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Public and Private: Are the Boundaries in Transition?

BREAKOUT SESSION SUMMARY

Financial Institutions
Moderator:
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Reforming Financial Regulation to Address the Too-Big-To-Fail Problem
Arthur E. Wilmarth, Professor, The George Washington University Law School

Interchange Fees as a Public Utility
Henry Polmer, Attorney, Law Offices of Henry M. Polmer

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REFORMING FINANCIAL REGULATIONS TO ADDRESS THE TOO-BIG-TO-FAIL-PROBLEM

Arthur Wilmarth, Professor of Law at the George Washington University Law School, discussed the pending financial reform legislation and evaluated its potential impact on the too-big-to-fail ("TBTF") problem. Wilmarth argued that the primary objective of the legislation should be to eliminate TBTF subsidies, and that sweeping structural reform, which separates traditional banking from high-risk investment banking in complex institutions, is necessary to curb excessive risk-taking among large financial conglomerates.

Wilmarth stated that the global financial crisis has demonstrated that TBTF financial conglomerates receive enormous public subsidies (i.e. taxpayer-funded support in the form of liquidity assistance, capital infusions, asset purchases, and financial guarantees), which distort economic incentives and encourage excessive risk-taking. About half of the world's large, complex financial institutions ("LCFIs") reside in the U.S. A majority of the U.S. LCFIs were among the recipients of a massive ($300 billion) capital infusion, and other public subsidies, granted by the federal government to prevent the systemic failure of the financial industry. Because of their TBTF subsidies, LCFIs were able to pay significantly lower interest rates on their deposits and bonds, and to operate with substantially lower capital ratios, compared to smaller banks. Thus, public subsidies give TBTF institutions a tremendous competitive advantage over smaller banks. Wilmarth contended that this advantage has increased as the financial services industry has become highly concentrated.

Currently, the combined assets of our six largest banks are equal to 63% of our GDP (up from 56% in 2006, and 17% in 1995).

Wilmarth outlined the high-risk lending and investment practices that led to the financial crisis. LCFIs used an "originate to distribute" strategy to fund more than $9 trillion of high-risk residential mortgages, credit card loans, commercial mortgages and leveraged corporate loans, many of which were pooled to create asset backed securities ("ABS"). LCFIs repackaged many of the resulting ABS into collateralized debt obligations ("CDOs"), which contained even higher risks. After paying handsome fees to credit rating agencies to provide investment-grade ratings to ABS and CDOs (thereby masking their underlying risks), LCFIs sold ABS and CDOs to investors around the world. LCFIs magnified the risks of ABS and CDOs by issuing about $15 trillion in credit default swaps and "synthetic CDOs," which essentially allowed LCFIs and investors to place multiple bets on the performance of the high-risk loans. In addition, some LCFIs utilized off-balance-sheet conduits and other legal/accounting maneuvers, which enabled them to misrepresent their risk exposures and minimize their capital requirements. In mid-2007, the underlying loans began to default in droves and their true risk was revealed. This spurred a global financial crisis, and forced the government to rescue LCFIs from imminent failure by granting them enormous public subsidies.

Wilmarth identified two key provisions in the pending legislation -- the "Volcker Rule" and the "Lincoln Proposal" -- as proposed measures that most closely resemble the type of broad restructuring he believes is necessary to regulate risk-taking and eliminate TBTF subsidies. Paul Volcker's rule, he explained, would separate banking from proprietary trading and private equity investments. This means that LCFIs would be prevented from: (a) using their own money to place directional market-sensitive bets unrelated to serving their customers, and (b) investing their own money in hedge funds and private equity operations. In sum, the Volcker Rule would sever high-risk proprietary trading and investing from access to FDIC-insured assets. Sen. Blanche Lincoln's Proposal would bar FDIC-insured banks from dealing in credit default swaps and other derivatives by cutting off their access to federal deposit insurance and their ability to borrow from the Federal Reserve's discount window, as long as they maintain derivative-trading divisions. This measure would force banks to spin off their derivatives operations into separate nonbank subsidiaries of their holding companies.

Wilmarth projected that the Volcker Rule is likely to pass, but he was concerned that the rule will fall short of the degree of structural reform necessary to combat the TBTF problem. He noted that Wall Street lobbyists have fought the Lincoln Proposal "tooth-and-nail," while they have been less outspoken against the Volcker Rule. Wilmarth observed that LCFIs appear to concede that some degree of greater regulation is an inevitable outcome of the crisis. Wilmarth hypothesized that LCFIs may accept the Volcker Rule because its operative terms (e.g. "proprietary trading" versus "market making" for customers) are vague and may create new opportunities for "regulatory arbitrage."

Wilmarth argued that Congress should adopt a two-tiered system of bank regulation and deposit insurance that incorporates aspects of both the Volcker Rule and the Lincoln Proposal. He proposed that first-tier banks should operate as traditional/community banks that accept deposits, make loans, and receive FDIC deposit guarantees. First-tier banks would be barred from affiliating with companies that are involved in capital markets activities (including securities/insurance underwriting and dealing in derivatives). In contrast, second-tier, nontraditional banking organizations (i.e. LCFIs) could engage in capital market activities, but they would be required to operate their banking subsidiaries as narrow banks. Narrow banks would not be allowed to make loans or other funds transfers to their holding company affiliates (except for lawful dividends) and therefore could not transfer the benefits of their deposit insurance subsidy to affiliates engaged in capital markets activities. Wilmarth argued that both types of banking organizations should be prohibited from making private-equity investments.

In addition to the broad structural changes discussed above, Wilmarth contended that Congress should adopt numerous other regulatory measures in order to control systemic risk and shrink/eliminate TBTF subsidies. He argued that the reforms must include a systemic risk supervisor with authority to establish specific capital requirements for LCFIs. In addition, Wilmarth emphasized the need for a systemic risk insurance fund paid for by LCFIs. Versions of both measures exist in the pending legislation, but Wilmarth cautioned that they each need to be strengthened from their current forms if they are to prevent excessive risk-taking.

Wilmarth concluded his presentation by emphasizing that the focus of the pending legislation should be to force LCFIs to internalize their risks, and to prove that they can provide excellent customer service and investor returns without relying on TBTF subsidies. He suggested that large financial conglomerates might be forced to break up voluntarily (as industrial conglomerates did during the 1980s and 1990s) if they could no longer exploit federal safety net subsidies to boost their earnings.

CREDIT CARD INTERCHANGE FEES AS A PUBLIC UTILITY

Henry Polmer, of the Law Offices of Henry M. Polmer, examined the propriety of regulating card interchange fees as a public utility. Polmer argued that, because credit cards provide an important function to society, but the duopolistic interchange fees of Visa and MasterCard have become too pervasive to correct through other means, the government should regulate credit card and debit card interchange fees as a public utility.

Polmer briefly outlined the problem of credit and debit card interchange fees in the U.S. Visa and MasterCard collectively control over 80% of the general purpose credit and debit card markets. While these firms process the transactions, they rely on banks to issue the cards to consumers. The result is that Visa and MasterCard compete to deliver the highest returns to the card-issuing banks, rather than to offer lower prices to consumers. The card companies generate these returns by extracting a supra-competitive "interchange fee" that consumers are forced to pay to the issuing banks through merchants on all of their credit and debit card transactions. These interchange fees cost U.S. consumers in excess of $48 billion per year.

Polmer contended that interchange fees are largely what stands between the current anticompetitive credit card system and one that is procompetitive. Since Visa and MasterCard control 80% of the market, retailers are forced to accept the two cards in order to stay in business. Because both cards promise high interchange-fee-based returns to their issuing banks, those banks have little, if any, incentive to deal with smaller card companies. Thus, as Polmer illustrated, there are extremely high barriers to entry in the general credit card market, and the interchange fee itself is instrumental in blocking potential competition.

Polmer characterized Senate Majority Whip Dick Durbin's recent amendment to the pending interchange fee legislation as a promising development. Durbin's amendment seeks to reduce interchange fees on debit card transactions by giving the Federal Reserve the authority to regulate the fees by requiring that they be "reasonable and proportionate" to processing costs. The amendment would also strike from Visa and MasterCard contracts provisions which prevent merchants from offering discounts for less expensive forms of payment. Polmer called the Durbin amendment "a huge step in the right direction."

While the current interchange fee legislation signals progress, Polmer argued that much stronger, public-utility-type regulation is appropriate for both credit card and debit card interchange fees. Polmer explained that several historical factors in the development of the debit card made it more attractive than the credit card for Congress to address. Debit cards evolved from ATM access cards, which utilized a PIN to access the users account. Banks simply transferred the PIN system to point-of-sale debit card transactions, at very little cost. Debit cards essentially function as "plastic checks." There are no interchange fees for checks, and, initially, there were no fees for debit transactions either. Polmer theorized that, because of the debit card's history, Congress perceives it as providing safer grounds than the credit card for rate-regulation. Contrary to the approach taken by Congress in the pending legislation, Polmer argued that rate-regulation is every bit as appropriate for credit cards as it is for debit cards.

Polmer asserted that the experiences of the approximately 30 countries abroad that have challenged interchange fees set by MasterCard and Visa stand as proof that such regulations are necessary, and that they benefit consumers. He highlighted the rate-regulations in Australia and New Zealand, and the proceedings against Visa and MasterCard in the European Commission ("EC") as notable examples of effective interchange fee regulation abroad.

In 2003, the Reserve Bank of Australia ("RBA") cut the credit card interchange rate in half (.95% to .50%). Five years later, the RBA estimated that the rate-cut had saved Australian consumers approximately $1.1 billion (US $1 billion) in 2007. In 2006, New Zealand's trade regulatory body ruled that Visa and MasterCard (collectively representing approx. 90% of credit card billing in NZ) were engaged in collusive activities and price fixing. This ruling led to a settlement in 2009, which instituted numerous measures to effectively lower the rate of interchange fees. There, the chair of the regulatory commission publicly stated that the settlement is expected to reduce the overall costs to consumers by cutting interchange fees and facilitating merchant steering towards less expensive payment methods. Lastly, in 2007, the EC ruled that MasterCard's interchange fee practices were a violation of its antitrust laws, and ordered the firm to eliminate its cross-border interchange fees. (Similar proceedings were brought against Visa in 2008). Pending appeal, MasterCard agreed to reduce the rate at issue by about half (from .7% to .3%). Polmer noted that the rate found unacceptable by the EC was about a third of what the rates are in the U.S., and the U.S. rate is 6 times higher than what Europeans will now be paying.

Polmer concluded that the Durbin amendment signals a willingness in Congress to begin viewing debit card interchange fees as a public utility. He stressed that this view must be extended to credit card interchange fees. Lastly, he argued that the U.S. should draw from the experiences of Australia, New Zealand, and the EC in their successful application of antitrust law and competition policy to protect their consumers against excessive, duopoly-imposed interchange fees.