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The Vitter Amendment Breaches the Banking/Commerce Barrier

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It’s no surprise that financial reform is being resisted by the financial system. Many firms - especially the largest - want things to remain as they are. Change brings uncertainty. But their resistance also reflects failure to acknowledge how the practices under scrutiny by Congress and the Financial Crisis Inquiry Commission brought on the Great Recession that devastated households’ jobs and savings, the economy as a whole and the fiscal position of the US government. It should also come as no surprise that, as the reform effort opens up the statutes governing financial activities, there will be opportunities to slip in provisions that would not only weaken that effort but even bring about the opposite outcome: further, dangerous deregulation.

Both kinds of efforts have been underway since the House and Senate bills were introduced. For example, the large investment banks that found it necessary to become bank holding companies are trying to weaken the constraints in the BHC Act. While their bank-like activities required - and will continue to require - the liquidity support that only the Fed can give, they view limits on interactions between different lines of business a hindrance to their customary free-wheeling amalgamation of activities and the opportunities for conflicts of interest (and profits) it provides.

But while the surviving large investment banks and the commercial banks that acquired their failing competitors are pushing back at reform efforts in order to preserve this sector’s less-regulated status, other large institutions have found champions for new efforts to break down regulatory barriers. There can be no doubt that the American people want financial reform and it would be a terrible irony and betrayal of their expectations if adoption of the Vitter amendment succeeds in removing one of the most critical elements in US financial structure: the prohibition against mixing banking and commerce. While the sustained effort to erode the Glass-Steagall barrier between commercial and investment banking culminated in the Gramm-Leach-Bliley Act of 1999, the Bank Holding Company Act of 1956 and the Amendments of 1970 have been reasonably successful in keeping banks from owning businesses and businesses from owning banks.

Now, however, the Vitter amendment would break down the 1970 restrictions which, as President Nixon noted at the time, protected the US system from the anti-market practices inherent in Japan’s "zaibatsu" style banking structure. Its provisions would allow non-financial companies to have bank-like finance affiliates as long as finance is
not the "predominant" activity of the overall company. But the definition of "predominant" allows 85 percent of the firm's total revenue to come from its financial activities.

The great majority of US businesses do not need the Vitter loophole. The major oil companies make only a tiny fraction of their income from interest and fees on credit cards issued to customers to buy fuel. Most manufacturers and retailers provide credit to customers to buy the goods they make or sell, earn only a small amount from their credit facilities and do not compete with banks in offering credit for purposes unrelated to their primary business.

But there are notable exceptions. General Motors Acceptance Corporation (GMAC) for example, was one of the largest mortgage lenders before the crisis and received $12.5 billion in TARP capital even though its parent company, General Motors, was not "predominantly" engaged in financial activities. GE Capital is another, even more egregious example. With $620 billion in assets at year-end 2007, its lending activities were larger than those of all but the biggest banks. But, as a non-depository institution, the scale of the short-term borrowing it needed to support those assets made it the largest US issuer of commercial paper. Like GMAC, its lending was not confined to facilitating the sale of its parent company's products. It bought a sub-prime mortgage lender, WMC Mortgage, and competes with banks in lending to unrelated businesses. As the crisis unfolded and the commercial paper market froze up, questions about GE Capital's balance sheet intensified its problems. Regulators' assessment of the threat it posed to the system led to its becoming the second largest beneficiary of the FDIC's unprecedented debt guarantee program.

These shadow banks operated without oversight and the cost to the economy was enormous. The Vitter amendment perpetuates this regime, potentially providing a loophole for entities like GE Capital and GMAC that would allow them to operate without the regulatory oversight needed to prevent a repetition of the systemic threat these companies posed in 2008. Equally alarming is the possibility - nay, the probability - that other versions of GE Capital and GMAC will emerge to threaten the system.

Under these provisions, a large commercial company could form a non-bank holding company by buying or expanding an existing finance affiliate that could reach a size comparable to - or even larger than - all but the biggest bank holding companies. Another possibility is that a big non-bank financial company could escape its existing regulatory yoke by buying a small non-financial company - a chain of health clubs, for example, or a manufacturer of sports equipment - that would account for at least 15 percent of its total revenue. In either case, the lending activities of the finance arm would be supported by borrowing short-term liabilities eligible for purchase by money market funds - a major funding source for the shadow banking system - and would perpetuate the potential for the kind of systemic disruption that was at the center of the 2008 crisis.

The Vitter amendment must be defeated. Replacing "substantially" with "predominantly" to define the level of financial activity permitted for non-financial firms may seem like no more than a relatively small change in wording. In reality, it is a change that threatens to erase those structural elements that have ensured a fair, open and competitive US financial system - one that accommodates the needs of all borrowers, depositors and investors rather than those of large financial and non-financial corporations.