

A REQUIEM FOR SAM'S BANK

RONALD J. MANN*

INTRODUCTION

Wal-Mart's application to form a bank ignited controversy among disparate groups, ranging from union backers to realtor's groups to charitable organizations.¹ The dominant voice, though, was that of independent bankers complaining that the big-box retailer would drive them out of business. Wal-Mart denied any interest in competing with local banks by opening branches,² claiming that it was interested only in payments processing. Distrusting Wal-Mart, the independent bankers urged the FDIC to deny Wal-Mart's request and lobbied state and federal lawmakers to block Wal-Mart's plans through legislation. Ultimately, Wal-Mart withdrew its application, concluding that it stood little chance of overcoming the opposition.

The controversy dovetails with a banking regulatory concern about the existing system for supervising commercial firms that own non-traditional banks. Wal-Mart sought to form an industrial loan company ("ILC") under Utah law,³ which it could do only if the FDIC approved its application for deposit insurance.⁴ Under what many regard as a loophole in the existing

* Professor of Law, Columbia Law School. I am grateful for input from presentations at the law schools at the University of Michigan and Columbia, at the Payment Cards Center at the Federal Reserve Bank of Philadelphia, and at the Conference on Rethinking Payment Law at the Federal Reserve Bank of New York.

1. The FDIC received thousands of comments in response to Wal-Mart's application for deposit insurance and held the first formal public hearings ever on such an application. Wal-Mart's application as well as the public comments, written statements and hearing transcripts are available at <http://www.fdic.gov/regulations/laws/walmart/index.html>.

2. A number of states nevertheless reacted by introducing bills to ban out-of-state industrial banks from opening bank branches in their states, several of which appear to violate the Riegle Neal Act, 12 U.S.C. §§ 36(g), 1828(d)(4). See Letter from Julie Williams, Chief Counsel, OCC, et al., to John "Buz" Gorman, General Counsel, Conference of State Bank Supervisors (July 28, 2006).

3. Utah Code Ann. § 7-8-3. Industrial loan companies were created a century ago to make loans to workers but they have evolved in recent years as they gained limited powers to accept deposits and make loans.

4. Without regard to any intent to accept deposits, Wal-Mart would need deposit insurance to satisfy both its stated business objectives and the requirements of Utah law. Wal-Mart did plan to offer certificates of deposit to charitable organizations and individual investors generated through deposit brokers, but not demand deposits. See Application, *supra* note 1.

statutory framework,⁵ Wal-Mart's regulator would have been the FDIC, and Wal-Mart's primary responsibility to this entity would have been to refrain from plundering its assets.⁶ By contrast, entities that own traditional banks ("bank holding companies" or "financial holding companies") are subject to oversight by the Federal Reserve and to various "prompt corrective action" rules that obligate the parent in times of distress to provide aid to the banking subsidiary. In some cases the Federal Reserve can force divestiture.⁷

Despite Wal-Mart's ability to provide more than adequate capital for an ILC, the FDIC responded first by freezing all deposit insurance applications submitted from proposed ILCs first for six months (through Jan. 2007), and then by freezing applications filed by non-financial entities for another year (through Jan. 2008).⁸ The FDIC explained that it needed more time to examine the impact of ILCs on the banking system.⁹ Federal regulators are concerned about the ILC structure because the number and size of the entities using the ILC loophole has mushroomed in the last few years.¹⁰ Absent some action, the owners of an increasingly significant share of institutions will become largely unsupervised.

At the same time, financial holding companies and thrift holding companies (entities like CitiGroup and Merrill Lynch that own both deposit institutions and other financial services companies) believe that Wal-Mart's

5. The loophole appears in Section 101 of the Competitive Equality Banking Act of 1987 (CEBA), which defined "bank" for purposes of the Bank Holding Company Act to exclude qualifying ILCs, credit card banks (as defined in CEBA), and certain then-existing "nonbank" banks. Because this entity would not be a "bank" for purposes of that statute, Wal-Mart could own it without being a bank holding company. Among other things, the exemption requires the ILC to obtain deposit insurance from the FDIC. 12 U.S.C. § 1841(c)(2)(H). The statute also requires that the entity satisfy one of the three following conditions: that it have not changed control since 1987, that it have less than \$100 million in assets, or that it not accept demand deposits. Utah law uses the term "industrial bank" to refer in Utah Code Ann. § 7-8-3 to the Utah entity that qualifies for the federal ILC exception in Section 1841(c)(2)(H). To make matters confusing, Utah also recognizes a separate type of entity called an "industrial loan company" (under Utah Code Ann. § 7-8-21), which does not qualify for the federal ILC exception. Rather, that entity avoids bank status entirely under 12 U.S.C. § 1841(c)(1)(B) because it is not qualified to accept deposits. For simplicity, the text uses the common term "ILC" to refer to the Utah industrial bank.

6. Federal Reserve Act §§ 23A, 23B, 12 U.S.C. §§ 371c, 371c-1.

7. See 12 U.S.C. §§ 1843 (notice obligations), 1844 (reporting obligations), 1831o (capital requirements); 12 CFR Part 325 (prompt corrective action rules).

8. For analysis of what the "non-financial" limitation means in this context, see Federal Reserve System, Order Determining That Certain Activities Are Complementary to the Financial Activity of Underwriting and Selling Health Insurance (Sept. 7, 2007).

9. See FDIC Press Release PR73-2006 (July 28, 2006) (announcing a 6-month moratorium on ILC applications); FDIC Press Release PR7-2007 (Jan. 31, 2007) (12-month extension of the moratorium).

10. The assets of ILCs have grown from \$4 billion in 1987 to \$140 billion as of 2005. U.S. Government Accountability Office, GAO-05-621, *Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority* (2005).

ability to avoid intrusive oversight and supervision would give it an unfair competitive advantage. Wal-Mart's response is that the loophole has been around for decades, and that there is no difference between Wal-Mart using this loophole and companies like GM, BMW and General Electric that do the same.¹¹ Most pointedly, why should Target, a prominent competitor, have access to this loophole while Wal-Mart does not?¹² Given the large share of Target's corporate profits derived from its ILC and its credit card bank,¹³ Wal-Mart's question is a fair one.¹⁴

This article situates those debates in the context of payments policy. Stepping away from banking policy per se, Wal-Mart's plans should be viewed in the historical context of the overlapping shifts in payment systems that are happening in this country: from older payment systems (cash and checks) that are public, paper-based, and universal, to newer systems (predominantly credit and debit cards) that are private, electronic, and networked.¹⁵ Thus, in 2004, for the first time, the value of retail purchases made with credit and debit cards exceeded the value of retail purchases made with checks.¹⁶

At the turn of this century, a new era of payments is beginning. Despite the obvious benefits payment cards have brought to our

11. The prominent ILCs of non-financial entities have remarkably different missions. BMW uses an ILC to issue a consumer credit card. Target and Volvo use ILCs to issue payment and credit cards for businesses. General Motors uses its industrial bank to provide car financing. GE's ILC is a diversified multinational financing entity. Most interesting of all, Volkswagen's industrial bank specializes in home equity lending.

12. Target uses its Utah ILC to issue its business credit card. It also has a CEBA credit card bank (under 12 U.S.C. § 1841(c)(2)(F)) for its consumer credit card operations.

13. About one quarter of Target's 2005 earnings (\$573 million out of \$2.4 billion) came from its credit card operations. Target 2005 10K at 24.

14. I note for the sake of completeness three similar organizational forms that would not suit Wal-Mart's purposes: a nonbank bank, a CEBA credit-card bank, and a Utah industrial loan company under Utah Code Ann. § 7-8-21. Wal-Mart cannot form a nonbank bank because the loophole for those entities was closed in 1987 – entities holding those banks are exempt from BHC status only if they controlled the bank before 1987 and if the entity refrains both from making commercial loans and from accepting demand deposits. The Federal Reserve previously had tried to treat the parents of those entities as BHCs under Regulation Y, but the Supreme Court overturned the applicable regulation in *Board of Governors v. Dimension Financial Corp.*, 474 U.S. 361 (1986). A CEBA credit-card bank (authorized by 12 U.S.C. § 1841(c)(2)(F)) might be useful for credit card operations, but would not be useful if Wal-Mart wished to engage in other activities such as electronic check processing. Finally the Utah industrial loan company under Utah Code Ann. § 7-8-21 would solve Wal-Mart's BHC problem (because the entity would not be a bank under the BHCA), but without deposit insurance it could not get an account at the Federal Reserve. 12 U.S.C. §§ 342, 461(b)(1)(A). A bank without an account at the Federal Reserve could not send or receive ACH transactions directly, a significant part of Wal-Mart's plan.

15. For a detailed discussion of those shifts, see Ronald J. Mann, *Charging Ahead: The Growth and Regulation of Payment Card Markets* ch. 1 (2006).

16. See Nilson Report Issues 761, 823.

economy,¹⁷ the maturation and market dominance¹⁸ of the private networked electronic systems operated by Visa and MasterCard has had two adverse effects. First, a diminished incentive to innovate has led to stagnation in the development of less expensive payment systems. Second, the network effects that pose a barrier to entry have allowed Visa and MasterCard to deploy strategies designed to suit the interests of the banks that control them, to the detriment of the merchants and cardholders that use and accept the cards. The last decade has seen increased recognition by merchants of the important link between payment systems and the profitability of their operations. Wal-Mart's application is but one of the steps merchants and others are taking to undercut the effective control of the payments systems that the large payment card networks have established in the last half century. Seen from that perspective, a powerful case can be made that granting Wal-Mart's application would have had a salutary effect on a market that has seen too little competition and innovation for the last two decades.

Part 2 begins by discussing the payments markets in which Sam's Bank would have participated and the likely consequence of permitting its entry into those markets. Part 3 analyzes the regulatory interests affected by the creation of Sam's Bank. Finally Part 4 discusses broader policy concerns that weigh even more directly in favor of facilitating greater entry to the payments industries. Finally, Part 5 proposes a new regulatory framework for "payment services providers," designed to facilitate the entry of parties like Wal-Mart that would bring new strength to the payments industries without engaging in activities that implicate the traditional concerns associated with regulation of depository institutions.

II. WAL-MART AND PAYMENTS POLICY

The existing debate has not seriously analyzed how Wal-Mart's stated business objectives might affect the policy decision whether to permit Wal-Mart to go forward. However much Wal-Mart might be able to operate a profitable set of retail banks from its immense network of retail locations,¹⁹

17. See Mann, *Charging Ahead*, *supra* note 15, ch. 3 (discussing cost savings from the use of cards for payment and lending transactions).

18. Although the market in which the literally thousands of potential credit card issuers compete against themselves is highly competitive, competition at the network level (with and between Visa and MasterCard) is considerably less robust. As discussed below, there are several other electronic payments networks, the PIN-based debit networks, the ACH network, and the developing Check 21 processing networks. In general, however, those networks are competing to draw volume from paper-based systems rather than competing against the credit card networks.

19. The skepticism about Wal-Mart's proposal comes in part from Wal-Mart's previous attempts to acquire banks and in part from its current forays in to retail banking in places like Mexico and

the reason Wal-Mart wanted a bank at this time was to lower the costs it incurs in collecting payments from its customers. A bank would have given Wal-Mart direct access not only to the systems for processing credit cards and debit cards, but also to the increasingly important electronic systems for check processing (automated clearinghouse or “ACH” networks).

Wal-Mart and Cost-Cutting

Wal-Mart’s desire to cut payment costs should not be surprising. Wal-Mart is famous for pressing suppliers to lower their costs – steadily, substantially, and repeatedly. But the costs of payment services for Wal-Mart – the costs it pays to process checks and the fees it pays when it accepts credit cards or debit cards – have not gone down substantially in years. On the contrary, the price of those products – which are at their core sophisticated information processing services – has remained stable as the costs of information processing have fallen. There was a time when Visa and MasterCard were leaders in the deployment of cutting-edge information technology,²⁰ but as their dominance in the marketplace has grown, the incentives to increase the efficiency of their technology have become less pressing.

To be sure, Wal-Mart has benefited in labor-cost savings and in speed of checkout as customers have shifted from slower paper-based checking systems to faster card-based payment systems.²¹ And the rise of electronic check conversion lowers Wal-Mart’s payment acceptance costs considerably, at least for the check writers that patronize its stores.²² But the charges for the increasingly mainstream credit card products offered by Visa and MasterCard remain stagnant. Thus, by comparison to the costs of the other products their customers might use to make payments, the charges

Canada. See Steve Goldstein, Wal-Mart Gets Approval to Offer Banking in Mexico, N.Y. Times, Nov. 24, 2006; Hollie Shaw & Carrie Tait, Wal-Mart Eyes Banking, National Post, Oct. 31, 2006. It also is relevant that Wal-Mart’s present plans would not bind the resulting ILC. Under applicable FDIC regulations, Wal-Mart after only a few years would have been able to broaden the scope of its operations considerably, though it would have needed the consent of the FDIC for major changes. See 12 CFR § 333.2.

20. See Dee Hock, Birth of the Chaordic Age ch. 12 (1999); Dee Hock, One from Many: VISA and the Rise of Chaordic Organization ch. 12 (2005).

21. See Elizabeth Klee, Paper or Plastic? The Effect of Time on Check and Debit Card Use at Grocery Stores (unpublished November 2004 manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=687159 (empirical analysis indicating that check transactions typically take about 30 seconds longer than payment card transactions).

22. Electronic check conversion converts a paper check at the point of sale to an ACH transaction cleared through the NACHA network (a POP entry in NACHA’s terminology). Wal-Mart has been among the market leaders in retail adoption of that technology. Stuck in a Rut, POP E-Checks Get a Boost from Bentonville, Digitaltransactions.net (Sept. 13, 2006).

that Wal-Mart pays when it accepts Visa and MasterCard products seem increasingly out of line.²³

Wal-Mart's dissatisfaction with the credit card, in particular, is exacerbated by competition with discount and dollar stores that often do not accept credit cards at all. The costs of credit card acceptance are less problematic for high-end retailers, which operate on high margins and depend on the discretionary and impulsive spending that credit cards facilitate.²⁴ Wal-Mart's traditional emphasis on low prices,²⁵ by contrast, leaves it with low margins against which a fixed payment cost that does not decline over time has become increasingly conspicuous.

Cutting the Costs of Payments

The tension between the relatively stable costs of credit card acceptance and Wal-Mart's cost-cutting philosophy has long motivated Wal-Mart to explore possible responses that would lower its costs. For example, Wal-Mart was one of the lead plaintiffs in the successful "honor all cards" litigation against Visa and MasterCard and has been a leader in facilitating non-card payment systems at its Web site. Thus, properly viewed, the application to form Sam's Bank is the latest in a continuing series of payments policy initiatives. To understand this particular initiative, it is useful to explore exactly how it would lower payment costs.

Credit Cards

The conventional explanation assumes that Wal-Mart would form an industrial loan company that would operate as an acquirer much like the ILC subsidiary of First Data Corporation (the largest acquirer in the country, with more than a 50% share of a market).²⁶ But this would not

23. Although it is difficult to generalize because precise figures are proprietary, a merchant like Wal-Mart on a \$100 transaction probably pays about \$1.80 if it accepts a credit card, \$1.00 if it accepts a Visa or MasterCard debit card, eighty cents if it accepts a check, fifty cents if it accepts a PIN-based debit card, and twenty-five cents if it performs an electronic check conversion. Honor-all-cards policies have made it difficult for merchants to limit the types of networked payment products that they accept, while surcharge restrictions have made it difficult for merchants to affect consumer choice between and among networked and universal payments. The result from the merchant's perspective is that consumers driven by advertising and rewards programs choose payment products unaffected by the high marginal cost that the merchant pays to accept those products.

24. See Mann, *Charging Ahead*, *supra* note 15, chs. 4, 12 (showing that consumers spend more when they use payment cards than when they use paper-based payment products).

25. See Wal-Mart: *The Face of Twenty-First-Century Capitalism* 52-56 (Nelson Lichtenstein ed. 2006).

26. Visa and MasterCard require all entities that participate directly in their networks (either by issuing cards or acquiring transactions) to be banks. Because ILCs qualify as banks without subjecting their parents to federal BHC regulation, nonbank processing companies like First Data have used ILCs to conduct their acquisition businesses. (First Data recently converted its Colorado ILC to a non-

lower Wal-Mart's net payment costs in any substantial amount. Let us suppose that Wal-Mart is currently paying its acquirer (Chase Paymentech, a joint venture including Chase and First Data) about 1.65% in merchant fees on its Visa and MasterCard transactions (an excellent rate for a merchant that is not a grocery store).²⁷ If we substitute Sam's Bank as the acquirer, Wal-Mart would pay that 1.65% to its subsidiary instead of to Chase Paymentech.

The problem, however, is that Sam's Bank would have to forward something in the range of 1.43% of those funds to Visa and MasterCard (the interchange share) and would have to fund its payment processing operations out of the remaining 0.22% of revenues. Because the business of acquiring credit card transactions is competitive, the spread that acquirers retain has been dropping substantially in recent years. As information technology advances, it becomes cheaper to process payments, particularly for the largest companies (First Data, Bank of America, and Nova). There is little reason to think that Sam's Bank could process its payments at a cost that would leave it with any substantial profit – indeed there is good reason to think that Sam's Bank would lose money if it undertook to process payments at the same price as Chase Paymentech. Even with Wal-Mart as a client, Sam's Bank would be a much smaller and less experienced acquirer than First Data.²⁸

If that were the whole story, then Wal-Mart in fact might lose money if it inserted its subsidiary as the acquirer. That possibility suggests that Wal-Mart's plan is more complex. Perhaps, it also includes issuing Visa or MasterCard credit cards to its customers, something Wal-Mart cannot do

industrial trust, to accommodate its pending takeover by KKR. See *First Data Gets OK to Convert Industrial Bank*, DENV. BUS. J., July 19, 2007. Originally, all acquirers were banks, but in recent years, the market has become dominated by technology companies that specialize in efficient processing. First Data Corporation now processes about half of all general-purpose credit card transactions in the United States. See Top U.S. Acquirers, Nilson Report, Issue 854, at 1, 7 (Apr. 2006). Although the market is increasingly concentrated, the market for acquisition is competitive, in the sense that a large number of acquirers compete for merchants based on the price that they charge. As of 2006, 90 acquirers processed more than \$1 million transactions per week.

27. The lowest credit card interchange rate for a non-supermarket merchant is 1.43% under the current rates for either Visa or MasterCard, available at http://usa.visa.com/download/business/accepting_visa/ops_risk_management/Interchange_Rate_Sheets.pdf and at http://www.mastercard.com/us/wce/PDF/14992_MasterCard_Interchange_Rates_and_Criteria_-_October_2006.pdf. If Wal-Mart pays 1.65% of the sales price to its acquirer and its acquirer (currently Chase Paymentech) pays 1.43% of the sales price to the issuers, the acquirer receives only 0.22% of the revenues to fund the costs of processing Wal-Mart's transactions.

28. If anything, the pending acquisition of First Data by KKR suggests the possibility of an inflow of capital likely to increase the aggressiveness of First Data's operations. See Joe Bel Bruno, *KKR Continues Talks for First Data Loans*, FORBES, Sept. 10, 2007 (discussing difficulties KKR faces in obtaining financing for its acquisition of First Data).

directly unless it owns a bank. Target, of course, has done this with great success, with its earnings in recent years from its credit card unit growing much more rapidly than earnings from retail sales.²⁹ And this is an option on which Wal-Mart would save even if it were not as skillful as Target at lending to its customers. The key point would be that Sam's Bank as issuer would receive the interchange revenues, the roughly 1.4% of all sales that the acquirer currently forwards through the Visa and MasterCard system.

Of course, Wal-Mart could try to accomplish the same thing by offering its own store-branded card without opening a bank. But it has done that already, most recently with a Discover product issued by GE Consumer Finance. Historically, however, as Target's experience shows, it is much easier for a retailer to get a card to the "top of the wallet" if it is a Visa or MasterCard product than if it is a store-branded card. If Wal-Mart's customers (like Target's before them) used the store-branded card rarely, then that strategy would not lower Wal-Mart's payment costs substantially. Thus, Wal-Mart's plan likely includes not only acquiring card transactions from its stores, but also becoming a Visa or MasterCard issuer.

Check Conversion

As the discussion above suggests, Wal-Mart also is interested in the costs it incurs when it accepts payments from customers that do not use credit cards.³⁰ For example, given the demographics of Wal-Mart's customers, Wal-Mart presumably is one of the largest recipients of checks among American merchants, and thus has the greatest incentive to lower the costs of check processing.³¹ If Wal-Mart in its capacity as merchant can save money by converting those paper checks to electronic checks at the point of sale, it is natural to wonder if Wal-Mart could not save even more money by eliminating the middleman and participating directly in the processing of check conversion transactions. Those transactions already are much cheaper for the retailer than checks or conventional credit and debit

29. Target's credit card earnings grew from \$420 million in 2004 (13% of total earnings) to \$573 million in 2005 (23% of total earnings) to \$693 million in 2006 (25% of total earnings, while its non-credit card earnings shrank from \$2.758 billion in 2004 to \$2.094 billion in 2006. See Target 2005 10K at 24; Target 2006 10K.

30. Although the share of customers that pay with checks has fallen from 27% to 16% in the last 4 years alone, Wal-Mart will still receive more than 1 billion checks in 2007. The cost savings to Wal-Mart of converting those checks to electronic transactions is significant. Wal-Mart Goes Chainwide With POP In Bid To Cut Payment Costs, *DigitalTransactionNews* (Apr. 17, 2007).

31. Check use is increasingly concentrated among adult Americans without credit cards. Adult Americans without credit cards are for the most part lower in income and wealth than those with credit cards, and because Wal-Mart is a dominant retailer for that sector of our society, Wal-Mart presumably has a higher share of customers that do not have credit cards than many other retailers.

card products. Moreover, continuing developments of technology and infrastructure are making the product even better suited for large retailers like Wal-Mart with many checkout lanes at a single location.³² Still, they have been slow to gain a major place in the consumer payments market. Yet Wal-Mart is ideally suited to deploy them, with a large customer base unusually likely to contain check writers. Thus, Wal-Mart well might believe that it eventually could present and settle those items more cheaply than existing financial institutions.³³

Debit Cards

Similar reasoning applies to PIN-based debit card transactions, which traditionally have been processed over regional networks like NYCE and Pulse, rather than the international networks like Visa and MasterCard. Again, because that market has faced less competition than the market for acquiring Visa and MasterCard transactions, it is easier to see how Wal-Mart could profit by cutting out a “middleman” bank from those transactions. Wal-Mart has taken indirect steps to cut out that middleman by its participation in Debitman (now Tempo).³⁴ But Debitman has been slow to penetrate the market.³⁵ As with any new payment system, it is not enough that one party (the merchant in this case) prefers the system; there has to be some effective motivation to cause the consumer to use the system as well. The difficulties Debitman has faced are the most conspicuous evidence of the continuing power of the network effects associated with the maturation of the Visa and MasterCard systems. In the end, it should be no surprise that Wal-Mart’s application emphasizes its intention to deploy its own debit cards.³⁶

32. See Nadia Oehlsen, *Check Conversion Moves to the Back Office*, *Cards & Payments*, Dec. 2006, at 44; Christopher Westfall, *The U.S. Payments System: Needing Consolidation, or Fine As Is?*, *Banking Insider*, Dec. 22, 2006.

33. If Wal-Mart has any interest in that product, it could not form a CEBA credit card bank under the 1841(c)(2)(F) exception, because it would go beyond the “credit card operations” to which those entities are limited.

34. Debitman is a debit card network in which customers obtain cards from retailers rather than from their banks. The cards fund purchases through the ACH network, which is much less expensive than the conventional debit card processing systems. NACHA presumably cooperates with Debitman because the success of Debitman would shift transaction volume to the ACH network from the traditional check-processing and PIN-based debit-card networks. A Debitman transaction costs a participating retailer about fifteen cents, much less than the fifty cents that is the typical cost of a conventional PIN-based debit card transaction. The transaction is even cheaper if the customer uses a Debitman card issued by the retailer, because the retailer receives a rebate of about half of the fifteen-cent fee. See www.tempopay.com; *Debitman Rebuilds and Targets Card Association*, *Cards Int’l*, Issue 372, at 1 (Dec. 2006) [hereinafter *Debitman Rebuilds*].

35. See *Debitman Rebuilds*, *supra* note 34.

36. See *Application*, *supra* note 1, at 1.

Internet Payments

Wal-Mart's concerns have particular significance on the Internet, where Visa and MasterCard traditionally have held an even more dominant position than at retail. Credit cards dominated Internet retail when that market first arose in the late 1990's largely because traditional competitors (checks and cash) were wholly impractical for remote electronic purchases.³⁷ But the failure of Visa and MasterCard to give adequate attention to problems of fraud and data security has given merchants a powerful incentive to search for new payment alternatives. And in the Internet environment, where all interactions are electronic, products like Bill Me Later and Google Checkout (both discussed in more detail below) have spread much more rapidly than products like Debitman have spread in the conventional retail environment.

Wal-Mart.com is a major force in Internet retail, with more than a billion dollars in annual sales, one of the very largest operations outside the office supply and electronics sectors.³⁸ As discussed above, Wal-Mart already has been a leader in supporting the use of electronic check conversion at the retail counter. If Wal-Mart had a bank (and thus had direct access to the networks over which those payments are processed), there is every reason to think that it could accelerate the design and deployment of non-card payment products on the Internet, breaking down the dominant market power that Visa and MasterCard have in that sector.

III. BANK REGULATION

Although the preceding discussion suggests that consumers might benefit if Wal-Mart had a bank, it provides no justification for exempting Wal-Mart and its bank from appropriate banking regulations. On that point, the United States has abandoned since the Great Depression the notion that the market can be trusted to monitor the safety and soundness of banks.³⁹ The problem is not simply that banks are large enterprises with substantial assets. American car manufacturers, airlines, and steel companies all at one time were large enterprises with assets far exceeding those of most banks.⁴⁰ Yet those entities were never subject to the kind of pervasive ongoing

37. See Ronald J. Mann, *Payment Systems and Other Financial Transactions* 260-70 (3rd ed. 2005).

38. *Internet Retailer, Top 500 Guide* (2006).

39. Jonathan R. Macey et al., *Banking Law and Regulation* 80-92 (3rd ed. 2001).

40. That is particularly true in the United States, where populist concerns have kept most banks relatively small. See Mark J. Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* (1994).

bureaucratic supervision to which banks and their owners are regularly subjected (and from which Wal-Mart is now and would continue to be exempt). Some in recent years have argued that banks should be treated like other large companies – with considerably less supervision and regulation.⁴¹ But the idea that banks need no constraints will get little policy traction as long as the crises of the 1980's can be recalled. In this context, two particular concerns are important: the separation of commerce and banking, and the systemic harms from bank failure. Neither concern would apply to an ILC limited to the provision of payment services.

Separating Commerce from Banking

Among other things, the systemic bank failures during the Depression produced an abiding sense that banks should be separate from large commercial enterprises.⁴² The importance of this concern in modern banking regulation is difficult to gauge. For one thing, it is not clear that this concern has ever been entirely sincere. It always has had the effect of insulating financial institutions from competition by potentially more nimble non-financial firms. And given the relatively small size of American banks, it often (as in the case of Wal-Mart) excludes owners of undoubted liquidity and soundness.⁴³ It also is relevant that most of our important trading partners (Japan and Germany being the most conspicuous examples) have robust banking systems without any such separation.⁴⁴ The weakening of legal constraints on non-financial companies that came with Gramm-Leach-Bliley surely reflects growing skepticism about the importance of this problem.⁴⁵ Yet, federal law still imposes considerable restraints on financial holding companies, restraints that Wal-Mart wishes to avoid.

Whatever their general weight, concerns about the confluence of commerce and banking are ill-placed here. The principal argument against confluence points to the likely concentration of financial assets and the

41. Peter Wallison, Why Do We Regulate Banks, Financial Services Outlook (AEI Online Aug. 1, 2005).

42. See Macey et al., *supra* note 39, at 22-24. The concern is not nearly as strong in Canada, where a system of larger banks survived the Depression unscathed. See Duncan McDowall, *Quick to the Frontier: Canada's Royal Bank* (1993).

43. See Lawrence J. White, Should Wal-Mart, Real Estate Brokers, and Banks Be in Bed Together? A Principles-Based Approach to the Issues of the Separation of Banking and Commerce, NYU Center for Law and Economics Working Paper No. 07-23.

44. For a detailed discussion, see Bernard Shull, The Separation of Banking and Commerce in the United States: An Examination of Principal Issues 24-33 (OCC Working Paper 99-1).

45. See Macey et al., *supra* note 39, at 464-67.

corresponding potential for inequity in the lending markets.⁴⁶ The idea is that the commerce/banking conglomerate will have an advantage over the purely commercial enterprise because it will provide financing to its related commercial enterprises that will not be available to unrelated third-party competitors. As the Senate Banking Committee said in a report on the subject: "The separation of banking from commerce helps ensure that banks allocate credit impartially, and without conflicts of interest. The nonbank bank loophole * * * raises the risk that banks' credit decisions will be based not on economic merit but on the business strategies of their corporate parents."⁴⁷ More generally, the distinction between commerce and banking increasingly seems incoherent as applied to payments providers, which increasingly are IT firms. The increasing importance of IT as the core competency of these firms raises the natural question why First Data should be treated differently from Microsoft or Google, or even from Wal-Mart.

In sum, that rationale offers little reason to oppose Sam's Bank, at least in the form in which it was proposed, because Sam's Bank would not have been a commercial lender. Rather, it would have been a payments processor. A payments processing enterprise need not involve the aggregation of assets and lending power that poses a risk to the efficient allocation of investment capital.

Systemic Effects of Bank Failure

The most obvious justification for the distinction between banks and other large enterprises is that the failure of a bank that accepts deposits is more likely to have a cascading effect than the failure of any other corporate enterprise, even a large one. When a large corporate enterprise fails, the resulting financial distress is borne primarily (though not entirely) by that institution's shareholders and its contract partners (creditors, suppliers, employees, and the like). In the case of a depository institution, however, there is a greater risk that the failure of the institution will have ripple effects extending throughout the economy to the creditors of creditors. This is particularly true when the bank that fails holds large deposits from other banks. So, regulators traditionally have regarded large banks as "too big to fail," because of the likelihood that their failure would

46. See Macey et al., *supra* note 39, at 460-63.

47. See S. Rep. No. 100-19, at 8-10 (1987).

bring down other banks, causing distress to the depositors of those banks and more broadly through the economy.⁴⁸

More recently, as the sophistication with which examiners study bank operations has increased, regulators have given growing attention to the likelihood that a bank's financial arrangements are so intertwined with those of other entities as to create a substantial risk of this kind of cascading failure. Thus, we can see now, even relatively small institutions could create serious problems if they are involved in activities that affect other banks. In this literature, the risks rest not only on the size of deposits, but also on large-scale payments processing.⁴⁹

At first glance, the focus of Sam's Bank seems to play directly into this justification.⁵⁰ But that view fails to account for the nature of the payments that Sam's Bank would handle and how those differ from the large-dollar wholesale payments that create systemic payment risks. In general, serious risks from payments processing are associated with the "real-time gross value" settlement systems that are customary for wholesale payment operations – in which each entity gives and receives full credit for a transfer at the moment that it is made.⁵¹ In the United States, for example, the Fedwire system transfers about \$1.5 trillion each day, and provides real-time value at the moment a transfer is made for each of those payments. In that type of system, the possibility that a bank might be unable to settle its position at the end of a business day raises a risk for each institution to which the failed bank sent payments during the course of the day. In the Fedwire system, the Federal Reserve banks mitigate that risk by guaranteeing Fedwire payments through the course of each day.⁵²

The payment operations of Sam's Bank would present less risk. For one thing, the individual daily obligations would be much smaller. The Fedwire system commonly permits major banks to make payments during the course of a single day that substantially exceed the capital of the

48. Gary H. Stern & Ron J. Feldman, *Too Big to Fail: The Hazards of Bank Bailouts* (2004).

49. James R. Barth, Gerard Caprio & Ross Levine, *Rethinking Bank Regulation: Till Angels Govern* (2006).

50. Thus, a bipartisan group of congressmen, in a Mar. 10, 2006 letter to the FDIC, assert that given the retailer's "massive scope and international dealings," its entry into the banking industry would carry too many risks. For example, "a financial crisis within the company could damage the bank and severely disrupt the flow of payments throughout the financial system." Letter from Stephanie Tubbs Jones et al. to Martin Gruenberg, Vice Chairman, FDIC (dated Mar. 10, 2006), available at http://www.fdic.gov/regulations/laws/walmart/comment_letters_5/tubbs-jones.pdf.

51. It was the exposure of wire-transfer participants at the time of the 1974 failure of Germany's Herstatt bank that first made the systemic payments risk a common topic of policy concern. See Mann, *Payment Systems*, *supra* note 37, at 239-40; see also Proposed Directive on Payment Services in the Internal Market, (COM(2005)603), at 6 [hereinafter *Payment Services Directive*].

52. See Mann, *Payment Systems*, *supra* note 37, at 211-15.

institution. The sums at stake in the consumer realm are not nearly so large. Even for the largest participants in the credit card system, the daily sums are much smaller than the institution's capital base. JPMorgan Chase cardholders, for example, spend about \$1 billion per day, but the institution's net worth is in the range of \$20 trillion.⁵³ JPMorgan's solvency is unlikely to be substantially affected by daily fluctuations in the inflow and outflow of payments that typically amount to a tiny fraction of a percent of its market capitalization.

Moreover, the settlement systems for the small consumer payments are designed to avoid the liquidity risks associated with wholesale funds transfers. For example, payments made through the Visa and MasterCard system are made through multilateral netting at the end of each day. Visa and MasterCard use Fedwire to apply a single daily credit (or debit) to the Federal Reserve account of each of their members that reflects the net inflow or outflow of that member's daily cards transactions. Similarly, the electronic check payments that Sam's Bank might clear through its Web site would be processed in batches through the ACH network on a daily basis, with net settlements that pose little if any systemic risk.⁵⁴

If it seems technical to suggest that the details of the process of settling payments can have such an important effect on the systemic risk those payments raise, consider the following hypothetical. On a given day, Bank of America acquires \$100 million of credit card transactions on cards issued half each by CitiBank and Chase, Citibank acquires \$80 million of transactions on cards issued half each by Bank of America and Chase, and Chase acquires \$60 million of transactions on cards issued half each by Bank of America and CitiBank. In a gross settlement system, each of those banks would pay to the others the entire sums that they owed. Bank of America would send out \$70 million (\$40 to Citi and \$30 to Chase). Citi would send out \$80 million (\$50 to BoA and \$30 to Chase). And Chase would send out \$90 million (\$50 to BoA and \$40 to Citi). In a system of multilateral netting, the payments are much smaller. Bank of America receives \$30 million, Citi would make no payment at all, and Chase would send out \$30 million.

Because the total payments are so much larger in a gross system (\$240 million as opposed to \$30 in multilateral netting), it is crucial that consumer payments processing involves multilateral netting rather than

53. See Card Volume at Merchants, Nilson Report, Issue 859, at 1, 9 (June 2006); JPMorgan Chase 2005 10K.

54. See Benjamin Geva, *The Law of Electronic Fund Transfers* § 5.01 (discussing ACH settlement process).

gross settlements. Thus, even if an entity like Sam's Bank were to fail, it is unlikely that the amounts that it would owe to any particular institution would undermine the solvency of that institution. Looking back to the regulatory justifications discussed above, this suggests a relatively limited systemic need for supervision of the operations of Sam's Bank.

IV. THOUGHTS ON A BETTER WAY

As discussed above, the primary consideration should be the possibility that Wal-Mart's entry to the payments markets would drive product innovation and cost-cutting that would benefit consumers either directly or through diminution of the dominant market positions that Visa and MasterCard currently hold. We seem to stand at a decisive point in the history of the payments industry. Long dominated by cash and checks, payment systems that were directly or indirectly supervised by the government, the last thirty years have brought increasing dominance to the private and largely unregulated payments networks built by Visa and MasterCard. Those networks have contributed great value to the economy by driving down the costs of payments and lending,⁵⁵ but the fact remains that they are operated for the private benefit of the banks that own them. At the same time, Visa and MasterCard have retained for decades a dominant market position, repelling repeated challenges from entities like American Express, Discover, JCB, Diner's Club, and Carte Blanche. It is easy to understand the reasons for that dominance: network effects make it extremely difficult for new entrants to gain a foothold in the provision of payment systems.⁵⁶ Because those effects underscore the strength of the networks' market dominance, the shift from public systems to a pair of persistently dominant private systems is at least potentially troubling.⁵⁷

Of course, one possibility is that the antitrust system will break down the dominant positions of Visa and MasterCard – either through private litigation or through actions brought by federal regulators. But given the difficulties and complexities of an antitrust response, surely it is worth considering a more market-oriented approach: fostering entry by competitors. Entry by Wal-Mart well might present the incumbents with a more serious challenge than they have faced in decades. Wal-Mart has a network of almost 4000 locations in the United States, with tens of millions

55. See Mann, *Charging Ahead*, supra note 15, ch. 3.

56. See Mann, *Charging Ahead*, supra note 15, chs. 6-8 (attributing the unique dominance of credit cards in United States markets to their earlier deployment here).

57. For discussion of the effects of the competitive power of the major networks, see Mann, *Charging Ahead*, supra note 15, ch. 11.

of devoted customers. If Wal-Mart is as capable here as it has been in other aspects of its business, pressure from Wal-Mart could drive considerable improvement – some combination of new products or better prices.

The entry of Wal-Mart would be salutary not solely because of the possibility that competitive pressure will reduce costs and drive innovation in product design. By broadening the groups involved in the design and deployment of products, it would broaden the range of pricing strategies. To explain, the existing networks of Visa and MasterCard increasingly depend on a strategy under which merchants will pay an interchange fee that provides sufficient revenue to issuers to fund programs that foster higher spending and borrowing by cardholders.⁵⁸ That strategy has been effective because network effects pose a barrier to new entrants that might use different strategies and because even with a high interchange fee the payment card system is in many contexts more attractive to merchants than the paper-based systems it is replacing.

But systems designed by merchants or other industry players would doubtless use a fundamentally different pricing strategy. The most obvious approach is a system like Debitman, which can provide payment services more cheaply because it avoids the costs of subsidizing the business-development programs issuers fund with interchange revenues. Similarly, Bill Me Later is rapidly gaining attention, especially among airlines, but also at mainstream sites like Walmart.com. Bill Me Later undercuts standard credit-card interchange rates by avoiding the speedy approval and settlement process of the credit-card networks.⁵⁹ The neutral pricing strategy of products like Debitman and Bill Me Later makes sense for merchants that do not depend on the discretionary spending that the aggressive rewards and teaser-rate strategies of Visa and MasterCard motivate.

More intriguing are the recent developments that presage a world of below-marginal-cost pricing of payments services, as payments themselves are used to subsidize other business activities. The leader here is Google Checkout, which can undercut standard credit-card interchange fees because it uses the payments business as a way to attract advertisers.⁶⁰

58. See Mann, *Charging Ahead*, *supra* note 15, ch. 13; Ronald J. Mann, *Bankruptcy Reform and the "Sweat Box" of Credit Card Debt*, 2007 Ill. L. Rev. 375.

59. See Peter Burrows, *Big Plastic's Online Challenger*, *Business Week*, Dec. 30, 2005; Jennifer LeClaire, *Online Merchants Choosing Alternative Payment Options*, *E-Commerce Times*, Dec. 21, 2005.

60. See Miguel Helft, *Google Steps More Boldly into PayPal's Territory*, *N.Y. Times*, Dec. 20, 2006, at C1. PayPal pioneered a simpler strategy. It offers payment services to merchants at a blended price that undercuts the credit card networks because some PayPal purchasers fund their purchases through cheaper ACH transactions. Visa and MasterCard initially contested PayPal's right to process

The pricing strategies that Wal-Mart has used for its other financial products strongly suggest that Sam's Bank could subsidize payments costs in a similar way. The financial services that Wal-Mart already offers are priced very competitively. For example, in the 45 states in which it cashes checks, Wal-Mart charges a flat \$3 fee, compared to charges from \$6 to \$15 for other check cashers. Apparently Wal-Mart's prices for money orders and wire transfers are very low as well.⁶¹ As discussed above, owning a bank would allow Wal-Mart to broaden its product lines, bringing lower prices to more niches of the consumer financial services market. In an era when we are concerned about the ability of traditional financial institutions to design products that can be priced attractively for lower-income individuals, the entry of Wal-Mart bodes well.

This is not to say that there are no concerns about what Wal-Mart might do with its bank. Let us suppose (as seems likely) that Wal-Mart prices check cashing so low because the people for whom it cashes checks will spend their money in Wal-Mart's adjacent stores, and that it will use the same strategy with new products and services it can deploy through Sam's Bank. Should that cross-subsidization of consumptive activity trouble us? My inclination is to view that problem as minor. It may be that Wal-Mart can use this tactic to boost sales in its stores, and it may be that these kinds of bundling techniques can be used to entice consumers into dubious consumption decisions. But given the product lines and brands available at Wal-Mart's typical stores – not exactly focused on indulgence and luxury – this problem does not seem serious.

Another area of concern relates to the credit card product in particular. If Wal-Mart plans to issue a general-purpose credit card, should we be concerned because of the historical example of Target, where the profits from the credit card soon may dwarf the profits that flow directly from retail operations?⁶² As I demonstrate elsewhere, there are significant relations between credit card spending, overall debt and bankruptcy, so a strategy designed to increase the effectiveness of card marketing to Wal-Mart customers would raise a serious concern.⁶³ Again, the countervailing factor is the likelihood that Wal-Mart would not focus on the profitability

transactions for third-party sellers, but ultimately backed off because PayPal's use of the card networks increased overall transaction volumes. See Ronald J. Mann, *Regulating Internet Payment Intermediaries*, 82 Texas L. Rev. 681 (2004). Even now, it is not clear that PayPal ever will be a threat to Visa and MasterCard's market position on the Internet.

61. *Supercentre Banking: Wal-Mart and Financial Services*, The Economist, Sept. 3, 2005 (discussing Wal-Mart's competitive prices for money orders, wire transfers, check cashing services, and express bill payments).

62. See *supra* note 29.

63. See Mann, *Charging Ahead*, *supra* note 15, ch. 5.

of credit card issuance per se, but instead on lowering the costs of retail payments as a way to foster profits from retail sales. Indeed, the longstanding hostility of Wal-Mart to Visa and MasterCard suggests that it is much more likely that Wal-Mart will focus on making payment products cheaper (something at which it excels) and much less likely that it will focus on maximizing interest and fee-based revenue streams (something repugnant to its competitive culture, at which it has little or no experience).

V. A NEW APPROACH

The preceding discussion underscores both a mismatch between the existing regulatory framework and the risks that Sam's Bank actually would pose and an increasingly arbitrary distinction between financial and non-financial owners of payment service providers. This suggests value in a new approach that would address payment processing risk in a uniform and coherent way. The EU's proposed Payment Services Directive provides a useful model. Indeed, because the market position of the credit card networks is much stronger here than it is in the EU, there is an even greater reason to design a regulatory framework that would encourage competition.⁶⁴

The first step is to identify the best regulator and the appropriate population of regulated entities. Because the concern is the risk of payment processing, all entities that have access to the clearing and settlement systems should be included, and the status of their owners as financial entities should be irrelevant. The Federal Reserve Board's position at the center of the major clearing and settlement systems makes it the obvious choice as regulator.

The second step is to decide what type of monitoring and supervision is required. Because these institutions would neither take deposits nor engage in commercial or consumer lending,⁶⁵ the level of supervision should be considerably less than for traditional depository institutions. The principal regulatory activity should be to ensure the maintenance of a level of liquidity commensurate with the types of payment operations in which the entities engage. The emphasis should be on liquidity rather than capital,

64. The sanguine competitive position in the EU might change if the implementation of SEPA (the Single Euro Payments Area) leads to continent-wide dominance for Visa and MasterCard. See, e.g., EU Warns Cards Market over SEPA, *Cards Int'l*, Issue 371, at 1 (22 Nov. 2006); ECB Concerned About SEPA Duopoly, *Cards Int'l*, Issue 372, at 17 (6 Dec. 2006).

65. The purpose of this framework is to permit access to payment systems for entities that have no need to engage in banking. To the extent the owners of these entities are involved in other finance-related businesses like credit-card lending or other types of consumer finance, those activities would remain subject to appropriate scrutiny under other frameworks.

because the concern is whether the entity will be able to settle its transactions on a daily basis, not whether it has the long-term financial strength measured by capital accounts.

Entities, like Sam's Bank, that limit themselves to net-settlement consumer systems would require relatively low levels of liquidity. Entities that seek access to riskier real-time gross settlement systems would be held to higher levels. As compared to current regulatory frameworks, this has the advantage that the Federal Reserve would be charged with directly monitoring and assessing the appropriate levels of liquidity for those entities most likely to disrupt the steady flow of payments on which our economy increasingly depends. Indeed, given the importance of this activity it is startling that the Federal Reserve's current mandate on these questions is so indirect.

My proposal does not directly address the propriety of retaining the rules that exempt ILCs from the supervision required of other entities that control financial institutions. Level-playing-field concerns, however, do suggest that the other entities that currently use the ILC framework for payments operations should be forced into the payment service provider category. The existing regulatory framework involves a serious mismatch between the activities of those entities – pervasive involvement in payments – and the regulatory purposes—attending to deposit protection for entities that receive few deposits. Resolution of that mismatch is at the heart of my proposal, even without expressing any opinion on the care with which the FDIC currently supervises those entities.

CONCLUSION

The focus of this symposium is on the proper level of uniformity in the legal rules that govern payment systems. My submission identifies a threshold problem, the lack of competition and barriers to entry in the markets for payment services providers. My thesis is that a revision of the regulatory framework designed to foster competition and lower barriers to entry is a valuable part of an effort to design coherent rules. Greater competition should foster innovation in payment systems development, with more rapid convergence on the systems that respond most effectively to the needs of commerce. At the same time, we might have more confidence that rules developed in competitive markets provide satisfactory answers to problems with unauthorized transactions, error, and the like.