of approximately 200 small banks by Mercatus found that most have experienced increased compliance costs corresponding to the hiring of one or two personnel. These banks believe that the greatest impact has been on the traditionally important mortgage lending business. The size and complexity of DFA has overwhelmed managements, which have no spare executives to work through thousands of pages of new regulations and are being distracted from business development and operations. As DFA continues to be rolled out, the cost of regulatory compliance is likely to force smaller banks to merge because of higher costs and loss of revenue from traditional lines of business that are now overregulated.

As we see it, there are other serious indirect, hidden costs not often acknowledged that are affecting large regional banks. Several IBISWorld bank clients have expressed concerns that stress-testing and other heightened regulatory demands have been a distraction and that risk managers were “taking their eye off the ball.” (Think model runs, model validation, examinations by multiple regulatory agencies, new and unpredictable scrutiny, etc., etc.) To bravely paraphrase, “The overload, inconsistency, and limited practical relevance of our regulatory compliance actually prevents us from doing our jobs; supporting ERM and prudent business development.”

\(^{11}\) “How are Small Banks Faring under Dodd-Frank?” Hester Peirce et. al., Working Paper, Mercatus Center at George Mason University, No. 14-05, February 2014.

PUSHING THE FINANCIAL SERVICE INDUSTRY INTO THE SHADOWS

The overregulation of the banking industry is driving both individuals and corporations alike to seek out little-regulated alternative financial services (AFS). *The Economist* dedicated much of its May 10, 2014, issue to the subject of shadow banking and in the June 2013 *RMA Journal* we wrote about the issue and its underlying demographics. It’s about more than payday lenders, pawn shops, or auto title loans. It’s about PayPal, prepaid credit cards, and large retailers that offer “debit cards” as well.

It is also not just a matter involving lower-income families; young wage earners with incomes sufficient to afford a starter home face tougher credit hurdles thanks to more stringent borrower requirements and increased “protection” provided by the CFPB. Talk about unintended consequences. Add to this the mounting burden of student debt and it’s no wonder that, as American Bankers Association CEO Frank Keating noted in a June 20 interview, the average age of a first-time home buyer has soared to 37.

And has anyone thought about the potential loss of banking business due to overregulation once the migration debate is resolved? Once people become accustomed to AFS it will be difficult to lure them back into traditional banking services.

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13. See the May 10, 2014 issue of *The Economist.*
SUBTLE UNINTENTIONAL SIGNALS IN THE DFAST FORWARD-LOOKING STRESSTEST

The most recent Federal Reserve Dodd-Frank Stress Test\textsuperscript{16,17} exercise reinforces the industry-wide view that mortgage lending and operations have become unduly risky. The Federal Reserve reported that the aggregate results of this stress testing exercise estimate that under both the adverse and severely adverse scenarios, mortgage lending and operations would cause 40% of all credit and operational losses in all business lines taken by the 30 largest bank holding companies. The Federal Reserve views these scenarios as forward-looking, inferring that the industry has learned little from the recent mortgage banking failure and is destined to repeat those same underwriting and operational mistakes.

Consequently, the Fed expects banks in the mortgage banking business to hold higher levels of capital than for other lines of business. We wonder: Why would a bank return to mortgage banking with such capital requirements when the return on assets is so fundamentally low?

FED MONETARY POLICY: HERE WE GO AGAIN? HOPE NOT…

In the May 2013 \textit{RMA Journal} Buczynski\textsuperscript{18} analyzes the unprecedented measures taken by the Federal Reserve Board during and in the wake of the Great Recession. Of relevance are moves to drive short-term interest rates to zero and inflation-adjusted long-term rates down to near zero on both treasuries and mortgage-backed securities through quantitative easing, or so-called QE. The ramification, whether intended or not, was to drive net interest margins of banks down to where the search for returns distorted risk appetites.

\begin{itemize}
\item \textsuperscript{16} Consult “Dodd-Frank Act Stress Test 2014: Supervisory Stress Test Methodology and Results,” Board of Governors of the Federal Reserve System, March 2014.
\item \textsuperscript{17} For an innovative approach to stress testing and a critique of current methods, see “Stress-Testing a C&I Portfolio,” Rick Buczynski, \textit{RMA Journal}, November 2008.
\end{itemize}
Doesn’t this sound like what may have helped ignite the financial crisis? To quote that 2013 article, “There are growing fears that the Fed’s bond-buying spree is fomenting the same frenzy to seek out higher returns that helped fuel the financial crisis in the first place.” In late October of 2014, Greenspan, now the ex-Fed chair, aired concerns that the Federal Reserve won’t be able to exit from its accommodative monetary policy without some “turmoil” in financial markets.

Even though the Fed’s bond buying has ended, its balance sheet has swollen to around $4 trillion and rates remain extremely low, especially in inflation-adjusted terms. This entails various consequences including:

- Together with low rates, the Fed has painted itself in a corner and has limited ability to deal with an inevitable cyclical downturn.
- Markets have become so accustomed to low rates that “good” economic news often leads to a perverse decline in stock and bond markets in anticipation of rate hikes.
- A return to historically normal rates may prove difficult and interest rate risks are a chief concern.
- The Fed has opened itself up to scrutiny; consider the Federal Reserve Accountability and Transparency Act (FRAT) that has bipartisan support.

FRAT is perhaps the scariest unintended consequence. To quote Alan Blinder from the July 17, 2014, *Wall Street Journal*, “the meat-and-potatoes of the House bill has little to do with either transparency or accountability. Instead, it seeks to intrude on the Fed’s ability to conduct an independent monetary policy, free of political interference.”

**CONCLUDING REMARKS: WHERE DO WE GO FROM HERE?**

Let’s accentuate the positive…

Despite a bumpy ride, much progress has been made in terms of re-establishing the health, profitability, and management of the financial system. Not only is the financial system far better capitalized and more liquid, risk management techniques have improved greatly. Much of this progress was presented by Federal Reserve Governor Daniel Tarullo at the Fed’s annual Stress Test Modeling Symposium last June in Boston.19

Positive sentiments, many of which are included in Mr. Tarullo’s speech, are below:

- Stress tests have become more dynamic, transparent, and forward-looking. These metrics offer a better measurement of risk than many of the old-fashioned ones.
- Capital plan requirements under Dodd-Frank have significantly strengthened the capital position of the industry.
- The management of counterparty and systemic risk is improving along with standards for general risk management. A better acceptance of enterprise risk management is flourishing.
- Greater attention is now being given to liquidity risk given the realization that the market implosion that froze financial markets during the crisis was not merely a symptom of an under-capitalized industry.

Still, bank lending remains lackluster in spite of these low interest rates and a system flooded with liquidity. And many banks have become extremely risk averse for fear of future prosecution by the Justice Department or sanctions by the regulators for any incidental missteps.

Moreover, although the nation’s employment has steadily improved over the past year, growth has at least for now, returned to a 3% plus rate, and the stock market has recovered from its 2008–2009 freefall, after more than five years of near zero interest rates, GDP growth and the job market have not matched previous recoveries. More importantly, incomes and wage growth remain stagnant for the majority of households.

Also troubling is the underlying state of labor markets. As noted recently by Mitchell Hartman,20 “the number of people who are not working, but would like to work, is unprecedentedly high. These people have given up looking—possibly because they don’t think any jobs are available for them, or perhaps to attend school and upgrade their skills, or to go into semi-retirement. They’ve pushed down the labor force participation rate to its lowest level (62.7% in September) since the late 1970s...Combine these discouraged and marginally attached workers with the ‘underemployed’—people who would like to find better-paying full-time jobs but can only find part-time jobs—and total unemployment, as measured by the BLS, is averaging well over 12% in 2014.”

All of this suggests that there is something else amiss with the economy, especially within the confines of policies designed to help low- to middle-income families.

TIME TO TURN THE TABLES

The Fed has played an important role in the rehabilitation of the financial system, particularly during the market collapse of 2008/09. Fed monetary policy helped avoid a deep and protracted crisis, and return the economy to a modest growth rate. But we believe that the Fed’s traditional monetary policy and financial system supervisory tools are not the right ones for the long-term task at hand.

Perhaps the Fed should use its position and prestige to convene an in-depth national inquiry into the fundamental problems of the economy, including the matter of long-term stagnant income for such a large portion of households. The Fed, working together with industry and labor leaders, academics, and government policymakers could then redirect attention to the real issues to be addressed, rather than apply the same threadbare treatments of the past few years.

For Congress, the solutions go well beyond expansion of deficit-driven entitlements for the masses. Politicizing the strategies and operations of the Fed, called for by some in Congress, would only result in the financial markets and the citizenry losing respect for our nation’s central bank. Congress needs to address the continuing failure of its own fiscal and tax policies and the over-regulation of business activity.

The Fed’s survey of household income shows that the demographic group that has suffered the most from stagnant and declining incomes is households headed by people without high school diplomas. For more than three decades, the high school dropout rate has exceeded 20% annually.

Congress needs to deal with our expensive education system’s ineffectiveness in supporting the nation’s economy. Affordable housing and increased homeownership, very noble ideas, need creative, well thought out yet conservative solutions by Fannie and Freddie, with, of course, support from Congress. No national housing policy should ever put the low- and moderate-income families at risk in the name of political expediency.
We wonder if the policies prevalent over the past 50-plus years have lost their luster. Taxes, subsidies, entitlements, and the like have had no effect on eliminating the disparity of incomes and wealth in America nor the stagnation in real wages.\(^{21}\)

On the other hand, extreme conservative policies aimed narrowly at far-reaching deregulation and reducing taxes are politically untenable, plus there is no successful paradigm to work from.

The authors are not experts in socio-economic policy. But we do know that long-term lackluster economic growth doesn’t bode well for the banking industry. The crucial unintended consequence of all of these efforts to restrain and punish the banks has been the willful neglect of the fundamental problems in our nation’s economy. With the midterm elections behind us, and the general elections on the horizon, let’s open the debate and consider what’s best for the American people.

*To reiterate: We are all indeed in the same boat. Let’s keep it from capsizing again. Or even worse: sinking.*

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21. The Gini Index, a measure of income inequality, has been on the rise since the early 1980s and sadly continued its ascent post-crisis.

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ABOUT RMA

The Risk Management Association (RMA) is a not-for-profit, member-driven professional association serving the financial services industry. Its sole purpose is to advance the use of sound risk principles in the financial services industry. RMA promotes an enterprise approach to risk management that focuses on credit risk, market risk, operational risk, securities lending, and regulatory issues.

Founded in 1914, RMA was originally called the Robert Morris Associates, named after American patriot Robert Morris, a signer of the Declaration of Independence. Morris, the principal financier of the Revolutionary War, helped establish our country’s banking system.

Today, RMA has approximately 2,500 institutional members. These include banks of all sizes as well as nonbank financial institutions. RMA is proud of the leadership role its member institutions take in the financial services industry. Relationship managers, credit officers, risk managers, and other financial services professionals in these organizations with responsibilities related to the risk management function represent these institutions within RMA. Known as RMA Associates, these 16,000 individuals are located throughout North America and financial centers in Europe, Australia, and Asia.

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