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It Works for Mergers, Why not Finance

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It Works for Mergers, Why Not for Finance?

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The financial collapse that triggered the current great recession has launched a wave of proposals to reform the financial sector to prevent a recurrence. Most, though, are either unlikely to have much of an effect on systemic financial risk or are too complex to be implemented successfully. The administration's 'Volker' proposal to limit speculative trading by banks on their own accounts, for example, is well-intentioned, but a mere band-aid. After all, speculation can be done by hedge funds, insurance companies,

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investment banks, and other financial players, as we learned from Lehman Brothers and AIG. Requiring full disclosure of all financial trades including derivative contracts is too complex. The amount of data would overwhelm the resources of existing regulatory authorities and would require an operation on the scale of the National Security Agency to analyze.

We propose an intermediate approach that borrows from experience with mergers. The Department of Justice and Federal Trade Commission review merger activity to detect mergers that may raise prices. Under the Hart-Scott-Rodino Act, all proposed mergers (public or private) that exceed a threshold value must be reported to the Federal Trade Commission. The details of the proposed

merger are then reviewed by either the DOJ or the FTC, which can challenge the merger or negotiate modification of its terms.

The system works. In a typical year the FTC receives about 2,000 to 3,000 merger proposals, of which about 3 percent get a 'second look'.¹ The other 97 percent proceed without any regulatory oversight. Of the 3 percent that get a second look, the antitrust authorities require some modification prior to approval for roughly half, and formally object to a small handful.

In evaluating mergers, the antitrust authorities conduct an exhaustive analysis and intervene only when they conclude that a merger is likely to harm consumers. Most economists believe that merger review has benefited the economy.

Why not do something similar for the U.S. financial industry?

A FINANCIAL VERSION OF HART-SCOTT-RODINO

What are the keys to merger oversight by the antitrust agencies? One is that self-reporting is required for all deals over a size threshold. A second is that penalties are sufficient to ensure almost full compliance. And, a third is that the substantive standard for review is a general charge, not a long list of specific rules. The general charge is to stop mergers that “may substantially lessen competition,” which has come to mean raising prices. The legal standard is as simple as that.

The savings from self-reporting is that the antitrust authorities don’t have to find the mergers—the mergers find them. The merging parties must not only identify themselves but must come forward with information about the merger to the authorities and pay a significant fee that can be used to fund the agencies’ public interest analysis.

In cases where the agencies are concerned about the merger, they have broad powers of investigation and can ask intrusive questions to understand whether the deal threatens

the public interest. For deals that threaten to raise prices, the agencies can sue to block mergers entirely or can pressure the parties to restructure the proposed merger, for example by spinning off divisions or products.

So what would be the financial analogue? It would be to require detailed reporting of the financial structure and major assets and liabilities for all financial firms whose liabilities exceed some size threshold. For firms over the threshold, regular reporting (likely quarterly) would be required with random audits possible to avoid window dressing before reporting dates.

Instead of intricate and detailed regulations, we would have a standard that avoided firms creating ‘substantial systemic risk,’ by which we mean the kind of risk that is likely to cascade through financial markets. The regulator would be charged with making sure these large firms’ financial positions do not create undue systemic risks. The regulator would be empowered to require that firms restructure their portfolios, cease taking on more liabilities, raise capital, or even close.

The point of self-reporting is to identify firms worthy of concern, particularly firms

that come from otherwise unregulated or lightly regulated sectors such as insurance and hedge funds. The collapse of AIG is a recent reminder of systemic financial risk, but by no means the first such reminder. The hedge fund Long Term Capital Management, which collapsed in early 2000, had derivative positions valued at about \$1.2 trillion,² equal to about 15 percent of U.S. GDP at the time. The New York Federal Reserve Bank had to orchestrate a complex unraveling of Long Term’s trading positions in order to avoid a potential financial meltdown.

Inspired by merger law, we suggest the general standard of preventing firms from creating ‘substantial systemic risk,’ because we believe it impossible to write specific financial rules in advance that cannot be gamed and that sufficiently anticipate evolving financial instruments and practices. Better to have a standard like merger law that allows flexibility and evolution with experience.

We focus on liabilities for the threshold because the prospect that liabilities may not be paid in full is inevitably what spawns financial panic. Liabilities should be broadly

and generally defined so as to avoid, as much as possible, being blindsided by derivatives; at the same time it must be recognized that firms may of course have huge liabilities without creating systemic risk provided that they have appropriate assets to pay the liabilities, or that those who they owe the money to can bear the loss.

Financial collapse from excessive leverage is a familiar theme and it is sure to play again in the not too distant future unless something is done (and maybe regardless). Hedge funds and investment banks know that if they can make 10 cents on a \$1 trade, then it pays to borrow heavily and earn \$100 million on \$1 billion in trades, even if they have to pay some interest on the debt. These liabilities are rarely completely hedged and when the markets change in unexpected ways, the financial system can go into rapid freefall as counterparties to these trades take actions to contain their risks.

To be sure, the financial industry will be horrified by our proposal. Isn't it intrusive for government to demand that a firm reveal confidential details of its business, let alone be forced to change its risk strategy? Maybe so. But we have long accepted the government's

role in mergers and the government is equally intrusive in gathering information and in requiring spinoffs of divisions or conduct restrictions before blessing a merger. More is surely at stake with systemic financial risk than with mergers, so we should be willing to accept significant loss of business freedom to reduce the risk of financial collapse.

One difference between mergers and financial regulation is that mergers are a distinct event. Once a merger is approved (i.e., not challenged), no ongoing monitoring is needed. Moreover, it seems clean to simply say "no" to a merger, whereas it may appear that financial intervention will involve unscrambling eggs, a difficult task at best.

We think this overstates the differences. Mergers can be challenged after the fact and firms have been broken up (particularly before Hart-Scott-Rodino). It is true, though, that once a merger is approved, generally the antitrust authorities do not actively monitor the merged firm. Financial regulation must be different in this respect as very large firms, whether banks or other financial institutions, require ongoing monitoring. Unwinding transactions may be difficult and costly if

done quickly, but if monitoring is sufficiently regular, dramatic restructurings will hopefully be unnecessary. In many cases it will be sufficient to tell a firm that it can't take on more of a worrisome risk unless it raises capital that can't flee. And, where more dramatic action is necessary, better sooner than later.

THE DODD BILL

The Dodd bill that emerged from the Senate Banking Committee on March 15 has much in common with our proposal. The bill calls for a new Financial Institutions Regulatory Administration (FIRA) that would be charged with monitoring bank and non-bank companies to guard against systemic risks they may pose for the economy. The bill also empowers FIRA, along with the Federal Deposit Insurance Company, to require financial institutions that pose such risks to adjust or divest certain assets or operations.

We would add to the Dodd bill a self-disclosure requirement akin to merger law. In our view, the severity of the recent financial collapse justifies requiring every financial institution to report its assets and liabilities to FIRA when its liabilities cross or exceed some

threshold. We would also advocate severe penalties for firms that violate the self-disclosure requirement, akin to those in merger law.

Liabilities, like any accounting concept, are ambiguous. So, among the challenges for a regulator is to define liabilities in a sufficiently general way to discourage gaming. Firms like Lehman, for example, are now known to have used repurchase agreements to make loans look like sales. Rather than making a specific rule to address that issue, we would urge a general approach in which contracts that are functionally similar to liabilities, or are likely to pose similar risks, be treated as liabilities. Thus, for example, if Long-Term Capital Management entered \$1.2 trillion of interest-rate swaps, then for our purposes, this should count as \$1.2 trillion in liabilities backed by \$1.2 trillion in assets.

DANGERS OF POLITICS AND CAPTURE

Giving broad powers to a regulator is a scary thing. Government may abuse that power and politics could interfere with sound decision-making. But financial meltdowns scare us more.

The history of merger review and antitrust offers us significant comfort, however (as, by

the way, does the history of Federal Reserve independence). Even during its most interventionist period, antitrust never stood significantly in the way of economic progress, and it has rarely been bent for parochial economic interests or partisan political gain.

The exceptions and their rarity prove the rule. Contributions to the Nixon campaign by ITT may have led the Nixon DOJ to be easy on ITT in settling an antitrust case. In fact, that was one of the charges in Nixon's impeachment. Since Nixon, though, there has been a solid wall between the White House and the day-to-day operations of the antitrust division at the DOJ, even though the antitrust chief is a political appointee. In the only case where we know of White House interference, the White House did not fare so well. Bill Baxter, a Reagan political appointee, was in the process of suing AT&T, which he planned to litigate "to the eyeballs." President Reagan called a Cabinet meeting in July of 1981 and pointed out in AT&T's defense that when Reagan was young it cost 2 cents to mail a letter cross country and \$2.00 to make a phone call. By the 1980s each was 20 cents. Baxter, quick as a whip, told Reagan: "Well, Mr. President,

when I finish AT&T, I will be happy to take on the Post Office." Baxter proceeded to dismantle AT&T ignoring politics.³

We can't, of course, be sure that politics will be kept at bay, leaving a financial regulator free to protect the economy as best it can, but the antitrust experience gives us some hope.

SUMMING UP

The system works for mergers. It does not require a vast commitment of resources to protect the economy from mergers that might hurt consumers, and firms have become accustomed to the necessity of merger review when they contemplate a major acquisition. The economy deserves the same kind of protection against unbridled financial speculation. Our proposal will offer at least some modest insurance.

Letters commenting on this piece or others may be submitted at <http://www.bepress.com/cgi/submit.cgi?context=ev>.

NOTES

1. Hart-Scott-Rodino Annual Report, 2008.
2. See Edwards (1999), p. 198.
3. See Areeda, Kaplow and Edlin, p. 797.

REFERENCES AND FURTHER READING

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