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Should Regulation Supplant the Applicability of Competition/Antitrust Principles in Dealing with Systemic Risk?

(An Outline of Remarks)

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This is not a plea to "break up" the banks. Those words are still too ill and multi-defined. This is rather a suggestion that there is a serious missing element in today's considerations of the future of the banking industry and systemic risk – antitrust and competition issues.

Three years after the financial collapse, basic antitrust principles have not been sufficiently considered as applicable to the current "big bank" market – if there is such a market. A study of the appropriate focus for antitrust in the banking industry is needed because on the face of it, there seems to be a "big bank" market, both commercial and investment banking, which is relatively concentrated. But, this is debatable and needs unfolding because the big banks arguably have become conglomerates selling a number of different financial products and services, many of which have become increasingly sophisticated.

The focus, instead, has been on regulation, perceived gaps in enforcement, and the enactment of legislation, principally the Dodd-Frank Act, in order to try to address risk taking and to stabilize financial institutions. Antitrust law and competition values have taken an almost non-existent role, which is best exemplified by the fact that no antitrust regulator is a member of the Financial Stability Oversight Council ("FSOC") established by the Dodd-Frank Act.

An in-depth examination of competition involving the various lines of commerce impacted by the big banks should involve the various stakeholders and enforcement agencies with expertise, including the Antitrust Division of the U.S. Department of Justice ("DOJ"), as well as the federal bank regulatory agencies. Similar antitrust investigations have been undertaken in the intellectual property and pharmaceutical sectors. Assumedly, the banking sector is no less important, especially today. An additional benefit of this collective effort will be the ability to access and analyze a wealth of financial data gathered as part of recent regulatory developments.

A serious investigation of competition in the banking industry will involve complexities and subtleties, so at the outset we will need to decide whether on an objective cost/benefit basis, setting aside all the rhetoric, it is worth the effort.

The goal of this note is to raise some thought provoking points and questions on the subject of regulation and antitrust law in the financial services sector.

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* The current crisis prompted me to return to my antitrust roots in and out of government. I sincerely appreciate the assistance of Weil Associate, Eric Hochstadt, in preparing this outline. The views expressed in this article are solely my own and not necessarily those of my law firm or of my fellow partners at Weil, Gotshal & Manges LLP.

Between 1994 and 1999, before the repeal of Glass-Steagall and after the enactment of Riegle-Neal Interstate Banking and Branching Efficiency Act, there was a period of 5 to 6 years close to utopia for banking regulation. In that utopian world, there would only be five ultimate provisions requiring enforcement 1) the Federal Deposit Insurance Corporation, whereby the U.S. Governments stands behind deposit accounts; 2) the re-instatement of the Glass-Steagall Act, by which commercial banking is separated from other forms of banking; 3) Consumer Protection which enforces the laws ensuring disclosure in the issuance of securities and credit, such as the Securities and Exchange Act the Truth and Lending Act, and the Electronic Fund Transfer Act; 4) the continued allowance interstate banking, whereby banks can cross state lines and operate nationally; and 5) lastly, the preservation of competition, whereby the U.S. Government vigorously enforces the antitrust laws.

Such a world is probably not politically possible today – it is too late.

When we re-enter the reality of this economic crisis era, we are met with an abundance of regulations.

The Dodd-Frank Act requires that regulators create 243 rules, conduct 67 studies, and issue 22 periodic reports.[1] The Volcker Rule alone, an honest effort to prohibit proprietary trading in order to avoid breaking up the banks, is generating a firestorm of controversy from all relevant stakeholders. Critics question its complexity and whether it is capable of being executed effectively.

Additionally, Section 622 of the Dodd-Frank Act, "The Concentration Limits on Large Financial Firms," provides that no one firm be able to "merge and consolidate" in such a way as to raise its share of "aggregate consolidate liabilities of all financial companies" above 10%.[2] However, is that a relevant "market" and is a static, some might say arbitrary, cap the best answer?

The Financial Stability Oversight Council conducted a study of Section 622, completed in January 2011[3], from which the Federal Reserve Board plans to adopt regulations. It is critical to point out that, the FSOC is composed of 15 state and federal financial regulators.[4] There is no representative from the Department of Justice or the Federal Trade Commission ("FTC") on the FSOC.

Sections 163 and 604 of the Dodd-Frank Act amend relevant provisions in the federal banking laws relating to mergers and acquisitions to include systemic risk or "financial stability" as a

[1] Davis Polk (9 Jul 2010), Summary of the Dodd–Frank Wall Street Reform and Consumer Protection Act, Passed by the House of Representatives on June 30, 2010.

[2] 12 U.S.C. § 1852(b).

[3] *See* Financial Stability Oversight Council, Study & Recommendation regarding Concentration Limits on Large Financial Companies (January 2011).

[4] Financial Stability Oversight Council, 2011 Annual Report (July 26, 2011), *available at* http://www.treasury.gov/press-center/press-releases/Pages/tg1257.aspx.

factor that federal regulators may use to block transactions.[5] To date, neither the Federal Reserve Board nor any other banking regulator has blocked a transaction on systemic risk grounds.[6]

Regulation has been the immediate response to the financial crisis. The Dodd-Frank Act is a noble effort, but it is widely thought of as a complex series of specific regulations designed to correct the problems that led to the last crisis, particularly with respect to its chief purpose of reducing systemic risk.

Ensuring appropriate regulation and vigorous competition in the banking sector, with antitrust playing an important role, may be the most efficient and optimal long term solution to minimize market bubbles, moral hazard, and other financial distortions on a going forward basis and without the unintended consequences and costs of total complex regulation. The antitrust laws would, by definition, reduce systemic risk and too-big-to-fail paradigm because factors such as size and interconnectedness are themselves implicit, and, in some cases, explicit, factors in the DOJ/FTC's merger analysis. At the same time, the antitrust laws provide additional benefits far beyond simply mitigating macro-financial instability, such as better pricing and products, more efficiencies, increased fairness, and options for consumers, among other benefits.

There is a meaningful role for antitrust in regulating the banks. The antitrust laws make this country great. They have been called "a comprehensive charter of economic liberty aimed at preserving free and unfettered competition,[7]" and the "Magna Carta of free enterprise.[8]" Their critical role has been supported, and confirmed, time and again.

In *United States v. Philadelphia National Bank*, (374 U.S. 321, 350-52 (1963)), the Supreme Court held that the Bank Merger Act did not preempt Section 7 of the Clayton Act governing mergers:

> *"No express immunity is conferred by the [Bank Merger] Act. Repeals of the antitrust laws by implication from a regulatory statute are strongly disfavored, and have only been found in cases of plain repugnancy between the antitrust and regulatory provisions . . . . Nor did Congress, in passing the Bank Merger Act, embrace the view that federal regulation of banking is so comprehensive that enforcement of the antitrust laws would be*

[5] *See* Michael J. Aiello & Heath P. Tarbert, *Bank M&A in the Wake of Dodd-Frank*, 127 Banking L.J. 909, 912-13 (Nov./Dec. 2010) (discussing the "financial stability" factor in the bank M&A context).

[6] *See, e.g.,* Capital One Fin. Corp., Order Approving the Acquisition of a Savings Association and Nonbanking Subsidiaries (Fed. Res. Bd. Feb. 14, 2012) (orders on banking applications) at p. 31-36, *available at* http://www.federalreserve.gov/newsevents/press/orders/order20120214.pdf (approving Capital One's acquisition of ING Direct upon determining "considerations relating to financial stability [were] consistent with approval"); Mitsubishi UFJ Fin. Grp., Inc., Order Approving Acquisition of Interests in a Bank Holding Company and Certain Nonbanking Subsidiaries (Fed. Res. Bd. June 14, 2011) (orders on banking applications) at pp. 13-14, *available at* http://www.federalreserve.gov/newsevents/press/orders/orders20110614a1.pdf (same).

[7] *Northern Pac. Ry. Co. v. U.S.*, 356 U.S. 1, 4 (1958)

[8] *United States v. Topco Associates*, 405 U.S. 596, 610 (1972).

either unnecessary, in light of the completeness of the regulatory structure, or disruptive of that structure."

Additionally, it is important to note that although the Dodd-Frank Act contains many new regulations for the banking industry, it contains a "savings clause":

> *Nothing in this Act, or any amendment made by this Act, shall be construed to modify, impair, or supersede the operation of any of the antitrust laws, unless otherwise specified. For purposes of this section, the term ''antitrust laws'' has the same meaning as in subsection (a) of the first section of the Clayton Act, except that such term includes section 5 of the Federal Trade Commission Act, to the extent that such section 5 applies to unfair methods of competition.*

This savings clause means that the antitrust laws remain fully in effect.[9]

However, the overwhelming focus on regulation in recent years has avoided the question of whether the scope of the antitrust laws differ, in the merger context – and the conduct context, in the financial services sector.

In 1995, over 15 years ago, the federal banking agencies and the Department of Justice issued a "Bank Merger Competition Review" to explain the special procedures used to analyze bank mergers.[10] The bank merger guidelines focus primarily on local concentration issues. For example, the 1998 merger of NationsBank and Bank of America created the then-largest bank in the United States, holding 8% of nationwide deposits at the time. But, the Department of Justice, primarily, sought divestiture of 17 branches around Albuquerque, New Mexico, due to a lack of competition in middle market lending.[11]

In we jump forward several years, and examine the series of high profile transactions in 2008, Bank of America's acquisition of Merrill Lynch, Wells Fargo's acquisition of Wachovia, and JP Morgan's acquisition of Washington Mutual, we note that no public comment was issued by the Department of Justice explaining the merger analysis of those transactions. What, if any, role did the Department of Justice play? This is arguably contrary to the agency's laudable efforts to improve transparency in decision-making by issuing public statements when merger investigations are closed or no action enforcement action is taken.

In the almost 2 decades since the bank merger guidelines were issued, the banking industry has undergone substantial regulatory changes and extensive industry consolidation.

[9] 156 Cong. Rec. E1347 (June 30, 2010) (statement of Rep. John Conyers).
[10] Bank Merger Competition Review (1995), *available at* http://www.justice.gov/atr/public/guidelines/ 6472.htm.
[11] DOJ Chief, Litigation II Section, Robert Kramer, *Mega-Mergers in the Banking Industry*, (ABA Antitrust Section, April 14, 1999) [hereinafter DOJ 1999 Mega-Bank Merger Speech].

The Riegle-Neal Act of 1994 ushered in the era of large bank mergers by greatly reducing barriers to interstate bank mergers and bank branching.[12] The Act also prohibited bank mergers if the combined firm controlled deposits exceeding 10% of nationwide insured deposits.[13] However, we should note that Bank of America's share of national deposits reached nearly 12% as of 2009. There was also the repeal of the Glass-Steagall Act in 1999. The two substantive changes were coupled with major consolidations.

Between 1934 and 1986, the number of commercial banks was relatively stable at about 14,000 commercial banks. From 1986 to 2010, the number of banks has steadily decreased to 6,500.[14] In 1980, the assets of the 5 largest banks amounted to 29 percent of total banking assets, equivalent to 14% of GDP. In 2011, the 5 largest banks held more than 50% of total assets, equivalent to 86% of GDP.

Looking at today's financial services industry, there is evidence that there is a separate "Big Bank" market, as well. For instance, the 10 largest banks hold over $7 Trillion in assets, or 60% of total bank assets. Over 6,000 banks holding the other 40%.[15] Five banks (JP Morgan Chase, Bank of America, Goldman Sachs, Citibank, and Wells Fargo) represent nearly 96% of the notional amount of derivatives. 25 banks hold nearly 100% of all derivatives.[16] In 2009, the four largest banks originated 58.2% of all mortgage loans by volume, and service 56.3% of such loans.[17] That same year, the four largest banks controlled 56.6% of credit card purchase volume.[18] Even if these numbers are not absolutely precise, the trend is clear.

Based on the above key changes and figures, should the last Department of Justice speech on banking mergers from 1999 remain a current statement of the banking marketplace and/or bank merger enforcement policy?

> *"U.S. overall banking concentration remains low, and while the U.S. mergers [since the 1980s] have raised local horizontal concentration issues, the transactions often significantly expanded the product or geographic market coverage of the merged firms."*[19]

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[12] *See* Carl Felsenfeld, "The Antitrust Aspects of Bank Mergers – Introduction," 13 FORDHAM J. CORP. & FIN. L. 506, 508 (2008).

[13] 12 U.S.C. § 1842(d)(2). The Riegle-Neal Act also contains an antitrust savings clause. *Id.* § 1842(d)(4).

[14] Federal Deposit Insurance Corp. "Historical Statistics on Banking," available at http://www2.fdic.gov/ hsob/index.asp.

[15] Thomas M. Hoenig, President and CEO, Fed. Res. Bank of Kansas City, "Do SIFIs Have a Future?" Pew Financial Reform Project and NYU Stern School of Business "Dodd-Frank One Year On," (June 27, 2011).

[16] Comptroller of the Currency, "OCC's Quarterly Report on Bank Trading and Derivatives Activities, Second Quarter 2011" (available at http://www.occ.gov/topics/capital-markets/financial-markets /trading/derivatives/dq211.pdf), at p.1, Table 1.

[17] "Study & Recommendations Regarding Concentration Limits on Large Financial Companies," Financial Stability Oversight Council, January 2011, at p.13.

[18] *Id.*

[19] DOJ 1999 Mega-Bank Merger Speech at 1.

It is important to note that since the 1994 Riegle-Neal Act, no bank merger has been prohibited in a successful antitrust enforcement action.[20] When antitrust concerns have been raised, the remedy has generally been divestiture of retail branches in local geographic areas. Nor does it seem that antitrust will be a serious factor in ultimate "Resolution."

In the Citicorp/Travelers $70 billion merger in 1998, the Department of Justice analyzed "corporate and retail overlaps, ranging from investment banking debt underwriting, equity underwriting and advisory services to credit card processing, annuities and mutual funds." The agency concluded that "while there were several overlaps, that the markets with some exceptions appeared to be national markets with numerous competitors."[21] The DOJ also "heard numerous complaints that Citigroup would have an undue aggregation of resources—that the deal would create a firm too big to fail. But, we essentially viewed this as primarily a regulatory issue to be considered by the [Federal Reserve Board]."[22] Ultimately, though, Citigroup was too big to fail in the latest financial crisis. So, was it appropriate for the DOJ to have rejected that as a factor in the merger analysis?

Given the new banking environment, as described above, should the threat of systemic risk play a role in antitrust merger analysis? A leading current antitrust enforcer at the Federal Trade Commission says "too big to fail" should play a role in merger reviews:

> *"[M]ergers should arguably be examined with an eye toward whether they are creating a merged entity that is "too big to fail." If so, the transaction may violate Section 7 (or Section 1).... The Clayton Act is inherently prospective and the current standard prevents anticompetitive harm in its incipiency. Hence, if a merger creates a firm whose failure is likely to have a catastrophic effect on the market as a whole, because it is so integral to the market, the end result may be a substantial lessening of competition. It would arguably be better to avoid the creation of such firms in the first place through merger instead of having the Treasury Department bail them out."*[23]

Firms in the banking industry may be more appropriately characterized as financial conglomerates. But, U.S. antitrust law has generally been skeptical of anticompetitive effects raised by conglomerates.

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[20] *See supra* note 4 at 508.
[21] *Id*. at 6.
[22] *Id*. at 6.
[23] FTC Commissioner J. Thomas Rosch, *Implications of the Financial Meltdown for the FTC* (New York State Bar Association, Jan. 29, 2009), available at http://www.ftc.gov/speeches/rosch/090129financial crisisnybarspeech.pdf.

The 1984 Non-Horizontal Merger Guidelines state that "non-horizontal mergers"—of which conglomerate mergers are one type—"are less likely than horizontal mergers to create competitive problems."[24]

> *"[T]the U.S. antitrust agencies concluded that antitrust should rarely, if ever, interfere with any conglomerate merger. We simply could not identify any conditions under which a conglomerate merger, unlike a horizontal or vertical merger, would likely give the merged firm the ability and incentive to raise price and restrict output. We recognized, conversely, that conglomerate mergers have the potential as a class to generate significant efficiencies. These potential benefits include providing infusions of capital, improving management efficiency either through replacement of mediocre executives or reinforcement of good ones with superior financial control and management information systems, transfer of technical and marketing know-how and best practices across traditional industry lines; meshing of research and distribution; increasing ability to ride out economic fluctuations through diversification; and providing owners-managers a market for selling the enterprises they created, thus encouraging entrepreneurship and risk-taking."*[25]

Should this still be "good" antitrust policy in the new world of banking?

Given all of the above, many important open antitrust/competition questions remain, each of which deserve thoughtful address.

- How does the current interconnected nature and large size of the mega banks impact the antitrust and competition analysis of any future mergers and conduct?
- How does the conglomerate nature of the mega banks impact the relevant market analysis? How much future competition is being precluded by conglomerates? What is the evidence or efficiencies? What are the insights of the 2010 Horizontal Merger Guidelines?
- There are many banks, but many fewer than before, what ability does a new bank have to compete with the mega banks in a variety of products? Are these product markets local, national or international?
- There has not been an in-depth examination of the pricing practices of the mega-banks. How does the fact that there are a few mega banks impact oligopolistic pricing and coordinated effects analysis? For example, multiple banks imposed debit card fees in the fall of 2011 in response to reduced transaction fees from merchants under the Dodd-

[24] Non-Horizontal Merger Guidelines, § 4 (June 14, 1984), *available at* http://www.justice.gov/atr/public/ guidelines/2614.htm.

[25] William J. Kolasky, Deputy Assistant Attorney General, DOJ, *Conglomerate Mergers And Range Effects: It's A Long Way From Chicago To Brussels* (Nov. 9, 2011), *available at* http://www.justice.gov/atr/public/speeches/9536.htm.

Frank Act. There seems to be a current DOJ probe of interest rate-fixing amongst many banks.[26]

- Is there tension between traditional antitrust analysis and financial stability?
- Pro-competitive efficiencies or pro-consumer returns to scale may encourage greater risk-taking and systemic risk.
- Should practices surrounding vertical activities of mega banks such as mortgage origination, mortgage servicing, consumer lending, etc., be studied in an antitrust context?
- Overall, what is the appropriate effects-based analysis of financial conglomerates in today's banking industry?

The Department of Justice has stated that "[f]inancial products, like many other products, become better understood through experience."[27] Isn't this the time to take stock, with regard to antitrust and competition, of the impact of the immense changes affecting the banking industry?

I suggest it's time for a reasoned analysis and debate, without prejudging the outcome. There will not be magic bullets; but there will be better guidelines.

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[26] William Stendahl, *US Conducting Criminal Libor-Fixing Probe, DOJ Says (Mar. 7, 2012), available at* http://www.law360.com/newyork/articles/316859/us-conducting-criminal-libor-fixing-probe-doj-says

[27] DOJ, Supplement Note, *Roundtable on Competition and Financial Markets*, at 3 (Organization of Economic Cooperation and Development, Feb. 11, 2009).