Bauerle's Bank Notes

Summoning the Future: Part 2

January 31, 2017

Our son Philip recently forwarded a table showing the 10 year change in market capitalization of major U.S. retailers. Sears and Penney's are down 95% and 83% respectively. Also down but not by as much are Nordstrom, Macy's, Target, Kohl's and Best Buy. Gainers are Wal-Mart, up 2%, and Amazon, up 1,900%. The trend is news to nobody; but its magnitude is striking.

"The typical online retailer generates $1,267,000 in sales per employee versus $279,000 at bricks-and-mortar stores. Along with making online retailers much more efficient, that difference also helps explain why Amazon is a stock market darling while Macy's and J.C. Penney are laggards," reports the New York Times.[i]

As intermediaries of money instead of goods, banks face the same challenge as traditional dry goods retailers. But a safe and sound financial system is more essential to the nation's economy than the market for dry goods. So the challenge is to encourage financial system innovation while assuring safety and soundness.

The OCC's December proposal to grant limited purpose national bank charters to fintech startups is, in our opinion, wide of the mark. A national bank charter is of marginal value to fintech companies as long as they can otherwise access the financial system to carry out their business plans. Needed instead are regulatory initiatives that condition access to the financial system on safe and sound business practices and that require fintech companies to pay their fair share of system infrastructure costs, particularly those needed to fund infrastructure improvements.

The case of The Fourth Corner Credit Union illustrates the value of controlling access. After Colorado legalized marijuana, banks there refused to accept deposits from growers and distributors. So sponsors got the state to charter The Fourth Corner CU. The credit union then sought a master account from the Federal Reserve Bank of Kansas City in order to transfer funds to and from other financial institutions. The FRB denied the request and a federal judge refused to compel issuance of the master account. He reasoned that he took an oath to uphold federal law, which continues to say growing or selling marijuana is illegal.[ii] Consequently, The Fourth Corner Credit Union's website says, "Not Currently

Open for Business." To which should be appended, "and may never be."

The legal foundation for controlling access to the financial system already exists. The Gramm Leach Bliley Act gave the Fed power to regulate businesses that are "financial in nature." The statute and its legislative history call for "functional regulation". Under this rubric, regulators are to concentrate not on the type of charter an enterprise has (national bank, state bank, state savings bank, mutual savings bank, federal credit union, state credit union, industrial loan corporation, building and loan society, business corporation, broker-dealer, and so forth), but on what an enterprise does and how it does it. In other words, if it walks like a duck, swims like a duck and quacks like a duck, it is a duck.

In the nearly two decades since GLB became law, regulators have done little to extend their franchise accordingly. The time to do so is now. Preventing fintech-originated financial crashes requires three actions.

1. Control Access. Regulators' must define their jurisdiction based on GLB to encompass businesses that access the financial system. Without access, no fintech business can function, as The Fourth Corner CU's stillborn existence proves. Ample precedent exists. In the 2008 crisis, to prevent national economic collapse, federal authorities overnight granted bank holding company status to General Electric and other non-bank financial companies so they could take loans from the Fed and remain solvent. In a different context, use of telephones or the postal service has been the basis on which federal criminal law has been extended to bring crooks of many kinds to justice.

2. Evaluate and Publicize Capital Adequacy, Asset Quality and Liquidity. Equity analysts say Amazon and Wal-Mart are logistics companies more than retailers. Wal-Mart famously sells some consumer electronics at cost, but makes money by moving inventory so quickly that the company has 30 or more days' use of the buyer's money before Wal-Mart pays its vendors. Fintech companies like LendingClub mimic the "get it sold before you buy it" business model, as did mortgage originators like Countrywide pre-2008. E-commerce makes that possible on a large scale.

   Capital and liquidity shortfalls are existential threats to banks and non-bank financial companies to a greater degree than for dry goods merchants. The Dodd Frank Act focused on "systemically important financial institutions" such as JP Morgan and General Electric. As the fintech economy matures, a crisis at PayPal, which moved $83 billion through the banking system in 2016 Q3, could be just as crippling. Ditto for online lending platforms like LendingClub, which sell loans they originate to banks as well as hedge funds.

   Also unlike dry goods merchants whose vendors can and do recall defective products, or banks for that matter, fintech companies that originate loans set their own standards for loan quality. Post mortems on LendingClub's fall from grace have revealed corners cut. Insiders took out loans to make the company's business look more successful, altered dates on loan documents in an effort to make the debts fit within purchase criteria of secondary market loan buyers, and made multiple small loans to borrowers to make the debts appear less risky than if they were single, larger loans.[iii] Of the insider loan gambit, one of LendingClub's first round venture capitalist investors said, "you have to do lots of unnatural things to make sure transactions take place on the platform. You have to juice it."[iv]

3. Distribute Costs of Required Infrastructure Investment.As the backbone of electronic financial services, the Internet is now middle-aged and needs large scale capital investment to preserve functionality and assure transactions are executed securely and reliably. Congress has made the banking industry its whipping boy for many previous financial system improvement projects, including anti-terrorist financing initiatives, Dodd-Frank's strictures to reduce systemic risk, and policing lending practices involving high cost consumer loans. A wider net needs to be cast and costs distributed more equitably.

A prototype is the Telecommunications Act of 1996, which recast for the Internet Age many of the features of the Communications Act of 1934. In particular, the 1996 law created the Universal Service Fund, codifying the decades' old practice of having all consumers share the burden of extending telephone service to rural and other high-cost service areas.
The act also set out immediate priorities of universal service. These include quality and reasonably priced services, access to advanced telecommunication services, access for rural, low-income and high-cost regions, equitable and nondiscriminatory service, specific and predictable price structure, access of advanced telecommunication services for schools and health care and libraries (Sec. 254(b)(1)-(7)). The act provided ability in the constantly changing telecommunication environment to periodically revisit and adjust universal service, while setting core principles (Sec. 254(c)). The 1996 act also "mandated the creation of the universal service fund (USF) into which all telecommunications providers are required to contribute a percentage of their interstate and international end-user telecommunications revenues."[v]

Exactly how financial companies (including banks) and consumers share the costs of needed infrastructure is for others to determine. Our argument is all financial companies should be part of the solution, not the problem. The touchstone, again, should be the franchise the Gramm Leach Bliley Act granted to the Fed to regulate companies whose business is "financial in nature."

The Bloomberg article about LendingClub quoted above begins, "The San Francisco-based marketplace lender is either the most important company in the booming financial technology sector or, if its many critics are to be believed, a Silicon Valley-tinged credit crisis waiting to happen." Unregulated, e-commerce lending marketplaces are likely the latter. With appropriate but not overbearing regulation, the same marketplaces (and banks that adapt their businesses to today's realities) can have long, prosperous roles in the vanguard of the financial industry now being born again.

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[i] https://www.nytimes.com/2017/01/12/business/economy/amazon-jobs-retail.html?_r=0

[ii] http://www.post-gazette.com/opinion/2016/09/30/Medical-marijuana-sellers-in-Pennsylvania-will-have-to-deal-in-cash-for-now/stories/201609300151.

[iii] https://www.bloomberg.com/news/features/2016-08-18/how-lending-club-s-biggest-fanboy-uncovered-shady-loans

[iv] Id.

[v]   https://en.wikipedia.org/wiki/Universal_Service_Fund