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GROVER: Ignoring the disease, treating the symptom

Bills let Fannie and Freddie walk while big banks get collared

By Eric Grover

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House Financial Services Committee Chairman Barney Frank's 1,706-page Wall Street Reform and Consumer Protection Act and Senate Banking Committee Chairman Christopher J. Dodd's 1,616-page Restoring American Financial Stability Act have been promoted as reform vital to preventing another financial crisis. In fact, neither bill addresses the root causes of the housing bubble, mortgage crash and consequent American and global financial crisis. Neither bill, notwithstanding its establishment of a much-ballyhooed Consumer Financial Protection Agency, would enhance consumer choice or welfare.

A conference committee is trying to meld the two massive bills, which most congressmen who voted for them didn't read.

Mr. Dodd, Mr. Frank and President Obama decry a lack of regulation as the problem, yet hedge funds were relatively unregulated and not at the heart of the crisis. Banks - the most heavily regulated institutions - were.

Lack of credit-default-swap regulation and transparency is cited as an issue, but absent the extraordinary deterioration in the underlying mortgage assets, that wouldn't have been a problem. Mortgage charge-offs increased a whopping 3,650 percent from the second quarter of 2006 through the second quarter of 2009.

The primary cause of the financial crisis was former Federal Reserve Chairman Alan Greenspan supplying easy credit, fueling an explosion in cheap and easy mortgage availability and the housing bubble. The price of money matters enormously. It expresses time preferences, rationing current and future consumption. Artificially low interest rates cause bad investment, overconsumption and capital consumption. Fed funds rates

were negative from 2001 through the first half of 2005. Mr. Dodd's and Mr. Frank's putative reform would do nothing to rein in the Fed.

"Maestro" Greenspan's mispricing of credit was not the sole problem. The politicization of credit and government systematically weakening credit underwriting criteria spurred demand, risky mortgages and housing inflation. The Community Reinvestment Act was used to cudgel banks into making loans to politically favored borrowers that wouldn't have been made on their economic merits. And every year, Washington mandarins ratcheted up demands that government-sponsored enterprises Fannie Mae and Freddie Mac gut credit standards to increase homeownership.

In 2004, Mr. Frank dismissed suggestions that a credit problem was brewing in Fannie and Freddie, instead worrying that they weren't being aggressive enough. The Department of Housing and Urban Development instructed Fannie and Freddie that 45 percent of homebuyers whose mortgages they purchased between 2005 and 2008 should be of "low and moderate income," 32 percent come from "central cities, rural areas and other underserved areas," and 22 percent be "very low-income families or families living in low-income neighborhoods." Fannie and Freddie aggressively bought and guaranteed mortgages they wouldn't have if they had been private-sector enterprises free to fail. The American Enterprise Institute's Peter Wallison notes that almost two-thirds of bad mortgages in the system were bought by government agencies or required by regulation.

Consumer credit is more politicized now than ever. Since 2008, Fannie and Freddie have operated as government conservatorships, sucking up taxpayer dollars to buy, guarantee and prop up shaky mortgages. Serious reform would break up and privatize them, letting the resultant pieces sink or swim in the market.

Much ado has been made about Goliath financial institutions too big to fail. It's not clear, however, that a normal bankruptcy process couldn't unwind a behemoth such as Citi. That said, the market and bank management think Washington will treat the failure of any of the top 10 financial institutions as posing a systemic risk to the financial system, and act accordingly.

A corporatist regime reigns where the chief executive officers of America's largest banks' primary masters are Timothy F. Geithner, Ben S. Bernanke and Mr. Obama, rather than their customers and shareholders. That Bank

of America's Brian T. Moynihan decided that spending five of his first 13 days as chief executive in Washington was the best way of defending his shareholders was telling, and troubling.

As Bank of England governor Mervyn King noted, if a bank is too big to fail, it's too big. Better for gargantuan financial institutions to be broken up into pieces - each striving to prosper but permitted to fail - rather than operating as politicized wards of the state. The market is a relentless and ruthless regulator. Businesses that don't use their resources efficiently to satisfy and even delight consumers or that take improvident risks with their shareholders' and creditors' capital, go under, deservedly.

Messrs. Dodd, Frank and Obama should spell out what is too big to fail and why. Any serious legislation to reduce the risk of another financial crisis should break up institutions above the threshold.

The financial system regulatory overhaul also would establish a Consumer Financial Protection Agency to lord over consumer credit, stifling innovation and consumer choice. Five commissars would be drawn from the rainbow of anti-market and anti-consumer-sovereignty activist groups. The agency would tax industry and dictate products' structure - how they're sold and what practices are "fair." Financial institutions would have to limit what could be offered to consumers based on an assessment of their sophistication. It would mean in a world in which Americans can vote, join the Army and serve on a jury, they can't be trusted to pick a credit card.

At the 11th hour, Senate Majority Whip Richard J. Durbin added an amendment to regulate punitively card payment networks such as MasterCard and Visa in Mr. Dodd's bill - an amendment extraneous to Wall Street reform. It would impose price controls on debit and prepay card acceptance fees, including interchange fees, which payment networks use to balance participation of card issuance and acceptance, and network fees paid by merchants. They would be capped close to actual incurred incremental processing costs, which arguably are near zero. Mr. Durbin's harsh regulatory regime is worse than the traditional public utility model under which, generally, development and operating costs can be recovered.

It would, however, exempt thousands of financial institutions with less than $10 billion in assets, not because fees associated with their cards are

intrinsically fairer, but because community banks receive political sympathy from both sides of the aisle, whereas behemoths such as Bank of America and Chase are politically toxic, and MasterCard and Visa aren't viewed as worthy of political sympathy.

Interchange fees Mr. Durbin wants to eliminate are the primary revenue source for debit and many prepay cards. Card providers would simply increase cardholder fees and cut benefits to offset lost revenue. Debit and prepay card availability would be reduced. It's unlikely the 80 percent of Americans with debit cards would view this as pro-consumer.

The interchange funds are a fount of prepay-card innovation, helping governments and businesses reduce costs and better manage payments, and bringing safe and convenient electronic payments to millions of those not served and underserved by banks. States distribute benefits on interchange-funded prepay cards instead of checks. Mr. Durbin would destroy their viability. He would eliminate reloadable cards used by millions. Will consumers forced back to using check-cashing services and cash view Mr. Durbin's price controls as pro-consumer?

Networks would be punished. Fees MasterCard and Visa charge firms providing retailer card acceptance would, by diktat, be slashed 95 percent or more for purchases on large banks' debit and prepay cards.

Notwithstanding Visa's difficult-to-credit statement to the contrary, the networks would have to adopt a two-tier pricing system, with market share, network economics and innovation migrating to the least regulated domain - small financial institutions, which could offer free debit cards with rewards and a full range of viable prepay products.

Mr. Durbin's price-control amendment is a poisoned chalice for consumers, governments and merchants.

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