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Preserving Competition After the Banking Meltdown

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Preserving Competition After the Meltdown

Albert A. Foer*

The Great Banking Meltdown of 2008, which may yet metastasize into the Even Greater Depression, has already resulted in an unprecedented rearrangement of the financial services sector. Merrill Lynch and Countrywide Financial are now part of the Bank of America; Bear Stearns and Washington Mutual are now part of JPMorgan Chase; and Wachovia is now part of Wells Fargo. Goldman Sachs, Morgan Stanley, and American Express have become bank holding companies. Who knows what comes next? We seem to be moving at warp speed toward a highly concentrated system of capital allocation dominated by conglomerated financial services firms which will likely have substantial political as well as economic clout. This essay offers some thoughts on the implications of the sea change in the U.S. financial industry in terms of domestic and international competition and the transformed role of domestic and international regulation.

I. A SNAPSHOT OF BANK CONSOLIDATION AND DEREGULATION

Consolidation in the financial services sector has been going on for quite a while. A lot of the consolidation activity has been both the result of federal policy and beneficial to consumers. In the mid-1970s, I was a commissioner representing the Federal Trade Commission ("FTC") on the National Commission on Electronic Fund Transfers, a multi-

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year study commission established by the Congress to make recommendations for dealing with the emerging ability to transfer money electronically.[1] At that time the United States had thousands of small banks, restricted in many states to only one location, and banks were permitted to operate only in one state. As we observed this remarkably decentralized situation, and as we looked at the prospects for using computers and electronic systems to transfer money, we concluded that it wasn't in the consumers' interest to limit competition with unit banking laws and prohibitions on branch banking. Although we clearly recognized that removing those restrictions would lead to the growth of large national banks, we recommended certain deregulatory changes (as well as various important consumer protections). Congress endorsed most of our report, opening the way for national banking in the late 1970s.

Banking then entered a large-scale consolidation phase. Much of the consolidation involved banks operating in one part of the country merging with banks in another part of the country, creating a regional or national network. These geographic-extension mergers worked well, bringing competition to many localities that were previously served by only one or two small banks. To that extent, the consolidation was quite beneficial to consumers and small businesses. It gave the average citizen more choices, more options (and thus greater leverage) for borrowing, more convenient places to deposit, and also helped to facilitate the growth of electronic transfers. Today you can

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[1] NATIONAL COMMISSION ON ELECTRONIC FUND TRANSFERS, EFT IN THE UNITED STATES: POLICY RECOMMENDATIONS AND THE PUBLIC INTEREST (1977).

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visit an ATM any time of day or night, and make deposits, withdraw cash, or pay bills virtually anywhere.

As the consolidation progressed, however, the very large banks merged with other very large banks, creating megabanks. People legitimately began to voice worries about banks becoming too large or too complexly embedded in the economy to be allowed to fail.

Meanwhile, other types of deregulation were also having an impact. By the end of the 1990s, we had relinquished the separation among commercial banks, investment banks, and insurance companies and had erased other distinctions that kept different types of financial services in narrowly defined categories, each with what was considered an appropriate type of regulation. For example, we allowed Travelers Insurance and Citicorp to merge—a marriage of two quite different financial service functions, insurance and commercial banking. We permitted brokerage firms to sell cash management programs and thereby function as banks. But as this new conglomerate financial services industry structure came into existence, the regulatory structure failed to keep pace.

Commercial banking and other functions had been kept separate for what seemed very good reasons. Capital allocation authority, which is the essence of a bank or near-bank's function, had been seen to be very dangerous when it became too centralized, without enough alternative sources to which companies and other entrepreneurs may turn for capital. Segmentation of financial services was also relevant because the failure of a

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megabank in multiple financial areas would have huge, unpredictable ripple effects throughout the economy. Segmentation also limited the risk of investments that certain kinds of financial institutions would make with their depositors' funds. As conglomeration grew and regulations were removed, sufficient protections no longer remained. And when *laissez faire* ideology came to dominate government, even where regulations were in place, regulators were often lax.

II. THREE QUESTIONS

As a student of antitrust and competition policy, I have three questions to ask. The first is whether there are a sufficient number of separate institutions to keep the financial sector truly competitive. This is a standard antitrust question, answerable by normal antitrust analysis when there is not a crisis atmosphere that requires immediate action. As I will note, this requires deconstructing the financial sector into its constituent product and geographic markets.

Second, going beyond the narrow antitrust question, will we have placed too much centralized political power in these great financial institutions? Bank of America, for example, will be an even more massive employer, with huge leverage over the political and economic system from the money it has discretion to give out or withhold. The issue here is one of possible irreversibility. These mega financial services companies we're in the process of creating are going to be able to demand from Congress, quite persuasively, whatever it is they say they need, using the threat of failure. (Note to megabankers: when you come to Congress, do not fly into Reagan National in private

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jets.)

My third question is: What should we think of the "too-big-to-fail" argument, which is exacerbated by the political influence that goes with large-scale financial conglomeration and consolidation? Let's take these three questions in order.

A. The Role of Standard Antitrust

First, what is the role of antitrust both in terms of creating the mega-financials and going forward? The merger control laws have permitted the consolidation of the financial services industry in that they have been interpreted consistently over the past generation to permit unlimited growth, so long as the effect of a merger or acquisition is not likely to be an increase in prices in the near term. Today, there is no control over conglomerate mergers to the extent that there are no direct competitive overlaps between the two companies. Vertical mergers are almost never halted or restructured. Horizontal mergers that extend geographic markets are home free. Only horizontal mergers within the same geographic market might be stopped, but only if there will be a very high level of concentration and there is a compelling negative competitive effects story. As a result, in practice, if two financial services firms want to combine, they may have to pay a minor price of divesting some assets that are in direct competition (e.g., one of two branch banks located near each other), but otherwise their combination will be approved. Put another way, great size itself is not a target of antitrust policy and antitrust enforcement does not provide a protection against the creation, by merger, of companies "too big to fail."

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Can antitrust intervene today to unscramble the eggs that we have recently cooked? Without a change in the law, the answer is probably not. Even with all the consolidation, when one examines individual “relevant” antitrust markets (e.g., residential mortgages, small or large commercial loans, car loans, venture capital, etc.) we still find plenty of competitors. For some types of transactions, this conclusion rests on the domestic presence of foreign-based institutions. So long as we are comfortable that their presence will continue, it is difficult to make the antitrust argument that previously consummated mergers can (or should) be retrospectively attacked.

One might ask, shouldn’t antitrust be deeply involved in the current spate of emergency mergers? In theory, yes. The government should try to minimize the competitive harm of these transactions. But in practice, today’s mega-deals are being made under duress. Merger law recognizes a defense that one of the companies is on the brink of failure. The idea is that it is better to permit a merger that will save a company than to let it go down in the name of competition, since competition will be lost anyway if the competitor is doomed to depart the scene. In normal times, the failing company defense is given much scrutiny and a heavy dose of skepticism, but these are not normal times. When decisions have to be made over the weekend, antitrust scrutiny is going to take a back seat to the immediacy of a crisis.

It should also be mentioned that when deals are made over the weekend, the likelihood is that they will not work very well. Even well-conceived, carefully planned mergers rarely work out as projected, for a variety of reasons, including clashing

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corporate cultures. The weekend mergers we are seeing could very easily devolve into a series of voluntary divestitures over the next several years, as the parts that don't fit into an evolving corporate strategy get lopped off. But this is speculative and cannot be the basis for a policy of accepting the new status quo. The problem confronts us: should the law be revised to deal with companies that are "too big to fail"?

B. Politics and Reform

The second question, whether the consolidation of the financial services industry has created so much centralized political power that consolidation is irreversible, comes next. What if the incoming administration supported an amendment to the Clayton Act that says, in effect, the antitrust agencies may take into account whether a proposed merger will create a "too big to fail" risk? Could this pass? I will come back to the substance of such a proposal in a moment. Here, I simply pose the question of whether the political might of the mega-financials would be able to withstand a legislative effort to reshape the sector.

C. Too Embedded to Fail

"Too big to fail," the subject of my third question, is not necessarily about size. Let's make that clear at the outset: "too big to fail" is a misnomer. Nor is the problem simply one of market concentration. Rather, it is about systems, with a good analogy to ecosystems.[2] Within an ecosystem, some species are described as "keystone," because they are tied into the ecosystem in so complex a way that their extinction will bring down numerous other species in a domino effect. While there are good reasons to be cautious in

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[2] *See* Gregory T. Gundlach and Albert A. Foer, *Complexity, Networks, and the Modernization of Antitrust: The American Antitrust Institute's Roundtable on Complexity and Antitrust* in 51 THE ANTITRUST BULL. 1 (2006) and other articles in that volume.

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applying complex science to antitrust analysis, [3] the concept of a keystone niche seems applicable to certain organizations within the business world. AIG, the massive insurance conglomerate which will receive billions of dollars in federal assistance, is a good example. The problem is not that it is a monopolist or that it is very large in size. The problem is that it is embedded within the business ecosystem: so many other entities depend on AIG's ability to meet its commitments that there will be collapsing domino effect on other entities if there is a breakdown.

How would we recognize a keystone company? As with AIG or with the Detroit three automakers, it is an organization or an industry with such a substantial reach into many different markets, upstream and downstream, that its failure will cause harm in many markets which, in turn, are likely to trigger additional harm in still more markets. Everything is now not only linked, but linked more or less instantly through the miracle of modern computerized communications. One test of whether an organization fills a keystone niche is whether its threatened demise can scare Congress into bailing it out. Certainly this is circular, which is unfortunate, but I don't know whether we can provide a more specific definition. Was Lehman Brothers a keystone player that the government failed to properly identify when it was allowed to fail? It will be difficult to isolate the causal effects of that failure, given so much else was happening at about the same time. The bottom line is that government can no longer permit institutions of keystone

[3] *See* Thomas J. Horton, *Complexity or Monopoly? The Implications of Complexity Science, Chaos Theory, and Evolutionary Biology for Antitrust and Competition Policy*, 51 THE ANTITRUST BULL. 195 (2006). Complexity, embeddedness, networks, and systems are four separate but inter-related concepts whose differences and commonalities I am not attempting to work through in this essay.

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magnitude and systemic embeddedness to fail because the economic ramifications would be too drastic—domestically *and* globally.

In other words, keystone is a political as well as economic concept. Congress and the White House need to clearly recognize this as they ponder options in the current economic crisis. It is perhaps heartening to see many large governments take an ownership role in the companies they bail out, not for the official reason that this will give the governments hopes of being paid back and, maybe one day, making a return on their investment, but for the political leverage it could give to governments when we get to the day after tomorrow. On the other hand, ownership puts the government directly in the position of picking winners and losers when it comes to approving use of the bailout funds for certain transactions, and perhaps more. Avoiding this risk of politicization is exactly why we prefer markets. The sooner we can get back to markets, the better.

The consolidation problem is not restricted to banking by any means, and a governmental response to the current economic disaster will need to consider more than the financial sector. When we allowed other parts of the economy to become highly consolidated, we created companies that arguably need very large banks. Part of this is a reality of globalization, which allows corporations to expand to fill as much of the planet's demand as they can, subject to the economics of trade, transportation costs, and other limitations such as cultural barriers. But the number of really big players on a global basis in particular industries seems to be shrinking dramatically. The number of airlines on the Atlantic route is essentially three—the international alliances which

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operate more-or-less as single entities through differently branded but coordinating airlines.

Take a look at the audit industry, which plays a central role in providing the certified information at the core of a well-functioning capitalist system.[4] With the scandal-related disappearance of Arthur Andersen, we are down to the Big Four. Only four accounting firms handle all of the public corporation audits in the world, not just in the United States. It is the same Big Four worldwide. And there is a lot of concern voiced about this concentration, which is even finding its way into legislation that puts caps on these firms' exposure to litigation. Thus, we now apparently can't allow accounting firms that audit public companies to fail any more than we can allow the massive companies they audit to fail. This decidedly unvirtuous cycle of interdependency, generated by consolidation in key sectors that forces us toward a "too big to fail" rationale for government intervention, cannot be good public policy.

What can be done? In regard to the Big Four accounting firms, we could condition any granting of protection from overly large litigation risks on voluntarily spinning off a percentage of clients and the professionals who service these clients. A second tier of accounting firms that wants to enter the first tier might buy the assets and gain the same protection from catastrophic losses. This is one example of how the government could creatively work toward more competition in key sectors. There is precedent. After World War II, the U.S. government sold off some of the aluminum plants that had been operated for the government by the monopolist Alcoa to Kaiser and

[4]*See* Bernard Ascher, *The Audit Industry: The World's Weakest Oligopoly,* AAI Working Paper #08-03, *available at* http://www.antitrustinstitute.org/Archives/workingpaper08-03.ashx.

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Reynolds, intentionally creating competition in an industry that had long been under challenge as a monopoly.[5] The leverage of stock ownership that the government is purchasing in the bail-out firms may provide a basis for government to act with similar creativity after the crisis has ended. This fundamental restructuring has been a hallmark of key regulatory and antitrust decisions in numerous infrastructure industries.

Another strategy, at least for future cases, would be to modify the current Clayton Act to allow the Federal Trade Commission ("FTC") or Department of Justice ("DOJ") to take into account whether a merger will weaken a company financially, making it more susceptible to failing, thereby rendering the transaction ultimately anticompetitive.[6] This is not the current interpretation of the law, but it is a possible interpretation that the next administration might attempt, an implication of the established doctrine that capital market efficiencies can justify an otherwise anticompetitive merger. If one, why not the other? But a financial weakening of a merging party is not the key issue.

Beyond that, there is the industrial policy question of whether a merger should be stopped on the theory that the resulting company will be too embedded to be allowed to fail. The required analysis may go beyond the expertise, not to mention current statutory authority, of the antitrust agencies. But Congress could modify the Clayton Act in such a way that the antitrust agencies, together with the Treasury Department and perhaps the Federal Reserve, could participate when a potential merger is characterized as involving a keystone firm.

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[5] *See* Spencer Weber Waller, *The Story of Alcoa: The Enduring Questions of Market Power, Conduct, and Remedy in Monopolization Cases*, *in* ANTITRUST STORIES 121-138 (Eleanor M. Fox and Daniel A. Crane ed., 2007).

[6] This idea has been floated several times by former FTC Commissioner Thomas Leary.

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What about dealing with the centralization of financial power that has already occurred? Do we even know what we would want to accomplish, assuming the political will can be found? Do we want to break up the largest financial conglomerates and force them to operate separately in separately defined product markets, as they did before the Glass-Steagall Act was repealed? (This is called "putting the toothpaste back into the tube.") Do we want to make the institutions smaller by giving them incentives or even mandating that they divest themselves of assets; creating more companies out of those assets while allowing them to function in whatever markets they think best? Or do we want a policy approach that assumes they will always be too big to fail in this new global world, making the solution a permanently larger role for government regulation? (This would have been Teddy Roosevelt's policy.) Do we want all of these institutions to fall under the aegis of a single federal regulator, a bureaucratic sibling of the Homeland Security Agency? (I doubt it.) And don't we now recognize that hot money travels around the world at warp speed, so that we need to create appropriate new forms of global governance or at least some new institutional mechanisms for rapid coordination?

III. THE TNEC MODEL

These questions are of a complexity and importance that is comparable to those which the country faced during the Great Depression. In addition to experimenting with a variety of programs, many of which failed, President Franklin Roosevelt and the Congress set up the Temporary National Economic Commission (TNEC), to bring together key members of Congress, relevant government agencies, and civilian experts to

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undertake a large scale multi-year baseline study of the American economy and to make recommendations as to what should be done.[7]

The TNEC model is a way to bring together a variety of viewpoints and develop a consensus over a sustained period of time to recommend solutions based on evidence, diverse ideas, and directed debate. The actual contribution of the TNEC in terms of legislation was not great, but the TNEC led to the acceptance of the idea that high levels of concentration could be dangerous and deserved to be the focus of national attention. And that realization, in 1950, led to modifications of the Clayton Act intended to stop monopolies, or near monopolies, from being formed through mergers. I don't believe that the Clayton Act has been implemented in accordance with the desires of the Congress at that time, but the TNEC actually was a productive force in helping the country move into its next stage of capitalism, a stage that emphasized free markets and intervention to keep markets operating in the interests of consumers.

If we are now in a process of moving to a new stage of capitalism, the critical question is, can we control the transformative process in an intelligent way? I'd like to see the next President take the initiative in appointing a new version of TNEC with a three-year mission to study the capital allocation system, domestically and internationally, and to make recommendations as to its structure and governance. One of the major hurdles will be that the amorphous conglomerate financial companies are subject to different regulatory forces and a variety of separate oversight committees on Capitol Hill. These should all be represented, along with other non-governmental experts

[7] *See* ELLIS W. HAWLEY, THE NEW DEAL AND THE PROBLEM OF MONOPOLY 402 et seq. (1966).

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and stakeholders in a TNEC-type process. Once we can agree, largely through this mechanism, on our common goals, we can design a more permanent structure for financial services. Needless to say, there's a long unpaved highway between here and there.

We don't know who's going to be left standing a month from now, or two years from now. The Great Depression didn't all happen when the stock market fell in 1929. Unemployment grew over a period of years. We don't know today whether our economy is in a ditch or the Mariana Trench. Until we establish a firmer footing, I don't think we're going to have the time or calm to deal with the problems of consolidation that are being created. For now, we must recognize the problems that we are creating and commit ourselves to dealing with them in an appropriate and timely way. It would be a terrible but easily made mistake to silently accept that whatever happens in the crisis is necessarily going to be permanent.

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