LETTER TO THE EDITOR

FDIC Should Target Troubled Banks, Not Largest Ones

To the Editor:

An Oct. 6, 2006, article, "A Contrarian on Premiums Cites Cost of a Big Failure" [page 1], reported a concern of KeyCorp's Ashish Dev — the absence of "loss given default" in the FDIC's proposed risk-based deposit-insurance premium system.

Mr. Dev worries about a big loss to the FDIC arising from the failure of a large bank and suggests that, accordingly, large banks should be charged an additional premium. Mr. Dev's proposal is faulty for three reasons.

First, in today's banking world, large banks and thrifts (those over $10 billion of assets) are highly unlikely to fail overnight due to a sudden event, such as a massive fraud; the Barings failure in 1995 was very much an exception. Instead, large banks sink slowly and very visibly, accompanied by a declining stock price.

A large, troubled bank will be forced into a turnaround or sale long before it becomes insolvent. PNC's acquisition of Riggs in 2005 illustrates a marketplace resolution of a troubled bank without any cost to the FDIC.

Second, domestic deposits have a liquidation preference over a bank's other unsecured liabilities, including deposits in foreign offices. Consequently, domestic deposits are protected from loss by unsecured, nondomestic-deposit liabilities as well as by a bank's equity capital and subordinated debt. That is, nondomestic-depositor creditors (including foreign depositors) must be wiped out, along with stockholders and owners of a bank's subordinated debt, before the first dollar of loss reaches domestic deposits.

Any insolvency loss reaching that high in the preference ladder is shared proportionally by uninsured domestic depositors and the FDIC.

As of June 30, 2006, total domestic deposits of the 128 banks and thrifts with assets exceeding $10 billion equaled just 73.4% of their tangible assets (which exclude goodwill and other intangibles). These banks had approximately $4 of tangible assets for every $3 of domestic deposits. This loss-absorbing cushion was double the rest of the banking industry, which had $8 of tangible assets for every $7 of domestic deposits.

Almost 87% of domestic deposits in the 128 largest banks and thrifts were in institutions where these deposits were less than 90% of tangible assets. For the rest of the industry, that was true for only half their domestic deposits.

Third, if the "systemic risk" exception is invoked, which protects all of a bank's creditors against a loss, the FDIC's loss must be assessed, after the fact, on every bank and thrift. Therefore, it would be pointless for the FDIC to collect a premium in advance of any such situation.

In sum, instead of targeting large banks as a special problem, the FDIC should collect the bulk of its premiums from the most troubled banks, banking's drunk drivers, so they have an incentive to turn themselves around or sell to a stronger bank.

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Editor's Note: The author has consulted on deposit insurance-related issues for trade associations and individual companies, but the views expressed above are his own.

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Lessons Visa Can Learn From MasterCard's IPO

ERIC GROVER

As Visa prepares for an IPO, it will benefit enormously from the fact that its global payments cousin paved the way.

Investors now are better informed about payments networks, and MasterCard provides an almost perfect valuation benchmark. When it went public in May, there were no comparables remotely as good.

Visa also can improve upon MasterCard's experience, particularly in dealing with legal liability and corporate governance, aligning the interests of managers and owners, presenting a cohesive global story, and differentiating its strategy from MasterCard's.

The principal motivation for Visa's IPO, as with MasterCard's, is to reduce U.S. legal liability. For MasterCard investors, potential liability for the interchange and American Express/Discover suits was a huge uncertainty suppressing valuation, thereby hurting shareholder banks.

However, the ultimate damages from both suits are likely to be relatively modest. While the arguments by merchants, Amex, and Discover that Visa engaged in illegal conduct are strong, establishing that they were materially harmed will be more difficult.

U.S. antitrust law is market-oriented. In the interchange suit, merchants must make a persuasive case that interchange was higher than it otherwise would have been from January 2004 through the IPO. Looking to U.S. market benchmarks, Amex's interchange is higher, and Discover's is lower but rising. Moreover, MasterCard has ample incentive to increase interchange — to spur additional issuance and use — despite the PR firestorm that would attend such a move.

Interchange is critical to the MasterCard and Visa business models, but U.S. banks were the direct beneficiaries of those policies. Therefore, it is hard to imagine they would not bear the lion's share of any settlement or judgment.

Framing potential damages in the Amex/Discover suit is more straightforward. Judge Barbara Jones ruled that prohibiting U.S. member banks from issuing Amex and Discover products was illegal. The current suit, being tried by Judge Jones, will almost certainly focus on the extent of harm to Discover and Amex.

Discover must convince the court that without the prohibition, banks would have issued and promoted its product: a less profitable product for them than Visa's, and a product offering lower interchange rates, lower spending, and weaker acceptance. It's that black and white.

Amex's argument is stronger. It offered banks higher interchange but competes directly with them, and the cards it issues through banks are less profitable than those it issues directly. New issuers such as Bank of America — which is issuing the cards in part in exchange for Amex's dropping its suit — have customers with Amex-issued cards. If they cannibalize one Amex cardholder for every six cards they issue, Amex at best breaks even. If they cannibalize cards that revolve, Amex's sacrifice is appreciably worse.

In any event, Morgan Stanley's Ken Posner contends, rightly, that none of the parties will be keen to reveal their economics in a public trial, suggesting they will be highly disposed to settle.

Establishing good, clean governance is another area where Visa can do better than MasterCard.

As part of its IPO, MasterCard established a charitable foundation that holds 17% of its voting shares and will be subsidized by MasterCard, keeping the foundation beholden to the management. The foundation insulates the management from independent shareholder influence.

Though the managers should be applauded for donations they charge to their personal cards, MasterCard's charitable contributions are after-tax funds, not pretax spending on developing products, customers, or processing business.

Visa should set up no devices or special shareholder categories to shield itself from its owners.

It is axiomatic that a company's managers and investment bankers should try to maximize value for the owners in an IPO, but MasterCard's management received options with a strike price set at the IPO price of $39 a share. This created a conflict of interest.

In the four months since the IPO its stock price increased 80% with no change in fundamentals, testifying the opportunity was undersold. Though pricing an IPO is not an exact science, more than $4 billion that could have been realized by banks and MasterCard was not. Its managers, however, benefited.

Any options issued to Visa's management should be priced independent of the IPO.

For payments networks, a coherent worldwide story is more compelling than a regional one. Visa has a hurdle. European bankers are less favorably disposed to markets than American ones, and there is at least a whiff of anti-Americanism in persistent comments that MasterCard and Visa are American, with the implication that somehow the interests of European consumers and merchants are ill served.

MasterCard left its European business under bank control. Likewise, Visa could not get its European banks wholeheartedly on board for an IPO. Its E.U. business has become increasingly autonomous. Visa's management needs to stanch the increasing regional division within its federation. It would benefit from more cohesion, not less.

Visa's IPO story would have been decidedly stronger if Europe were included and if banks there became customers with no special privileges.

Outside Europe, the clean break from bank control will help Visa fend off increasingly aggressive efforts by regulatory mandarins to treat it like a public utility.

Historically, MasterCard and Visa were mirror images of each other. Visa should spell out if and how it plans to differentiate its interchange strategy, the markets and business it intends to cultivate, and the information-based services enhancing its customers' profitability.

Lastly, Visa's managers should address forthrightly how they plan to transform it from an association to a company with a vigorously commercial culture.

By taking lessons from its cousin's IPO, Visa should be able to command a substantially higher valuation.

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