Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

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There is no doubt that the banking agencies have approved all too many dubious merger applications along with charter conversions of convenience. However, the debate roiling over the Capital One/Discover merger harkens to an earlier age of thousands more prosperous small banks all operating strictly within a perimeter guarded by top-notch consumer, community, and prudential regulators. Whether this ever existed is at best uncertain. What is for sure is that all this nostalgia for a halcyon past will hasten a future dominated by GSIBs and systemic-scale nonbanks still operating outside flimsy regulatory guardrails.

The best way to demonstrate this awkward certainty is to run a counter-factual – that is, think about what the world would look like if opponents of the Capital One/Discover deal get their way. Would we quickly see a return to card competition housed firmly within a tightly-regulated system? Would the payment system be loosed from Visa and Mastercard's grip? Would merchants see the dawn of a new era of itsy-bitsy interchange fees? Would card rates plummet and rewards stay splendiferous? I very much doubt it. Space here does not permit a detailed assessment of the analytics underlying my conclusions, so let's go straight to each of them.

First, banning the CapOne/Discover deal would not ensure robust card competition under strict bank regulation. JPMorgan's and American Express' formidable stakes could grow because credit-card lending is a business dependent on economies of scale and scope vital to capital-efficiency through the secondary market. However, large banks will have a lot more trouble finding these and, even if the rules are modified, overall regulatory costs will make each of them less competitive.

Nonbanks have many ways to enter the regulated banking and payment sectors, arbitraging regulatory costs at the bank level with powerful profit-engines controlled by powerful diversified companies and huge tech platforms. Bank regulators in this Administration don't cotton to what used to be called nonbank banking, but 2025 could craft a wholly different regulatory and charter construct akin to the one almost completed by bank regulators in Donald Trump's last term.

One key driver – the "holy grail" according to CapOne – is Discover's payment system, a challenger to Visa and Mastercard if it can achieve the scale and scope that's also essential in this sector. The payment system is changing about as fast as a blockchain transaction and it's thus possible that other -veridically-regulated banks could take on these colossi, especially if the FTC's antitrust inquiry leads to substantive realignment at one or both companies. However, it seems most likely that nonbanks keen to achieve the benefits of proprietary cards would also want a payment system all their own, using all the regulatory-arbitrage advantages they could muster to control card front-end also to dominate the backroom.

2101 L Street, N.W. – Suite 300
Washington, DC 20037
Phone: 202.589.0880

E-mail: info@fedfin.com
Website: www.fedfin.com

Third, any nonbanks that enter this sector are likely to keep all the benefits that then adhere to them all to themselves. Horizontal integration across the retail, supplier, and finance sectors is already a hallmark of several massive tech platforms. Will they share any interchange-fee booty with their competitors? So far, none of these companies are exactly distinguished by their altruism.

And what of consumers? The CFPB is clearly doing its best to block this merger, but what if it gets its way? The outlook here depends in part on two unknowns – the capital and CFPB credit-card fee proposals – but it is safe to say that credit-card companies struggling to retain their profitability are credit-card companies diversified banks will close. Anyone who doubts the necessary ruthlessness of big-bank decisions should first go looking for their once-robust mortgage businesses. This stalwart of American banking is now a business of nonbanks, nonbanks the FSOC and Fed fear pose systemic risk due to the comfy precincts outside the regulatory perimeter.

Maybe giant nonbank card providers will be generous to cardholders if banks clear out, but the mortgage example also shows how unlikely this is. More providers outside the regulatory perimeter also pose challenges to fair-lending enforcement and community service – where exactly will small-dollar loans come from if payday lenders and subprime-card companies have it their way?

It may be that the Capital One/Discover merger raises prudential problems, and it will certainly plow new ground as the first complex deal under the new CRA rules. However, the counter-factual above suggest strongly that the systemic-risk concerns cited by Sen. Warren and Rep. Water's concentration qualms are more likely to occur without another significant regulated-bank competitor given the advantages it would afford to nonbank platforms with mighty-big systemic footprints.

If the CapOne/Discover merger has safety-and-soundness merits, would the payment system be better if a regulated bank such as the one that would result can't challenge dominant providers? That seems most unlikely. Would merchants finally get their inter-change fee dream? I think not. Would consumers and low-income community groups prosper if a key source of household credit is expressly or effectively exempt from the rules meant to protect them? One suspects not.