Consumer Federation of America

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On

Too Big to Fail? The Role of Antitrust Law in Government-Funded Consolidation in the Banking Industry

Subcommittee on Courts and Competition Policy
Committee on the Judiciary
United States House of Representatives

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Mr. Chairman and Members of the Committee,

My name is Dr. Mark Cooper. I am Director of Research at the Consumer Federation of America (CFA).[1] CFA greatly appreciates the opportunity to appear before you today to address one aspect of the financial meltdown that has plunged this nation into the worst economic crisis in three quarters of a century. For well over a decade, CFA has been warning policy makers of the dangers of excessive deregulation across a number of financial sectors including banking, credit, financial services, insurance, housing, and commodity futures. The topic of today's hearing, the threat that the principle of "too big to fail" poses to the public and the role of consolidation in the financial sector in magnifying that threat is but one of many problems that afflicts the financial sector.

Nobody Should be "Too Big to Fail"

This hearing is about an important problem that receives a lot of attention under the rubric of "moral hazard." The technical definition of moral hazard – "The effect of certain types of insurance systems in causing a divergence between the private *marginal cost* of some action and the marginal *social cost* of that action thus resulting in an allocation of resources which is not optimal"[2] – does not fully convey the implications of this problem in the current financial mess, so let me put a finer point on it.

> **Capitalism without bankruptcy is like Catholicism without hell; it lacks a sufficiently strong motivational mechanism to ensure good behavior.**

The financial system should never have been allowed to become exposed to a plague of banks and other financial institutions that were deemed to be "too big to fail." Moreover, size is not the only cause of systemic risk. As we learned when policymakers determined that Lehman Brothers was not too big to fail, complex and opaque interconnections among firms, most notably through credit default swaps, also create systemic risk. We have also discovered that some products, such as mortgage-backed securities, are so complex and prone to spread like a virus through the financial system that they pose a threat of systemic risk because they afflict so many institutions and they are nearly impossible to unwind when they fail. In other words, we must prevent products and institutions from becoming "too big or too complicated to fail."

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[1] The Consumer Federation of America (CFA) is a non-profit association of some 300 consumer groups that was founded in 1968 to advance the consumer's interest through advocacy, research, and education.

[2] The Dictionary of Modern Economics, p. 298. The Wikipedia definition is as follows: **Moral hazard** is the prospect that a party insulated from risk may behave differently from the way it would behave if it were fully exposed to the risk. Moral hazard arises because an individual or institution does not bear the full consequences of its actions, and therefore has a tendency to act less carefully than it otherwise would, leaving another party to bear some responsibility for the consequences of those actions… Financial bail-outs of lending institutions by governments, central banks or other institutions can encourage risky lending in the future, if those that take the risks come to believe that they will not have to carry the full burden of losses. Lending institutions need to take risks by making loans, and usually the most risky loans have the potential for making the highest return. A moral hazard arises if lending institutions believe that they can make risky loans that will pay handsomely if the investment turns out well but they will not have to fully pay for losses if the investment turns out badly.

Restoration of Effective Prudential Regulation is Vitally Necessary to Restore the Health of the Financial System

While we believe that vigorous antitrust enforcement is critically important to promoting a competitive industry that protects the public from a variety of abuses, we also believe that the only way to prevent the public from being exposed to the moral hazard of "too big or too complicated to fail" is to regulate financial institutions and products in a manner that imposes effective discipline directly on their behavior. Antitrust authorities do not have any special expertise in understanding systemic risk and the principles of antitrust law do not reach systemic risk. Given the financial sector's tendency to parallel, procyclical behavior (contagion) with complex products and opaque balance sheets, even an unconcentrated market can easily pose a systemic risk.

Moreover, as described in Table 1, we have identified six fundamental flaws that have afflicted the inadequately regulated financial markets of the past several decades, only one of which is the moral hazard involved in "too big or too complicated to fail." In addition to moral hazard, the flaws in financial markets that we have identified include asymmetric information, agency, conflicts of interest, perverse incentives and unfairness.[3] These problems also exceed the reach of antitrust law in many ways.

The theory of market fundamentalism that got the financial sector and the real economy into the current mess claimed that the market was all we needed to protect us from these flaws. Alan Greenspan recently admitted that this theory suffered from a flaw.

> "Those of us who looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief… I made a mistake in presuming that the self-interests of organizations, specifically banks and others, were such that they were best capable of protecting their own shareholders and their equity in the firms."[4]

Greenspan's admission of a fundamental flaw in market fundamentalism teaches us that we cannot rely on the market to ensure that the financial system performs its important role in society, as described by the Congressional Oversight Panel in its recent report.

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[3] The Wikipedia definition of moral hazard also points out that several of these flaws in the financial markets can be seen as different types of moral hazard: Moral hazard is related to information asymmetry, a situation in which one party in a transaction has more information than another. The party that is insulated from risk generally has more information about its actions and intentions than the party paying for the negative consequences of the risk. More broadly, moral hazard occurs when the party with more information about its actions or intentions has a tendency or incentive to behave inappropriately from the perspective of the party with less information….A special case of moral hazard is called a principal-agent problem, where one party, called an agent, acts on behalf of another party, called the principal. The agent usually has more information about his or her actions or intentions than the principal does, because the principal usually cannot perfectly monitor the agent. The agent may have an incentive to act inappropriately (from the viewpoint of the principal) if the interests of the agent and the principal are not aligned.

[4] "The Financial Crisis and the Role of Federal Regulators," Committee on Oversight and Government Reform, U.S. House of Representative, October 23, 2008.

> "A well-regulated financial system serves a key public purpose: if it has the power and if its leaders have the will to use the power, it channels savings and investment into economic activity… A healthy financial system, one that allows for the efficient allocation of capital and risk, is indispensable to any successful economy."[5]

Table 1: Causes of Market Failure in Deregulated Financial Markets[6]

Moral Hazard: Traditionally, moral hazard has been the focal point of concern in the financial sector, but the current crisis demonstrates a much broader set of problems and concerns. In the finance sector, there has long been a tendency to shift costs and risks onto the backs of taxpayers, where the government guarantees the ultimate soundness of financial institutions, either directly through insurance, or indirectly, by conceding that some institutions are "too big to fail." The shift of risk is highly visible where the government acts as insurer, and the counterbalance to that risk was supposed to be vigorous government regulation to constrain risky behavior. But market fundamentalism led to weak government oversight even at insured institutions. Financial institutions outside the insurance system were even less constrained in the risks they could assume. As a result, the government has been driven to bail out not only banks and the government sponsored enterprises, Fannie Mae and Freddie Mac, but also investment banks and the insurer AIG. What was once an abstract threat – that financial institutions would take irresponsible risks in the confidence that the government would bail them out – has become a pressing reality.

Transparency and Asymmetric Information: The second flaw that receives a great deal of attention in discussions of the current financial crisis is information transparency. The availability of information is central to the operation of efficient markets. Lack of transparency makes it difficult to evaluate risk and achieve efficient outcomes, while asymmetry of information between management, stockholders and the public provides an open invitation for mischief. These problems have been manifest in the current crisis in a host of ways, including collateralized debt obligations so complex as to be completely opaque even to many who bought and sold them; financial institutions who used accounting maneuvers to move risky assets off their balance sheet in ways that were supposed to be outlawed after the Enron scandal; and intricate inter-connections of institutions through over-the-counter derivatives transactions that left participants in the dark about the nature and scope of counter-party risk to which they were exposed.

Key players who had critical roles in the information chain had massive conflicts of interest that either blinded them to risks or made them reluctant to convey that information to other market participants. As a result, the quality of information was abysmal. This includes credit rating agencies, whose AAA ratings were essential to creating a market for mortgage-backed securities. Paid by issuers, the ratings agencies' profitability depended on their ability to win market share in the highly lucrative business of rating structured finance deals, and their ability to win that business too often depended on the "flexibility" of their ratings. Investment bankers, meanwhile, were responsible both for ensuring that credit rating agencies received complete and accurate information regarding the securities they were to rate and that investors received full and fair disclosures regarding the deal. But the massive fees they earned underwriting the securities left them with little incentive other than the public interest to fulfill their information responsibilities diligently.

Agency: The separation of ownership and control has long been recognized as a social problem for the capitalist economy, but the incentive structures of market fundamentalism make it urgent. There is a powerful interaction between information, agency, incentive structures and conflicts of interest. Because of imperfect information, it is often difficult to make sure that an agent does what he is supposed to do. Because of the failure to align incentives, it is often the case that he does not. The problems of agency and perverse incentives intersect in a highly visible issue in the current context – executive compensation.

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[5] Congressional Oversight Panel, *Special Report on Regulatory Reform,* January 29, 2009

[6] Mark Cooper and Barbara Roper, *Reform Of Financial Markets, The Collapse of Market Fundamentalism and the First Steps in Revitalizing the Economy*, Consumer Federation of America, forthcoming.

Compensation packages for financial industry executives not only increased dramatically in recent years, but also took on a structure that introduced short-term bias in business decision-making.

Perverse Incentives: Market fundamentalism has a pervasive incentive problem that creates an engine of instability in the structure/conduct heart of the unregulated financial market. This was evident in the current crisis, where a daisy chain of conflict-ridden market participants spread the risks from unsound mortgage loans into every corner of the global financial markets. As fees from making deals became a major source of income, the quality of the deals mattered less and less. After all, the deals could always be sold by conflict-ridden brokers, supported by loans from conflict-ridden banks, securitized by conflict-ridden investment banks, rated by conflict-ridden credit rating agencies, and moved off the balance sheets so that more deals could be made and more fees earned. As long as more money could be pulled in, the day of reckoning could be pushed off. The structure of income and compensation created a perverse incentive to pump up fees and bonuses, with little regard to the quality of the underlying assets and loans.

Conflicts of Interest: Conflicts of interest pervade the financial system. We have already mentioned the key role that conflicts at credit rating agencies and investment banks played in bringing about the current crisis through there impact on incentives. However, conflicts of interest can and do take many other forms as well. When, for example, a single entity owns both an insured business (e.g. a commercial bank) and an uninsured business (an investment bank), or both regulated and unregulated subsidiaries that deal with each other, there is a powerful conflict of interest. Profit can be increased by having the insured (regulated) entity, which is not supposed to get into risky lines of business, subsidize the uninsured (unregulated) ventures that do get into risky businesses, with imprudent loans. Or unregulated entities (such as off-balance sheet investment vehicles) can be used to hide risks assumed by the regulated entity (bank) in order to evade capital requirements designed to protect taxpayers from risk.

At the extreme, where agents not only pursue their interests at the expense of shareholders and the public, but also do so illegally, conflicts of interest become fraud. Fraud is not unique to market fundamentalism, but the institutional structure creates a fertile field for an endemic fraud problem. High stakes, lax oversight, creative accounting and a short-term perspective are conducive to fraud. In an environment that emphasizes short-term stock market returns and allows risk takers to take out earnings quickly, practices degenerate. As the bad actors get their short-term rewards, the good actors become desperate to keep up. In fact, given the structural conduciveness to fraud and the structurally induced race to the bottom in ethics, it is fair to argue that market fundamentalism has a uniquely endemic fraud/abuse problem.

Unfairness/Inequality: The five flaws described above have all been recognized as creating a potential for market failures in unregulated markets. In its report on financial regulatory reform, the Congressional Oversight Panel adds a sixth – unfairness. Unfairness in transactions, the COP argues, can starve the system of resources, raising costs and restricting activity. It describes two categories of problems, outright deception and fraud on the one hand and a more subtle problem that exists when parties to a transaction are unfairly matched. In addition to threatening the flow of resources into the system, unfairness in transactions can result in misallocation of resources, as lenders take advantage of overmatched borrowers to drive up household debt to precarious levels, for example.

This broader conceptualization of the importance of unfairness/inequality as a supply-side issue fits the current crisis in another sense, which is a demand side problem. The severe increase in inequality of income and resources that took place during the reign of market fundamentalism resulted in a failure of incomes to keep up with the rapid expansion of the production capacity of the economy. The rising cost of necessities – housing, education, health care, and energy – put severe stress on household budgets, causing them to plunge into debt to maintain their standard of living. Savings are too low, and concentrated wealth creates rampant speculation rather than productive investment in the real economy.

Regulation and Antitrust Go Hand-in-Hand

This means that competition alone is not enough to ensure the proper functioning of the financial system. There is no evidence that market discipline alone is sufficient to promote transparency, protect consumers, prevent conflicts of interest, discipline excessive greed and speculation, or solve agency problems, not to mention control systemic risk. On the contrary, competition and regulation should go hand in hand in rebuilding the financial system. Effective prudential regulation should establish the framework within which competition can work. And we should not forget that many of the competition authorities in the U.S. have consumer protection in their portfolio.[7] Therefore, they can play an important role in promoting transparency and fairness in financial markets.

For example, in order to control systemic risk, it is critically important to established effective capital ratios that increase as the size of institutions increase, to require originators of loans and assets to retain a substantial direct interest in those assets (i.e. to have skin in the game) and to ban off balance sheet investment vehicles, among other things. Having established these basic parameters for financial institutions, we still want vigorous competition to promote efficiency, within the constraints that regulation establishes. Financial institutions should not prosper by over leveraging and shifting risk to taxpayers; they should prosper by providing better customer service and having a sharper eye for evaluating risk. Regulation prevents irresponsible behavior that takes advantage of stockholders and consumers; competition promotes the efficient functioning of the market.

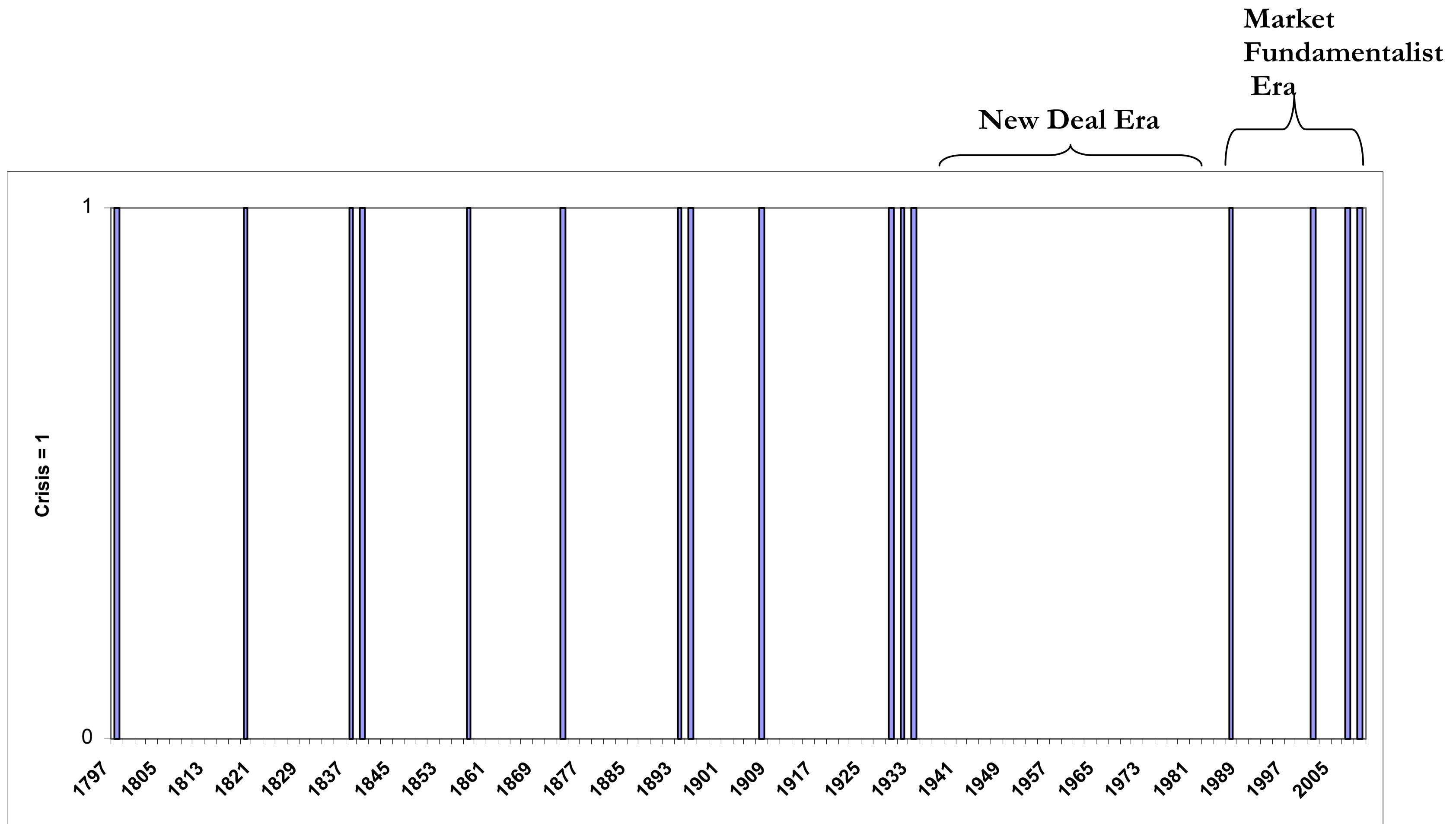
When the News Deal created the institutions of prudential regulation to repair the financial sector after the crash that ended the roaring twenties, ***it did not repeal the antitrust laws.*** It layered prudential regulation atop the antitrust laws. The result was a most remarkable half century, as depicted in Figure 1; the only half century that was free of major domestic financial crises in the history of the Republic.

Restoration of Effective Antitrust Oversight is Vitally Necessary to Ensure that Financial Markets Do their Job Efficiently

In order to ensure that competition and regulation work together in the financial sector, the Congress will have to be alert to a nasty trend that has developed lately at the Supreme Court. In a series of cases in the telecommunications sector, the court has ruled that where regulation exists, no matter how lax, the antitrust laws do not apply. That view is

[7] CFA supports the creation of a modern institution of prudential regulation, an independent federal agency to regulate credit products and payment systems for safety, to protect consumers and repair the financial sector in the wake of the current economic crash. Such an agency has been proposed by the Congressional Oversight Panel, Representative Delahunt (H.R. 7258 in the 110th Congress) and Senators Durbin and Schumer (S. 566.).

Figure 1: History of Major Domestic U.S. Financial Crises



Source: Mark Cooper and Barbara Roper, *Reform Of Financial Markets, The Collapse of Market Fundamentalism and the First Steps in Revitalizing the Economy*, Consumer Federation of America, forthcoming, based on Congressional Oversight Panel, *Special Report on Regulatory Reform,* January 29, 2009.

simply wrong. It stems from the extreme market fundamentalist view held by a majority of the members of the court, which fails to recognize the severe market imperfections and the harm of market failure that afflicts many markets in the 21st century economy.

In the past three decades, as market fundamentalists dismantled the institutions of prudential regulation, they also relaxed antitrust oversight based on the now discredited belief that the invisible hand of the market would correct its many problems. The combination of inadequate regulation and inadequate competition has produced the current disaster in the financial sector. We must restore the institutions of progressive capitalism, which recognized the need for both regulation and competition. It is time for us to abandon the market fundamentalism view of market failure and regulation and to return to the New Deal view of market failure and regulation. It is time to replace the age of irrational exuberance for markets, where regulation was seen as the *ex post* clean up after the occasional market failure, with an understanding that regulation is the *ex ante* prophylaxis to prevent market failure.

Regulation is not the bailiwick of this committee, so much of what needs to be done will happen elsewhere on Capitol Hill, but there is much to be done in the realm of antitrust enforcement to ensure that financial markets are competitive and produce consumer friendly, economically efficient outcomes within the parameters that regulatory policy sets. There are at least four areas of merger and competition policy in need of immediate and extensive repair.

Thresholds. Based upon decades of experience and theory, the Department of Justice's *Merger Guidelines* suggest that mergers in markets that have fewer than the equivalent of six equal-sized competitors are harmful and should be challenged. In the past decade, that standard seems to have deteriorated into a standard of "more than two is enough." The theory of the dynamic duopoly has proven to be just as wrong headed as market fundamentalism. Federal antitrust authorities should take their own guidelines more seriously, challenging mergers more consistently in highly concentrated markets.

Potential and Intermodal Competition. The lax standard has been driven in part by an over reliance on intermodal and potential competition to excuse the massive build up of market power that is evident when a rigorous 'traditional' view of product and geographic markets is taken. Intermodal and potential competition has simply not provided the effective disciplining force that head-to-head competition provides. Antitrust authorities must return to the fundamentals of head-to-head competition as the foundation of antitrust action.

Efficiency Defense. Over the past several decades antitrust has given far too much deference to efficiency at the expense of competition. The theory that private actors should be allowed to acquire market power where efficiency would be advanced rested in part on the assumption that firms would perceive and pursue their

interest in a manner that promoted the consumer interest. The economic literature is fairly clear that there is not much evidence there are efficiencies from mergers; in financial services the record looks even more dismal. We in the public interest movement have always maintained that the pursuit of private profit is not always synonymous with the public good and challenged the efficiency argument because, absent competition, firms with market power are not compelled to share the efficiency gains with the consumer. But Greenspan's admission raises another even more fundamental challenge and goes us one better, admitting that the pursuit of private profit may not be synonymous with the private interest. The assumption that private actors will be perceptive and well-intentioned in their pursuit of efficiency can no longer be relied upon. Private actors are at least as likely to be myopic, misinformed and maleficent. Competitive market structures should take precedence over claims of efficiency gains.

Vertical Leverage. The digital economy of the 21st century is very much an economy made up of platforms in which layers of complementary products and services sit atop one another. In traditional antitrust analysis, markets may look like separate markets vertically organized, but their close interconnection, frequently through technological dependency, renders the threat of exercise of vertical leverage much greater than was the case in the physical markets of the 19th and 20th centuries. Tying, anticompetitive bundling and exclusionary conduct take on much greater significance.

Thus, in the antitrust space, just as in the realm of prudential regulation of financial institutions, we have been afflicted by irrational exuberance for unregulated markets. The need for reform does not demand a radical new experiment. Rather, it demands a return to the traditional values of progressive capitalism that served us so well in the half century after the New Deal. The market fundamentalism of the past thirty years was the radical experiment and it has failed miserably.