Testimony of Robert Weissman
President, Public Citizen

Hearing on "Too Big To Fail –
The Role for Bankruptcy and Antitrust Law in Financial Regulation Reform"

Before the House Judiciary Committee
Subcommittee on Commercial and Administrative Law

October 22, 2009

Testimony of Robert Weissman
President, Public Citizen
Hearing on "Too Big To Fail –
The Role for Bankruptcy and Antitrust Law in Financial Regulation Reform"
Before the House Judiciary Committee
Subcommittee on Commercial and Administrative Law
October 22, 2009

Mr. Chairman and members of the Committee, thank you very much for inviting me to testify today. I am president of Public Citizen, a nonprofit research, lobbying and litigation public interest organization with 150,000 members and supporters. Based in Washington, D.C., and founded in 1971, Public Citizen accepts no government or corporate funds.

Public Citizen is a member of Americans for Financial Reform, a coalition of more than 200 consumer, community, labor, civil rights, housing, faith-based and other public interest organizations. I have appended to this statement the Americans for Financial Reform position paper on resolution authority issues.

I want to thank you for holding today's hearing. Financial re-regulation is the subject of intense debate and discussion in Congress -- and around the country -- right now. It is important that the issue of financial re-regulation be considered from multiple vantage points. The Judiciary Committee has a crucial role to play in the re-regulation debate, considering matters in light of its expertise in bankruptcy and, especially, antitrust.

Antitrust offers a different approach to addressing Wall Street abuses than traditional regulation. Antitrust looks to industry structure rather than just setting rules for all market participants. When it turns its attention to troubling conduct of institutions with market power, it commonly employs remedies which provide (somewhat) self-enforcing specific rules of conduct. This is in contrast to the agency rule-making and enforcement approach, which usually requires effective regulatory surveillance and enforcement. The traditional regulatory approach is vital; but policymakers need also to draw on the distinct and complementary wisdom embodied in antitrust.

There is widespread agreement that creation of too-big-to-fail financial institutions was a key contributing factor to the financial crisis -- and that addressing the too-big-to-fail problem is a central challenge for regulation going forward. The traditional regulatory approach directs policy inquiry into how regulatory agencies can monitor the too-big-to-fail financial institutions to ensure they do not engage in excessively risky operations. The antitrust approach suggests a more fundamental inquiry: Should the too-big-to-fail financial institutions be permitted to exist? What social value do they offer as against harms and risks to financial stability and a functioning democracy? Are the dangers of too-big-to-fail financial corporations great enough to overcome the presumption in favor of leaving private corporations to grow as they please? If too-big-to-fail Wall Street firms are permitted to continue to exist at current scale, should they be subject to specific conduct rules, including rules designed to limit their speculative undertakings? And, should government policy exhibit a bias against size, at least to the extent that government-facilitated combinations of financial institutions do not exacerbate the too-big-to-fail problem?

In this testimony, I will touch on these issues, in the context both of the current profile of the financial services industry, and proposals to create a resolution authority for too-big-to-fail non-bank financial institutions.

The first section of my testimony briefly reviews consolidation trends in the financial sector over the last quarter century, and highlights the serious and unique problems with excessively sized corporations in the financial sector. These include consumer and competition problems, but especially the familiar "too big to fail" issue and concerns with how large financial institutions impair a functioning democracy. The second section draws on antitrust principles to suggest a series of proposals to shrink excessively sized financial firms -- including but not limited to a call to break up the biggest banks -- and to control large firms that continue to exist. The final section turns attention to the issue of what to do with failing non-bank financial companies that pose a threat to the overall financial system. It concludes that the case for establishing new resolution authority is strong, but that this authority should be guided by legislative directives to prevent continuation of a misguided bailout policy.

The Rise of Too-Big-to-Fail -- and the Fall of the Financial System

Merger mania in the financial industry has been all the rage for more than 25 years. "Bigger is indeed better," proclaimed the CEO of Bank of America in announcing its merger with NationsBank in 1998.[1] In the United States, about 11,500 bank mergers took place from 1980 through 2005, an average of about 440 mergers per year.[2]

The size of the mergers has increased to phenomenal levels in the pre-crisis period: In 2003, Bank of America became a $1.4 trillion financial behemoth after it bought FleetBoston, making it the second-largest U.S. bank holding company in terms of assets. In 2004, JPMorgan Chase agreed to buy Bank One, creating a $1.1 trillion bank holding company.[3]

---

[1] Dean Foust, "BofA: A Megabank in the Making," BusinessWeek, September 13, 1999, available at: <http://www.businessweek.com/archives/1999/b3646163.arc.htm>.

[2] Loretta J. Mester, Senior Vice President and Director of Research at the Federal Reserve Bank of Philadelphia, "Some Thoughts on the Evolution of the Banking System and the Process of Financial Intermediation," Economic Review, First & Second Quarters, 2007, available at: <http://www.frbatlanta.org/filelegacydocs/erq107_Mester.pdf>.

[3] Loretta J. Mester, Senior Vice President and Director of Research at the Federal Reserve Bank of Philadelphia, "Some Thoughts on the Evolution of the Banking System and the Process of Financial Intermediation," Economic Review, First & Second Quarters, 2007, available at: <http://www.frbatlanta.org/filelegacydocs/erq107_Mester.pdf>.

From 1975 to 1985, the number of commercial banks was relatively stable at about 14,000. By 2005 that number stood at 7,500, a nearly 50 percent decline.[4] A staggering series of mergers led to ever larger banks at the top.[5]

By mid-2008, the top five banks held more than half the assets controlled by the top 150.[6]

Regulators and antitrust enforcers rarely challenged the rash of bank mergers and acquisitions.

(A similar story can be told about the securities side of the financial sector. Summarizes analyst Jane D'Arista: "Mergers have also consistently reduced the number of firms in the securities industry. At year-end 1984, the top 10 firms — 0.12 percent of the 7,800 firms registered — accounted for 41 percent of the sector's capital, 47 percent of total revenue and 55 percent of underwriting profits. Of the top 10, all but three (Merrill Lynch, Lehman Brothers and Goldman Sachs) had been acquired by or merged with other institutions by the beginning of 2008."[7])

Strikingly, the bursting of the housing bubble and subsequent financial crash has led to a sharp *intensification* of the quarter century trend. The top two mortgage companies, Wells Fargo and Bank of America, originated 44 percent of all mortgages in the second quarter of 2009, up from 28.6 percent the previous year. The jump reflects Bank of

---

[4] Loretta J. Mester, Senior Vice President and Director of Research at the Federal Reserve Bank of Philadelphia, "Some Thoughts on the Evolution of the Banking System and the Process of Financial Intermediation," Economic Review, First & Second Quarters, 2007, available at: <http://www.frbatlanta.org/filelegacydocs/erq107_Mester.pdf >.

[5] James Brock, "Merger Mania and Its Discontents: The Price of Corporate Consolidation," Multinational Monitor, July/August 2005, available at: <http://www.multinationalmonitor.org/mm2005/072005/brock.html>. (In a brief review of mergers through 2005, Brock writes, "Through two decades of ever-larger acquisitions, NationsBank became one of the country's largest commercial banking concerns, absorbing C&S/Sovran (itself a merged entity), Boatmen's Bancshares ($9.7 billion deal), BankSouth and Barnett Bank ($14.8 billion acquisition). Then, in 1998, NationsBank struck a spectacular $60 billion merger with the huge Bank of America, which itself had been busily acquiring other major banks. The merger between NationsBank and B of A created a financial colossus controlling nearly $600 billion in assets, with 5,000 branch offices and nearly 15,000 ATMs. Bank of America then proceeded to acquire Fleet Boston — which had just completed its own multi-billion dollar acquisitions of Bank Boston, Bay Bank, Fleet Financial, Shawmut, Summit Bancorp and NatWest. Giants Banc One and First Chicago NBD — their size the product of numerous serial acquisitions — merged, and the combined entity was subsequently absorbed by J.P. Morgan which, in turn, had just acquired Chase, after the latter had merged with Manufacturers Hanover and Chemical Bank in the financial business of underwriting stocks and bonds. Other mega-mergers include the $73 billion combination of Citicorp and Travelers Group in 1998, as well as the acquisition of leading brokerage firms by big banks, including Morgan Stanley's ill-fated acquisition of Dean Witter.")

[6] Loretta J. Mester, Senior Vice President and Director of Research at the Federal Reserve Bank of Philadelphia, "Some Thoughts on the Evolution of the Banking System and the Process of Financial Intermediation," Economic Review, First & Second Quarters, 2007, available at: <http://www.frbatlanta.org/filelegacydocs/erq107_Mester.pdf >.

[7] Jane D'Arista, "Financial Concentration." Wall Street Watch, August 2009, available at: http://wallstreetwatch.org/blog/?p=73.

America's acquisition of Countrywide, and Wells Fargo's takeover of Wachovia.[8] Other metrics also reveal a starkly more concentrated market: The market share percentage of deposits held by JP Morgan Chase, Wells Fargo, and Bank of America has risen from 21 percent in 2007 to 33.9 percent in 2009, according to SNL Financial data reported by The Washington Post.[9] The top four banks held 49 percent of total banking assets as of June 2009;[10] a roughly 50 percent jump from June 2003, when the top four held 33 percent of total assets.[11]

The financial industry has also witnessed another kind of consolidation over the last decade, following the repeal of the Glass Steagall and related acts, and adoption of the Gramm-Leach-Bliley Financial Modernization Act of 1999. Gramm-Leach-Bliley paved the way for commercial banks to merge with insurance companies and investment banks. It helped introduce the speculative risk-taking culture into commercial banking -- providing the toxic mix of government insurance and speculative betting that helped generate the financial crisis.[12]

The financial crisis has intensified the combination of commercial banks and other financial enterprises, with JP Morgan's acquisition of Bear Stearns and Bank of America's takeover of Merrill Lynch.

Bigger banks are bad for society. Although there are contradictory studies in the area, there is compelling evidence that large banks take on more risk than smaller banks, while providing inferior service and higher charges to consumers. Studies have shown that compared to smaller banks, large banks take on greater leverage,[13] more investments in derivatives,[14] and higher percentages of uninsured deposits.[15] Derivative risk, in fact, is overwhelmingly concentrated in the top banks: The top five banks own 96 percent of all

---

[8] Kate Berry, "Mortgages' Big Two Are Too Big to Avoid," National Mortgage News, September 30, 2009, available at: <http://www.nationalmortgagenews.com/lead_story/?story_id=96>.
[9] David Cho, "Banks 'Too Big to Fail' Have Grown Even Bigger (The Big Get Bigger)," The Washington Post, August 28, 2009, available at: <http://www.washingtonpost.com/wp-dyn/content/graphic/2009/08/28/GR2009082800426.html?sid=ST2009082800437>.
[10] <http://www.federalreserve.gov/releases/lbr/current/default.htm>.
[11] <http://www.federalreserve.gov/releases/lbr/20030630/lrg_bnk_lst.txt>.
[12] "When repeal of Glass-Steagall brought investment and commercial banks together, the investment-bank culture came out on top. There was a demand for the kind of high returns that could be obtained only through high leverage and big risk taking." Joseph Stiglitz, "Capitalist Fools," Vanity Fair, January 2009, available at: <http://www.vanityfair.com/magazine/2009/01/stiglitz200901>.
[13] Rebecca S. Demsetz and Philip E. Strahan, Federal Reserve Bank of New York, Research Paper 9506, April 1995, available at: <http://www.newyorkfed.org/research/staff_ reports/research_papers/9506.pdf>. See also Arnold Danielson, "Getting Ready for the 21st Century: A Look at Recent Banking Trends," Banking Pol'y Rep., March 15, 1999. (Banks larger than $50 billion had an average capital ratio of seven percent while banks between $100 million to $2 billion in size had an average capital ratio of just over nine percent).
[14] Rebecca S. Demsetz and Philip E. Strahan, Federal Reserve Bank of New York, Research Paper 9506, April 1995, available at: <http://www.newyorkfed.org/research/staff_ reports/research_papers/9506.pdf>.
[15] Office of the Comptroller of the Currency, "OCC's Quarterly Report on Bank Trading and Derivatives Activities, First Quarter 2009" available at: <http://www.occ.treas.gov/ftp/release/2009-72a.pdf>.

U.S. bank-owned financial derivatives (by notional value).[16] The top five banks own 80 percent of the entire U.S. derivatives risk.[17]

These risky policies combine to exacerbate institutional and systemic risk. Jane D'Arista offers one example: "Much of that increase [in borrowing by the banking sector] reflects leverage -- that is, borrowing (under repurchase agreements) using assets reported on their books as collateral to obtain cash to buy additional assets that could be held off-balance-sheet. Institutional size mattered because the margin of return over the cost of borrowing was so small that profitability depended on the size of the position and thus on the ability to attract the amount of funds needed to finance a huge pool of investments. The result of burgeoning leverage was even larger balance sheet and (especially) off-balance-sheet liabilities that increased the market dominance of these institutions at the same time that it exacerbated their fragility and interdependence."

The too-big-to-fail enterprises also benefit from an implicit subsidy, as they are able to raise funds on the capital markets at a lower interest rate, reflecting their perceived invulnerability to failure. Economist Dean Baker and researcher Travis McArthur find the cost of funds for institutions with assets in excess of $100 billion to be .78 percentage points less than the average cost of funds for smaller banks. The difference in cost of funds has leapt dramatically since the financial crash, which Baker and McArthur attribute to the adoption of a nearly formalized too-big-to-fail policy. This difference -- which Baker and McArthur emphasize is sure to change over time, and may shrink -- implies an annual subsidy to large financial institutions of roughly $34 billion.[18]

On the consumer side, there is evidence that larger banks charge higher overdraft fees, checking account fees and ATM fees.[19]

There is no public policy rationale for maintaining mega-financial institutions (beyond the not unimportant presumption that firms should be left alone). Proponents inevitably cite synergies and efficiencies for every merger, but retrospective analyses (as well as common sense) show that these do not emerge.[20] Even the savings from closing branches

---

[16] Office of the Comptroller of the Currency, "Quarterly Report on Bank Trading and Derivatives Activities, First Quarter 2009," available at: <http://www.occ.treas.gov/ftp/release/2009-72a.pdf>.
[17] David Katz, "Five Firms Hold 80 percent of Derivatives Risk, Fitch Report Finds," CFO, July 24, 2009, available at: <http://www.cfo.coma/article.cfm/14113089>.
[18] Dean Baker and Travis McArthur, "The Value of the 'Too Big to Fail' Big Bank Subsidy," Center for Economic and Policy Research, September 2009, available at: <http://www.cepr.net/index.php/publications/reports/too-big-to-fail-subsidy>.
[19] Timothy H. Hannan, "Retail Deposit Fees and Multimarket Banking," Federal Reserve Board, December 2005, available at: <http://www.federalreserve.gov/pubs/feds/2005/200565/200565pap.pdf>.
[20] See Allen N. Berger and David B. Humphrey, "The Dominance of Inefficiencies Over Scale and Product Mix Economies in Banking," J. Monetary Econ., 117-48, August 28, 1991; Allen N. Berger and David B. Humphrey, "Megamergers in Banking and the Use of Cost Efficiency as an Antitrust Defense," 37 Antitrust Bull. 541, 554-65 (1992); Simon Kwan and Robert A. Eisenbeis, "Mergers of Publicly Traded Banking Organizations Revisited," Fed. Res. Bank of Atlanta, Econ. Rev., 4th Qtr. 1999; Jane C. Linder & Dwight B. Crane, "Bank Mergers: Integration and Profitability," 7 J. Fin. Servs. Res. 35, 40-52 (1992); Stavros Peristiani, "Do Mergers Improve the X-Efficiency and Scale Efficiency of U.S. Banks? Evidence from the 1980s," 29 J. Money, Credit & Banking 326, 329-33, 336-37 (1997); Steven J. Pilloff,

and layoffs are offset by increased costs.[21] The behemoth financial institutions have long passed the point of absorbing all available economies of scale. Reasons the financial companies continue to grow in size, despite a paucity of evidence that such growth contributes to efficiency, include empire building and executive compensation, which often rises in conjunction with greater institutional size.[22]

Defenders of the goliath financial institutions sometimes claim they are necessary to service giant non-financial corporations, and that the United States needs goliaths to compete globally. But these claims are meritless. Large corporations may need large banks, but there is no reason to believe they need banks on the scale of today's giants versus the size of the top banks a year ago, or five years ago. The global competition argument collapses once it is recognized that larger banks are not more efficient -- on exactly what terms are the colossus banks supposed to be better competitors?[23]

But even if there were a narrow economic case to be made for preserving the giant financial corporations, it would be overwhelmed by two countervailing concerns: the creation of too-big-to-fail institutions, and the excessive political power of the Wall Street giants. These concerns signal the need for a policy bias against giant financial institutions, and a willingness to employ appropriate tools to prevent and unwind undue concentration among financial firms.

The too-big-to-fail problem has hovered over policymaking in the U.S. financial sector for at least a quarter century, since the bailout of Continental Illinois. The current crisis has now shown how too-big-to-fail endangers the national (and global) economy. Too-big-to-fail was a cause as well as cost of the crisis. On the one hand, the backstop of a de

---

"Performance Changes and Shareholder Wealth Creation Associated with Mergers of Publicly Traded Banking Institutions," 28 J. Money, Credit & Banking 294, 297-98, 301, 308-09 (1996).

[21] Arthur E. Wilmarth, Jr., "The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation and Increased Risks," 2002 U. Ill. L. Rev. 2 215 (2002), available at: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=315345>.

[22] Allen N. Berger and David B. Humphrey, "The Dominance of Inefficiencies Over Scale and Product Mix Economies in Banking," J. Monetary Econ., 117-48, August 28, 1991; Arthur E. Wilmarth, Jr., "The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation and Increased Risks," 2002 U. Ill. L. Rev. 2 215 (2002), available at: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=315345>.

[23] On these matters generally, see multiple posts by Simon Johnson and James Kwak at www.baselinescenario.com. In an October 12, 2009 posting, "Who Needs Big Banks?," Kwak writes: "Let's take a big, global transaction — say, a debt offering. Here, arguably, it might be good to have a single bank with global scale, since you want to sell bonds in as many markets as possible in order to get the broadest possible pool of investors. In 2008, J&J issued $1.6 billion (face value) of bonds. Who got the deal? Goldman, JPMorgan, Citi, Deutsche Bank, Bank of America, Morgan Stanley, Williams Capital Group, BNP Paribas, HSBC, Mitsubishi UFJ, and RBS Greenwich Capital. Eleven investment banks based in five countries, including five U.S.-based banks. (In 2007, J&J issued 500 million pounds of debt, using thirteen underwriters — six of whom were not involved in the 2008 offering; two out of three book-running managers were European banks.) So when push comes to shove, our beloved mega-banks are nowhere near up to the task. What this tells me is that it's the big companies that call the shots, and they like parceling out business to lots of banks. This is another basic principle of business: it's better to have multiple suppliers than one supplier, so you can keep them in competition." Available at: http://baselinescenario.com/2009/10/12/who-needs-big-banks/#more-5216.

facto federal guarantee helped drive the financial sector to an ever-greater speculative frenzy. The giants threw caution to the wind, in part because of the assumed federal backstop. On the other hand, the imminent threat of institutional failure has drained hundreds of billions of dollars from federal coffers, and required trillions of dollars of public supports for Wall Street.

Not unrelatedly, the Wall Street goliaths accumulate extraordinary and dangerous political power. This distorts appropriate policymaking in all kinds of ways, involving matters from trade to climate policy.[24] Most acutely, this accumulated power enables Wall Street to lobby effectively for deregulation that makes speculation, financial bubbles and subsequent collapse more likely;[25] for unconditional bailouts in the face of crisis; and against modest restraints even in the aftermath of financial crash and bailout (as is currently the case).

It is inconceivable that the advantages of maintaining giant financial firms, if any were demonstrated, could outweigh -- or even come close to offsetting -- the enormous costs attached to entrenchment of too-big-to-fail financial corporations and the associated subversion of effective democracy.

Antitrust Tools to Address Too-Big-to-Fail

In considering the too-big-to-fail problem, the issue, of course, is not whether the too-big-to-fail institutions are monopolies; although market concentration is fast worsening, the commercial banks and most too-big-to-fail financial institutions probably do not possess monopoly power nationally (although they may in local retail markets). Because the too-big-to-fail problem is nonetheless a problem of size (as well as the more complicated issue of interconnectedness), Congress, and relevant federal agencies, should employ appropriate antitrust principles and utilize appropriate antitrust tools to address the too-big-to-fail problem. The idea is to apply these concepts and instruments in a context closely akin to, but slightly different from, traditional antitrust analysis. What are the implications of this approach?

First, the most powerful implement in the antitrust toolkit is to break up existing enterprises. We believe using this tool is the simplest and most efficient way to deal with the too-big-to-fail problem. With Alan Greenspan, we agree that "If they're too big to fail, they're too big."[26]

Pursuing a break-up-the-banks policy would be no simple matter, of course, particularly given that a substantial (if uncertain) number of institutions that have achieved too-big-to-fail status. A deconcentration process would necessarily have to take place over time.

---

[24] On this matter generally, see Robert Kuttner, *The Squandering of America: How the Failure of Our Politics Undermines Our Prosperity*, New York: Knopf, 2007.
[25] See Robert Weissman and James Donahue, "Sold Out: How Wall Street and Washington Betrayed America," March 2008, available at: <http://www.wallstreetwatch.org/soldoutreport.php>.
[26] Quoted in Scott Lanman and Michael McKee, "Greenspan Says He's Not Concerned About Dollar's Drop," Bloomberg, October 15, 2009, available at: <http://www.bloomberg.com/apps/news?pid=20601103&sid=ai02YskF0RqI>.

It could be managed in a top-down fashion, with government regulators managing the break-up process. Alternatively, the government could instruct the mega institutions to sell off operations or spin off subsidiaries in line with government established targets. Graduated over time, it is very feasible. To address its own financial difficulties, Citigroup is undertaking this sort of process on its own initiative right now.

A more modest approach would be to unwind some or all of the recent megamergers. Undertaken in times of crisis, it is now evident, as noted above, that they have worsened both the size problem, and the problem of combining commercial banks and other, riskier financial institutions.

Second, Glass-Steagall, or an updated version of the venerable law repealed in 1999, should be reinstated. The core idea of Glass-Steagall remains highly relevant: Insured depository institutions should be kept separate from insurance companies, investment banks or other enterprises undertaking risky investments. The combination of commercial banks with risk-seeking subsidiaries in a single corporate entity is an invitation to disaster -- for the corporate entity, and, in the case of larger institutions, for the financial system overall.

Beyond Glass-Steagall's structural restraints, there should be put in place additional rules to control excessively risky practices by commercial banks. Paul Volcker has identified this set of activities as including ownership of hedge funds and private equity funds, and undertaking of heavy proprietary trading.[27]

Third, while we believe that breaking up the mega-financial institutions, and imposing a new Glass Steagall regime, are both desirable policies on the merits, we would also support less robust measures toward the same end. One less ambitious approach would be to impose a standstill or do-no-harm rule, so that the too-big-to-fail and related problems do not grow worse. This would suggest the need for a prohibition on acquisitions by existing too-big-to-fail institutions, a prohibition on mergers among large financial enterprises whose combination would create too-big-to-fail or nearly too-big-to-fail companies, and a prohibition on new mergers and acquisitions combining commercial banks with non-commercial bank enterprises.

Relatedly, the same rules should at least presumptively guide the actions of a resolution authority, an issue I discuss below.

Fourth, the existing 10 percent concentration limit for depository institutions should be enforced.[28] Under the Riegle-Neal *Interstate Banking and Branching Efficiency Act of*

---

[27] Paul Volcker, Testimony before the House Financial Services Committee, September 24, 2009, available at: <http://www.house.gov/apps/list/hearing/financialsvcs_dem/fchr_092409.shtml>. ("As a general matter, I would exclude from commercial banking institutions, which are potential beneficiaries of official (i.e., taxpayer) financial support, certain risky activities entirely suitable for our capital markets. Ownership or sponsorship of hedge funds and private equity funds should be among those prohibited activities. So should in my view a heavy volume of proprietary trading with its inherent risks.")

[28] 12 USC 1842(d)(2)(A) ("The [Federal Reserve] Board may not approve an application pursuant to paragraph (1)(A) if the applicant (including all insured depository institutions which are affiliates of the

1994, a bank may not acquire another bank if the acquisition will give it more than 10 percent of deposits held nationwide.

Congress should also consider lowering the limit to a point well below the too-big-to-fail threshold.

Fifth, Congress -- through hearings and/or commissioned studies -- should assess what constitutes appropriate size or interconnected limits for non-depository assets. These limits should be designated with an eye to both pro-competition objectives and preventing too-big-to-fail and systemic risk problems. The proliferation of financial assets makes an assessment of appropriate limits a complicated task. How great a holding of derivative instruments is required before an institution poses a systemic risk? Should this question be considered as a percentage of outstanding derivatives? An absolute total? This line of inquiry should also explore what set of assets should be subjected to limits: Does it matter from a pro-competitive or systemic risk perspective if individual institutions gain more than 10 percent each of all mortgages? All credit card business?

Sixth, if there is discomfort with acting immediately on break-up and Glass-Steagall proposals, Congress should create an independent commission to assess the structure and risks posed by the financial services industry.[29] This line of inquiry would be wholly distinct from the important efforts to investigate the causes of the financial crash. Instead, it would focus on how the evolving structure of the industry impacts competition and systemic risk.

Seventh, Congress should impose a fee on the too-big-to-fail institutions to capture for the public the subsidy these corporations are receiving in credit markets. This fee should be separate from other fees aiming to deter creation of too-big-to-fail corporations, fund a resolution authority for such institutions, or serve other purposes.

Finally, special conduct rules should be applied to the largest financial institutions. Because of the systemic threats they pose, the largest institutions should be subject to special rules aiming to deter risky behavior and enable effective monitoring by

---

applicant) controls, or upon consummation of the acquisition for which such application is filed would control, more than 10 percent of the total amount of deposits of insured depository institutions in the United States."

[29] Bert Foer of the American Antitrust Institute, who supports such a study commission, emphasizes the importance of the Depression era Temporary National Economic Commission (TNEC). "The TNEC model is a way to bring together a variety of viewpoints and develop a consensus over a sustained period of time and to come up with recommendations 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 acceptance of the idea that high levels of concentration could be dangerous and deserved to be the focus of national attention. And that realization eventually led to modifications of the Clayton Act, intended to stop monopolies, or near monopolies, from being formed through mergers." "The Centralization of Financial Power: Unintended Consequences of Government-Assisted Bank Mergers," An Interview with Bert Foer, Multinational Monitor, November/December 2008, available at: <http://www.multinationalmonitor.org/mm2008/112008/interview-foer.html>.

government regulators. And because these institutions are positioned to leverage their marketing and market power to gouge consumers, they should be subject to special consumer protection obligations. Appropriate conduct rules would include:

- Prohibitions on use of offshore tax havens, which facilitate complicated and non-transparent maneuvering.[30]

- Prohibitions, or at least stringent limits, on off-the-books accounting, which even if permissible obscure risk from regulators.

- Mandating that bonus pay for highly compensated executives and employees be linked to long-term performance, so that key employees are not incentivized to take speculative gambles with short-term payouts but long-term risks.

- Prohibitions on excessively risky undertakings, particularly derivative exposure where neither party has an underlying interest (e.g., naked credit default swaps).

- Enhanced reporting standards (not subject to exceptions otherwise in place) for derivative holdings and other risky investments, so that regulators and the public are better able to assess institutional and systemic risks.

- Enhanced capital reserve standards. Ideally, these would be set high enough to offset the real risks posed by too-big-to-fail institutions, and thus to meaningfully deter creation of such excessively sized corporations. MIT Professor Simon Johnson argues that the appropriate capital standard for too-big-to-fail institutions should be 15 percent.

- Enhanced consumer protection standards, including application of a "reasonableness" standard to dealings with consumers and the requirement of offering plain vanilla financial products.

- Enhanced affirmative obligations to serve consumers in underserved communities, including (for commercial banks) by offering lifeline accounts and accounts with low or no minimum balance requirements.

- Obligations to distribute invitations via regular and electronic mailings to consumers to join independent, federally chartered consumer organizations.

---

[30] In December 2008 the Government Accounting Office reported that Citigroup had 427 subsidiaries in jurisdictions listed as tax havens or financial privacy jurisdictions (including 90 in the Cayman Islands alone) -- the largest number of any Fortune 100 company. Government Accounting Office, "International Taxation: Large U.S. Corporations and Federal Contractors with Subsidiaries in Jurisdictions Listed as Tax Havens or Financial Privacy Jurisdictions," GAO-09-157, December 18, 2008, available at: <http://www.gao.gov/products/GAO-09-157>.

Resolution Authority and Resolving to Avoid Unconditional Bailouts

It is hard not to be somewhat sympathetic to the regulators who acted to rescue or merge (and in one notable case permit to go bankrupt) failing financial institutions in 2008 and 2009. They faced a crisis of a scale unmatched over the last 70 years, they were forced into seat-of-the-pants decision-making, there were no guidelines to direct their efforts, and they were forced to operate with unclear, at best, legal authority.

Nonetheless, it is hard to look at what was done over the past year-and-a-half and conclude it was anything less than disastrous. This is not to argue that the government should have done nothing. It had to intervene. But it did not have to, and should not have, offered an unrequited bailout.

It is worth very briefly reviewing the ad hoc fashion in which regulators treated failing institutions over the past 18 months, in order to highlight the flaws in the inconsistent strategies used.

In the case of the Bear Stearns, the Federal Reserve gifted JP Morgan with an agreement to absorb $30 billion in Bear Stearns risk, while orchestrating a low price amidst non-transparent negotiations for JP Morgan's acquisition of Bear.

In the case of Lehman Brothers, regulators decided to permit the firm to go bankrupt. This decision appears more reckless and misguided in retrospect than it did contemporaneously. It is also the case that a financial crisis was likely inevitable irrespective of what happened at Lehman. Nonetheless, the decision to permit the bankruptcy was clearly a mistake; it functioned as the trigger for an all-out panic in financial markets.

With AIG, regulators decided they could not permit another failure. Enormous sums of taxpayer money have been pumped into AIG in order to satisfy obligations to derivative counterparties. In this sense, the "AIG bailout" is a misnomer; the bailout of AIG has really served as a backdoor bailout of the giant firms on Wall Street, led by Goldman Sachs, and overseas (where AIG sent half of its credit default payments, after being bailed out). These firms, unjustifiably, escaped even a hair cut; instead, they were paid 100 cents on the dollar, even as AIG faced insolvency. New management is in place at AIG, but even though the government now owns nearly 80 percent of the company, it is not directing operations, though it does appear to be pressuring management to sell off units and take other steps to raise revenues.

With Merrill Lynch, regulators again arranged a shotgun marriage. The murky conditions of the deal are now the subject of major controversy, as Congressional investigators peel back layers of secrecy to determine who knew what about Merrill's pending bonus payments, and who promised what to whom.

In the case of Citigroup, the government has provided supports going far beyond TARP and the one-third share acquired in the company. Among other measures, the government has offered a guarantee on $290 billion of Citi's toxic assets. The FDIC is reportedly pressuring Citi both to shed assets and shake up internal management.

The government did not and has not required reciprocity from any of the bailed-out firms (the GSEs are a separate case, and unique in that the government is using these enterprises -- now 80 percent publicly owned -- as tools of public policy). Apart from insignificant standards in the important area of executive compensation, the government has not demanded changed behavior from the firms it has saved from ruin. Not an end to risky speculation, not mortgage modifications, not even an end to credit card ripoffs.

This recent history makes clear that things should be done differently next time, and offers a strong affirmative case for establishing resolution authority for non-bank financial institutions.

The government needs tools to move quickly and with some policy flexibility in cases of insolvency or pending insolvency of large financial corporations whose failure poses systemic risk.

On the one hand, bankruptcy is unlikely to serve as a satisfactory means to address the failure of too-big-to-fail institutions. The process is too slow, leaving too much uncertain for too long. For institutions with large derivative exposure, bankruptcy may trigger additional liability -- worsening the condition of the failing enterprise, and worsening the systemic risk problem. And, after the Lehman experience, it is implausible that government regulators will permit too-big-to-fail institutions to file bankruptcy; they will find some way to bail them out. As Paul Volcker told the House Financial Services Committee, "Experience, not only here but in every country with highly developed, inter-connected financial systems and institutions bears out one point. Governments are not willing to withhold financial and other support for failing institutions when there is a clear threat to the intertwined fabric of the financial system."[31]

On the other hand, the bailout strategy is unacceptable. It may alleviate some of the short-term risks of systemic collapse posed by the bankruptcy approach, but it unjustifiably plunders the public treasury to support failed, reckless enterprises, while reinforcing the cycles that lead to periodic failure and ever larger bailouts. The recent round of bailouts: 1) through trillions of dollars of public supports, maintained large financial institutions that likely are insolvent, encouraging further recklessness going forward; 2) resulted through mergers in larger and more interconnected too-big-to-fail institutions; and 3) provided counterparties of the otherwise-failing AIG with 100 cents on the dollar, shifting all costs from AIG's reckless behavior from the counterparties to the public.

The resolution authority, by contrast, rejects the let-the-chips-fall-where-they-may approach of bankruptcy as too dangerous in the case of systemically important institutions. Yet, in contrast to bailout approach, it offers a strategy of intentional and structured government intervention, rather than makeshift and haphazard action. A

[31] Paul Volcker, Testimony before the House Financial Services Committee, September 24, 2009, available at: <http://www.house.gov/apps/list/hearing/financialsvcs_dem/fchr_092409.shtml>.

resolution authority gives the government the tools it needs to address systemic risk, and the means to act through mechanisms other than throwing taxpayer money at financial behemoths that have grown so large that their failure threatens the functioning of the financial system.

A carefully vectored resolution authority will hopefully help deter financial institutions from mutating into too-big-to-fail enterprises; exercise of the authority would represent a failure both to curtail the existence of excessively sized institutions and of prudential regulation. But resolution authority can only do so much. It is no substitute for a competition policy breaking up the big financial institutions (as well as asymmetric standards -- including capital reserve standards and fee assessments -- tilted against excessively big institutions), nor for sound regulation.

Nor is resolution authority an automatic guard against the hazards of a bankruptcy process or the bailout approach. Unless carefully implemented, and with properly equipped regulators, resolution could potentially result in the same dangers as bankruptcy (for example, in triggering posting of collateral to derivative counterparties). A resolution authority is also vulnerable to becoming a bailout vehicle, or replicating bailout outcomes. This latter risk is particularly acute, and suggests the need for legislative directives and presumptions.

First, consideration should be given to establishing that institutional resolutions will presumptively draw exclusively on the available assets of the institution undergoing resolution. This approach would eliminate the risk of bailout. The presumption might be established by stipulating that the resolution authority not have access to external financing (besides some modest amount to administer institutions under conservatorship or receivership) unless there is a written finding of emergency need by a top official (for example, the Treasury Secretary, or the chair of the Federal Deposit Insurance Corporation) or perhaps by the systemic risk regulator, if one is created. A stronger presumption would prevent access to external financing except by act of Congress, although this approach would seem to build in unacceptable delays for what is by definition an urgent circumstance.

Second, and relatedly, there should be a strong presumption that -- excluding insured depositors, consumers in regulated industries such as insurance, secured creditors and perhaps other designated categories where there is a demonstrable public policy interest in providing de facto government insurance -- creditors of an institution in resolution will take a haircut. There should never be a repeat of the AIG fiasco, with credit default swap counterparties siphoning public funds in order to receive one hundred cents on the dollar.

Third, to the extent that the resolution authority will have access to substantial financing, these resources should be drawn from the category of too-big-to-fail institutions (if they are quasi-formally designated as Tier One institutions) or simply from the biggest financial firms. These resources should be raised from fees assessed *before* the next financial crisis. Based on recent experience, the needed resources may be very substantial in scale. There will understandably be reluctance to collect such fees in the aftermath of a crisis, while the financial sector is struggling; and delay is likely to mean the fees are never collected. Legislation adopted now should set a date in the near-to-medium future -- perhaps two years from now -- when fee collection will begin.

Fourth, direction should be given to the resolution authority not to deepen the too-big-to-fail problem. In merging a failing corporation into another firm, or selling off a failing corporation's pieces, there should be a strong presumption against combinations into an already too-big-to-fail institution, or one close to that status. It is important that this heavy presumption be legislated, and implemented in advance of the next crisis. Financial crises necessarily demand exigent decision-making, and in such circumstances the easiest solution will often be to merge a failing company into another financial giant, since only other behemoths will have the financial capacity to absorb the failed firm. Specific guidance directing the authority to work to avoid exacerbating the too-big-to-fail problem is also necessary, because an exclusive focus on recovery of taxpayer assets may prod the authority to turn to too-big-to-fail acquirers. While recovery of taxpayer assets must be a high-level concern, it would be a mistake to prioritize short-term repayment over the long-term public interest in preventing future crises.

Fifth, and following the principle of the preceding point, direction should be given to the resolution authority not to increase risk-taking by commercial banks. In merging a failing non-bank financial institution into another financial institution, or selling off a failing corporation's pieces, there should be a strong presumption against combinations into a commercial bank (or a bank holding company). The core of the too-big-to-fail problem is that de facto insured corporations will be incentivized to take excessive risk. This is a particularly acute problem when the too-big-to-fail institution is backed up by an explicit depository insurance program.

A presumption against combining investment banks and other risk-taking institutions into commercial banks may in some cases be in tension with a presumption against combinations that increase market concentration. This tension can be resolved by a sixth principle: The resolution authority should have the power to maintain ownership of a resolved firm, if doing so serves public policy objectives; and it should also have authority to break up a failing firm and sell it off in pieces.[32] In either instance, the resolution authority's power should not be unduly constrained by the objective of maximizing recovery to the public purse. Indeed, even where the resolution authority sees no purpose or advantage in holding a firm over time, there may be a strong pro-competitive or systemic risk rationale to selling the resolved firm in pieces (or spinning off components as standalone enterprises), a process certain to take more time than a one-off sale.

Last, in disposing of resolved firms, the resolution authority should strongly consider conduct rules to advance established policy objectives. It is possible that attaching such rules will diminish the sale value of the resolved enterprise; but any such diminution in price should be considered evidence that costs would otherwise be externalized on

[32] This issue is explored in a forthcoming paper from Corporate Ethics International, co-authored by Charlie Cray and me.

consumers or the financial system overall. Appropriate conduct remedies for consideration would track many of those elaborated above: ensuring incentive pay is linked to long-term performance; prohibiting practices that gouge consumers and requiring consumer-friendly practices such as plain vanilla offerings; prohibitions on off-the-books and deceptive accounting maneuvers; limits or prohibitions on use of offshore tax havens; and prohibitions on excessively risky undertakings (for example, naked credit default swaps).

Conclusion

Mr. Chairman, thank you again for the opportunity to testify today. I hope that the Committee follows up on today's hearing. The antitrust perspective suggests a range of needed policy approaches that are not instinctual for policymakers operating in other regulatory traditions.

Wall Street is now populated by a handful of dominant mega-corporations -- a smaller group of larger firms than existed even before the current financial crisis. Many -- including many who believe the too-big-to-fail problem is a looming, ongoing, long-term and recurring threat to financial stability -- believe this state of affairs is a fait accompli. The antitrust tradition teaches us that it need not be so.