The Impact of Monetary and Regulatory Policy on Main Street Banking

John A. Allison

I spent my career in business. In fact, I was at one time the longest-serving CEO of a major financial institution in the United States. BB&T, the bank I ran from 1989 to 2008, is a Main Street, community bank, and so I tend to think from that perspective. However, my experience since stepping down from BB&T has made it clear to me that a lot of influential people just do not see the world in the same way.

Between 2012 and 2015, I was president and CEO of the Cato Institute, and so I encountered a lot of policymakers. Right now, I'm teaching at Wake Forest University and so work alongside a lot of academics. Of course, I also have many friends and colleagues on Wall Street. And the thinking that characterizes each of those places is very different from the kind of thinking that takes place on Main Street. Certainly, there are some commonalities, but in the end it's a very different world view.

Accordingly, my goal in this article is to explain the impact of Federal Reserve policy on Main Street and—by extension—fundamental economic activity. In what follows, I am going to deal separately with monetary and regulatory policy. Sometimes those policies work together, but often they actually pull in different directions. I will

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John A. Allison is an Executive in Residence at the Wake Forest School of Business. He has served as president and CEO of the Cato Institute, and chairman and CEO of BB&T Corporation. This article is based on his remarks at Cato's 34th Annual Monetary Conference, November 17, 2016.

go on to draw a distinction between the policy responses to the financial crises of the 1980s and 1990s, on the one hand, and the approach taken to the more recent crisis on the other. Finally, I will offer my thoughts on the state of banking today, and its prospects under the new U.S. administration.

What Caused the Crisis?

I want to begin with some context, by looking at the last economic cycle. The commonly held belief is that deregulation, coupled with greed on Wall Street, caused the 2008 financial crisis. To put it bluntly, however, this account of the crisis is simply not true. On the contrary, based on my own experience, I believe very strongly that the recent financial crisis had its roots in government housing policy, which aimed to provide affordable homes *now* and gave no thought to the longer-term consequences. The Community Reinvestment Act, which put banks under enormous pressure to expand subprime lending, deserves particular blame, as do the activities of those giant government-sponsored enterprises Freddie Mac and Fannie Mae, which by the time they failed had amassed liabilities of $5 trillion, including $2 trillion of subprime mortgages.[1]

These misguided policies were amplified and made much worse, in my view, by the actions of the Federal Reserve. As CEO of BB&T, I saw this up close. It began in the early 2000s, when Alan Greenspan—at that time the Fed chair—responded to a much-needed market correction (the bursting of the dot-com bubble) by engineering a radical reduction in real interest rates. That turned out to be an incredibly destructive move.

You see, at that point we already had a housing bubble in the United States. At BB&T, we gauged the market by looking at the debt service on people's home mortgages versus their incomes. On that basis, we thought house prices were at least 10 percent too high and were gearing up for a housing correction. But the opposite happened when the Greenspan Fed crashed interest rates. It was like pouring gasoline on a fire: all of a sudden, house prices were 30 to 35 percent too high, and there was enormous overinvestment in the housing sector as a whole.

[1]For more on the contribution of government housing policy to the financial crisis, see Allison (2012: chap. 5).

What followed was very interesting. Greenspan claimed that there was a global savings glut and that as a result, interest rates would stay low indefinitely. At BB&T, we didn't pay too much attention to that. But then it went on for several years. At that point, we had to pay attention—for banks, prolonged low interest rates mean you have no spread in your business and therefore struggle to turn a profit. That's why many banks at that time started to lengthen the duration of their bond portfolios—they needed to find higher yields somewhere. BB&T was one of the last banks to join that party (Allison 2012: 27–28). But then—wouldn't you know it?—Greenspan suddenly started *raising* rates. He raised them very rapidly. In fact, this was the fastest percentage increase in interest rates ever.

Of course, the overall level of interest rates never went that high—and economists tend to focus on that level. However, if you're running a business, the cost of money is your cost of goods. And if that cost of goods doubles—or even triples—in a very short period of time, it becomes very hard to run that business. I often ask my students to imagine the following scenario: you go to college, and in your first semester, tuition is $25,000; the next semester, it rises to $50,000; then it goes to $75,000; and then $100,000. It's hard to handle that kind of price increase—but that's exactly what happened to the cost of goods for banks when Greenspan started raising interest rates.

Bernanke continued the trend when he took over. But then he did something incredibly disruptive—something I argue markets would never do on their own: he inverted the yield curve. In other words, short-term rates somehow ended up *higher* than long-term rates. This created an enormous problem for banks, who make their money by borrowing short and lending long. With an inverted yield curve, banks faced negative spreads and were therefore forced to take more risk if they wanted to maintain their returns. It is no surprise, in this context, that a disproportionate share of the bad assets held by the banks at the time of the financial crisis were acquired during the last couple of years of the economic cycle. In short, the Fed had created a massive, perverse incentive: the banking industry either had to take more risk or else go broke from negative spreads.

It is important to understand that the impact of all this was not just on the housing market. In fact, there were multiple bubbles, appearing everywhere from commodities markets to the automobile industry. By its actions, in other words, the Federal Reserve encouraged massive malinvestment across the economy. When the bubble inevitably burst, those investments were unwound very rapidly, at vast economic cost. The so-called Great Recession ensued.

The Impact on Main Street

Many Main Street business people feel fooled by the Federal Reserve. The perception is that the Fed said one thing but did something completely different. What's more, the Fed's predictions didn't reflect reality: Bernanke was still saying there wouldn't be a recession *after* the recession had started! As a result, people on Main Street are asking themselves whether America's monetary policymakers really know what they're doing.

That loss of faith has serious consequences. What's happening today is that the average Main Street business person—who is not an expert on monetary policy—expects inflation and can't figure out why it isn't happening. They read in the *Wall Street Journal* about quantitative easing and the massive expansion of the money supply, and they think inflation must surely be around the corner. Now, that may be a misinterpretation, but it's what the average Joe thinks is going on. Meanwhile, these people are running their businesses and not seeing any revenue increases.

Put yourself in their position: you're running a Main Street business, you expect inflation, and your revenues are flat. What do you do? For most Main Street businesses, the answer is to become very cautious. That means bearing down on costs and not making any big investments. Big public companies take advantage of cheap financing to buy back stock. Industries consolidate—but the mergers are driven by cost, rather than revenue.

It all stems from uncertainty. Main Street businesses believe they've been fooled in the past, are worried about what the future might hold, and have little faith in the Federal Reserve's ability to steer the right course. I like to use the analogy of the Wizard of Oz. That's how people saw Alan Greenspan when he was Fed chair—"the wonderful things he does!" But when the financial crisis hit, it was like the curtain being pulled back. Suddenly you realize it's just this old guy and that the rest was all smoke and mirrors. That analogy might not be entirely fair, but it does capture what a lot of Main Street business people think when they look at the Federal Reserve today.

The Consequences of Regulation

As much trouble as monetary policy has caused, when it comes to this correction, the regulatory side of policymaking arguably did even more damage. Of course, you hear all the time that banks were deregulated in the run up to the financial crisis, but, for someone who was actually running a bank during that period, this just seems like a bizarre argument. In fact, there was a massive *increase* in bank regulation under the George W. Bush administration. There was the Privacy Act, Sarbanes-Oxley, and the Patriot Act. Together, these pieces of legislation constituted a radical increase in the regulation imposed on the American banking industry—you can just go count the pages.[2]

What's more, banks were put under huge pressure to carry out subprime lending. For example, the regulators wouldn't approve mergers unless the banks in question were doing lots of subprime lending. Then there was the perverse way risk weighting was applied to banks' capital ratios[3]—you had to keep only half as much capital against a subprime mortgage loan as you did against a loan to ExxonMobil. In Europe, of course, you could loan money to the Greek government and then hold no capital against it whatsoever (Allison 2012: 51). Bank capital regulation made no logical sense, but it certainly provided a great incentive for crazy investments.

The worst part is that financial regulators don't seem to have learned anything from their mistakes. There's a discussion going on right now about the next set of Basel rules, which will aim to set capital ratio risk weights *globally*. This is a recipe for disaster. Let's imagine—and it doesn't take much to picture it—that the Basel committee underweights a particular asset, meaning that banks don't have to hold as much capital against it. What's going to happen? Well, you'd expect to see lots of investment flow into that particular asset, which means that asset is going to get a lot more risky. It's exactly what happened in the mortgage business a few years ago. It doesn't seem regulators have got any better at judging risk, either. Just look at energy credits, which were considered low-risk two years ago, but suddenly became high-risk when the energy bubble burst.

[2]For more on why the financial sector was *misregulated*, not deregulated, see Allison (2012: chap. 13).

[3]For more on the perversities of risk-weighted capital ratios, see Dowd (2014).

Ultimately, this risk weighting just isn't ever going to work. Financial regulators are presuming to know things they cannot possibly know with any degree of certainty, and storing up problems for the future in the process.

A Tale of Three Crises

During my career in the banking industry, I had the experience of going through several financial crises—first in the early 1980s, when I was running BB&T's lending business, and then again in the early 1990s and late 2000s, when I was CEO. What a lot of people don't seem to realize about these three crises is that the first two were handled radically differently by the regulators than was the most recent one. And those divergent regulatory approaches had a huge impact on the respective economic outcomes.

An economist looking at the 1980s crisis with no prior knowledge would probably guess at a much worse outcome than we had in the late 2000s, principally because the country was in much worse shape going into that earlier crisis. Same for the crisis of the early 1990s. Yet it didn't work out that way—why? A lot of it comes down to how bank examiners handled those earlier crises: they effectively attacked the bad banks, putting them out of business. But, crucially, they discriminated between banks and allowed the good ones to continue operating unmolested. As it happens, BB&T grew during those cycles. We were able to help our existing customers through the downturn, and we were able to help new customers who had been let down elsewhere.

This time around, we had an inverted regulatory action. Instead of letting the bad banks fail, the government bailed them out. At the same time, regulators attacked good banks—banks that had made prudent investments and had gone into the crisis with strong balance sheets—by radically tightening lending standards. That approach made things drastically worse: the last thing you want to do in a credit crunch is suddenly impose additional restraints on lending, but that's exactly what regulators did. As a result, BB&T was forced to put thousands of people—our customers, who were relying on us for credit—out of business for no good reason. If regulators hadn't taken such a destructive approach, those customers could have stayed afloat and kept creating jobs.

This terrible response to the crisis was, I think, driven by panic. Bernanke's book, *The Courage to Act*, offers an interesting window into his perception of what was going on. He really thought we were on the verge of a global Armageddon, that the entire financial system was about to collapse, and that the aftermath was going to make the Great Depression look like a picnic. But that perception wasn't rooted in reality, and it certainly didn't reflect what was happening in the Main Street banking business. BB&T wasn't about to go broke just because Goldman Sachs was going broke. In fact, at BB&T we were buried in cash; the same was true for Wells Fargo and most of the banking industry. Yet this irrational fear of "contagion" spread like wildfire, and the regulators completely overreacted. In the process, they helped turn a financial crisis into a prolonged economic downturn.

Banking in Trump's America

Looking forward, I am more optimistic. Nevertheless, a great deal of damage has been done since the passage of Dodd-Frank, and that will take time to unwind. The significant rise in capital requirements, while not necessarily a bad idea on its own (Allison 2012: 189), has come alongside a much-increased regulatory burden, as well as a much-narrowed yield curve spread. Together, those factors have made it hard for Main Street banks to make money. Another problem is the big increase in liquidity requirements. This forces banks to hold lots of short-term government debt and to maintain unproductive excess reserves.

Then there's the dramatic tightening of lending standards, which has continued since the financial crisis. This is of particular concern to me. I started out as a small business lender, and over the years the kind of "venture capital" loans I made helped entrepreneurs to create hundreds of thousands of jobs. But banks literally can't make those sorts of loans anymore. Bernie Marcus, a friend of mine who started Home Depot, says today he would never get the kind of financing he had then—and he's right. Lending standards for small businesses are tighter now than at any time in the last 45 years. We will never know how many great opportunities are being lost as a result.

It was interesting, though, to see the market reaction to Donald Trump's election, with bank stocks performing very strongly. Investors clearly think the new administration is going to make some beneficial reforms to financial regulation, and I think that's a reasonable expectation. For all his flaws, Donald Trump has agreed to support a bill—Rep. Jeb Hensarling's proposed

Financial CHOICE Act—that would do a lot to improve the regulatory climate. It's not a perfect free-market plan for banking reform, of course, but what it would do is allow banks to effectively opt out of Dodd-Frank so long as they maintain a strong leverage capital ratio. That would be a hugely liberating move for the banking industry.

Moreover, even if that bill doesn't get passed, we are still likely to get some regulatory relief. And that's because regulators always act in the regulatory interest and look to the federal government's political leadership to judge that. Let me explain with an example from my own experience: early in my career as a CEO, Bill Clinton was elected president, and for whatever reason, he was convinced that there was racial discrimination in banking. But this was the 1990s—there had been plenty of discrimination in the 1960s, but it was all over by the time Clinton came to office. Nevertheless, President Clinton instructed his FDIC staff to find racial discrimination and then put an end to it.

Of course, racial discrimination had been against the law for a long time. And officials at the FDIC knew banks in the 1990s weren't really discriminating against their customers. But these regulators had to make the boss happy, and so they started cutting some interesting deals. They would go into banks, use crazy formulas to prove the existence of racial discrimination, but then let the "guilty" banks off with a small fine and a slap on the wrist—just so long as bank executives accepted responsibility and let the FDIC get some good publicity for themselves out of it.

Now, when the FDIC came to BB&T, we refused to play ball.[4] We knew we didn't racially discriminate, and, after one look at the FDIC's crazy accusations, we said we'd see them in court. But the FDIC didn't want that, and so they took a different approach: they said they wouldn't let us do any mergers or open any branches; they said they'd send in an army of inspectors and just sit on our organization until we gave in to their demands. They said we'd be paralyzed as a business. And, for four months, we were. BB&T fought the FDIC like crazy, but in retrospect it was probably a bad business strategy—it would have been better for our bottom line if we had just rolled over like they wanted us to.

[4]For an expanded account of this episode, see Allison (2012: 43–45).

Then the 1996 mid-term elections came around, and the Republicans were elected to Congress. A couple of days later, every single FDIC examiner went home, and we never heard from them again. No laws had changed yet, but the shifting balance of political power was enough to completely change BB&T's regulatory environment. With the Republicans now in control of all three branches of the federal government, it's entirely possible something similar will happen again today.

Conclusion

Ultimately, you can't have a viable economic system—or a healthy level of economic growth—without a sound, dynamic banking system to support it. Main Street banks play a huge role in that but have been subjected to tremendous, unnecessary stress ever since the financial crisis of 2008. Policymakers today have an opportunity to set matters right. I, for one, hope they seize it.

References

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