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COMPETITION AND FINANCIAL MARKETS

-- Note by the United States --

This note by the United States which supplements the other US note on Competition Enforcement Issues, is submitted to the Competition Committee FOR DISCUSSION at its forthcoming meeting to be held on 16-18 February 2009.

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1. This submission supplements the U.S. paper that reviews bank mergers and antitrust enforcement and advocacy in the financial markets, and discusses selected additional questions raised in the call for papers.

2. History is full of examples in which past competition policy responses to financial collapse included justifying anticompetitive arrangements, *e.g.*, "soft cartelization" and price-fixing. However, such arrangements, based on "economic emergency" rationales, generally do not redound to the benefit of the economy and, to the contrary, have had the effect of stifling competition and undermining economic dynamism to the detriment of consumers. Competition agencies have a unique role to play in helping to prevent such outcomes in the current crisis. Through the vigilant promotion of competition principles, competition agencies can help stave off these challenges and even turn such tests into opportunities for advocacy and needed reform.

1. Principles: Financial Sector Conditions and Competition Policy

1.1 Definition

3. The financial sector consists of businesses primarily engaged in transactions that involve the creation, liquidation, or change in ownership of financial assets (stocks, bonds, and derivatives). These businesses are principally commercial banks, security brokers and dealers, portfolio managers, insurance companies, and exchanges.[1]

4. These businesses perform functions that are essential to the efficient functioning of the "real economy." They allow those who have savings and other assets to lend them to those who want to borrow capital. In exchange, these lenders accept a combination of risk and expected return. The need to pay a return to lenders provides borrowers with the incentive to use capital productively. The opportunity to earn a return provides lenders with the incentive to save rather than consume.

1.2 Unique Features of Financial Markets

5. Financial markets have unique features. Transactions occur at distinctively high speed, high volume, and low cost. This permits an entire subsector to be devoted to arbitrage, something which does not exist in the real economy at nearly the same scale and profitability. While the degree of arbitrage in this field is unique, arbitrage is not implicated in the current financial crisis. We identify it here as a unique tool that contributes to the transparency of financial instruments by ensuring that fundamentally identical instruments trade at the same price.

6. The uniqueness of financial markets that is relevant to this discussion comes not from any special features of financial markets but rather from a unique mix of properties. Asset managers offer lenders a mix of risk and return, but risk is difficult to measure. This means it is difficult for lenders to really know their exposure to risk. Second, all financial assets are ultimately promises to make payments at a later time or after certain events. Asset values therefore depend on information about the ability of a counterparty to make those payments. Few people have this information. Finally, leverage—borrowing money to increase returns in certain events—is especially prominent in financial markets. This brings an additional set of agents into transactions and also exposes them to risk. Other markets may share some of these individual properties. For example, many goods have properties that are difficult to measure, and concern about the long-term viability of a company is relevant to many decisions outside the financial sector (*e.g.*, when

1 The financial sector is code 52 in the North American Industry Classification System (NAICS). See http://www.census.gov/eos/www/naics/.

buying a car). However, the combination of these factors in the financial sector makes them unique to this area.

7. The difficulty in assessing risk and the dependence of asset prices on closely held information makes trust especially important in financial markets.[2] With the possible exception of credence goods like health care, buyers and sellers in other markets for real goods and services do not face quite so much difficulty in evaluating the fundamental quality of the goods and services they are buying. Financial markets have mechanisms to manage these risks, of course, but formal risk management is ultimately a cost. Trust reduces this expense in many ways, not only as a pure substitute for risk management but also by reducing the need to be aware of the possibility of certain events. Unfortunately, the importance of trust and leverage mean that financial markets are subject to sharp adjustments when trust erodes.

1.3 The Benefits of Competition in Financial Markets

8. These special properties of financial markets do not reduce the role that competition plays in this sector. Competition provides many of the same benefits in financial markets as it does in other markets. Within the financial sector, it encourages businesses to minimize costs and to innovate. Within the overall economy, competition in the financial sector plays its part in ensuring that resources are allocated efficiently across sectors, over time, and across risks (more formally, "states of nature"). A monopolized or poorly performing formal financial sector will have both static and dynamic effects including the misallocation: (i) of resources between the financial and non-financial sectors; (ii) between capital and labor within the real economy; and (iii) of income between savings and consumption, as well as slower than optimal growth.

9. It is natural that sentiment toward financial market innovation is negative in the current environment. However, it is important to keep this in perspective. Financial market innovation has increased the availability of capital to a wide range of markets in the real economy. Without these innovations, the real economy would have grown more slowly.[3]

1.4 The Limits of Competition Policy

10. Financial products, like many other products, become better understood through experience. Competition supports this learning process by providing numerous mechanisms for limiting losses and unwinding positions, and encouraging learning and the dissemination of information that ultimately lead to the more efficient allocation of risk and resources. In most circumstances, this process works very well.

11. However, the current crisis reveals some limits to these mechanisms. For example, the market for credit default swaps (CDS) grew very rapidly. The fact that many participants in a rapidly growing market may not correctly perceive the risks and rewards, or lack sufficient information to make such judgments, is not a problem that competition policy alone can address. Instead, the problems in the CDS

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2 "[F]inancial contracts are the ultimate trust-intensive contracts…. Financing is nothing but an exchange of a sum of money today for a promise to return more money in the future. Whether such an exchange can take place depends not only on the legal enforceability of contracts, but also on the extent to which the financier trusts the financee." Luigi Guiso, Paola Sapienza, Luigi Zingales, "The Role of Social Capital in Financial Development," *American Economic Review*, Vol. 94, No. 3 (June 2004), pp. 526-56. For a formal model and empirical analysis of trust, financial markets and growth, *see* Paul J. Zak and Stephen Knack, "Trust and Growth," *The Economic Journal*, Vol. 111, No. 470 (April 2001), pp.295-321.

3 On this point, *see* remarks of Charles I. Plosser, New York University Stern School of Business (June 5, 2008), *available at* http://www.philadelphiafed.org/publications/speeches/plosser/2008/06-05-08_nyu-stern-school-of-business.cfm.

market suggest that certain combinations of size, growth and lack of transparency require further investigation by regulatory authorities. These problems also suggest a more general principle that competition authorities and regulators need to pay attention to whether information asymmetries are present in fast growing markets, and must cooperate to identify markets where competition policy alone cannot address certain market imperfections.

2. Crisis: Role of Competition Policy in Financial Sector Rescue and Restructuring

2.1 Competition Law Set Aside

12. Setting aside competition law during times of crisis has proven unwise. Indeed, doing so is likely contrary to the public interest. The experience of the United States in the Great Depression, in particular the use of rationalization cartels pursuant to the National Industrial Recovery Act, showed that such an approach is more likely to cause further harm to the economy than to help recovery. Competition is central to well-functioning markets. Our experience and that of others indicates that relaxing existing principles of competition law, through such approaches as greater solicitude towards mergers in the financial industry, is unlikely to help solve an economic crisis, whether in the short- or longer-term.

13. Procedural rules regarding mergers may be altered when necessary to ensure that competition law does not create exclusively procedural obstacles to economic recovery. However, this has not proved necessary in the U.S. system to date. Under U.S. law, the Department of Justice and the Federal Trade Commission must be notified of mergers that meet certain thresholds.[4] After notification, the merging parties must wait up to 30 days before completing their merger, more if the agency reviewing it has concerns about the competitive effects of the merger.[5] Because such rules may prevent rapid mergers necessary to keep a troubled firm operating, flexibility in the timing may be appropriate. The Hart-Scott-Rodino Act provides that flexibility already, however. Nothing in the statute precludes the agencies from allowing a merger to proceed in less than 30 days once they have determined that the merger will not be anticompetitive, and indeed most mergers receive "early termination" in well under 30 days.[6]

2.2 Failing Firm Defense

14. Under U.S. antitrust law, merging companies may avail themselves of the "failing firm" defense. When absent a merger one of the merging parties would likely fail as a going concern, the merger may be found not to violate Section 7 of the Clayton Act.[7] This defense plays an important role in competition policy by ensuring that merger law does not unnecessarily lead to assets exiting a relevant market. Its application, however, is narrow. Most important, this defense applies only if there is no alternative purchaser that would create a less anticompetitive effect.[8] Relaxation of the requirements of this defense in times of financial trouble would pose the same problems as relaxing competition law more generally. In an economic downturn more firms may be "failing," making the defense potentially available to a greater number of companies. But that does not suggest that the requirement that the merging firm must show there were no other less anticompetitive alternatives is automatically satisfied.

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4 *See* 15 U.S.C. § 18a (Hart-Scott-Rodino Act).

5 *Id.*

6 *See* 15 U.S.C. § 18a(b) (Hart-Scott-Rodino Act).

7 *See United States v. General Dynamics Corp.*, 415 U.S. 486 (1974); U.S. Department of Justice & Federal Trade Commission, *Horizontal Merger Guidelines* § 5 (1997).

8 *See* Merger Guidelines § 5.1.

15. The reason for the greater number of failing firms in times of economic crisis also should be considered. In some instances, firms fail because they are inefficient or because demand for their products or services has declined. In such cases, firms should either exit the market or merge with firms that remain competitive.[9] In other situations, firms may be failing because of inefficiencies in financial markets. In those circumstances, the better course is to address the inefficiency in the financial markets that is creating the underlying problem, rather than altering merger policy as a way of managing the consequences.

3. Real economy: Challenges for competition policy in periods of retrenchment

3.1 Government Bailouts: Competition Policy Response and Economic Effects

16. The U.S. government's assistance to the Chrysler Corporation ("Chrysler") in 1980 was probably the most well-known example[10] of a government bailout in U.S. economic history prior to the automobile industry bailout at the end of last year. Chrysler's financial troubles largely stemmed from the fact that it did not respond quickly enough to consumers' demands for smaller, more fuel efficient automobiles. Chrysler, which was on the brink of bankruptcy, received $1.2 billion in federal loan guarantees. G. William Miller, Treasury Secretary at the time of the bailout, stated, "there is a public interest in sustaining [its] jobs and maintaining a strong and competitive national automotive industry."[11] Lee Iacocca, Chrysler chairman during the bailout, promised that "[f]ederal loan guarantees, import quotas, and a well-defined industrial policy … w[ould] be the key to American corporate success in the years ahead."[12]

17. Alfred Dougherty, Jr., Director of the Bureau of Competition at the FTC at the time of the first Chrysler bailout, stated before the U.S. Senate that

> *[w]here a firm has misperceived, or been unable to satisfy, the consumer's needs and preferences, little reason should normally exist to preserve the firm through artificial support. Rather, the opposite is generally true. The failure of the firm increases allocative efficiency by removing an inefficient user of economic resources.*[13]

18. Mr. Dougherty went on to state that, "government support for a failing firm should occur, if at all, only where the most compelling social policy considerations militate for the continuing existence of the firm."[14] As public calls for a more active industrial policy in the U.S. grew in the 1980s, representatives from the FTC continued to advocate against a more interventionist approach. Former chairman of the FTC, James Miller III, remarked in 1983 that, "active industrial planning policies did not work in this country in the 1930's … [a]nd they are not the answer for the United States in the 1980s."[15]

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9 The drawbacks of a third alternative—government subsidies or "bailouts"—are discussed in the next section.

10 Other examples include the Penn Central Railroad (1970) and the Lockheed Corporation (1971).

11 "Chrysler's Crisis Bailout," *Time Magazine* (August 20, 1979).

12 Hickel, James K., "The Chrysler Bail-Out Bust," *Backgrounder* 276 (July 13, 1983), p. 1.

13 *Statement of Alfred F. Dougherty, Jr., Director, Bureau of Competition, Federal Trade Commission, Before the Committee on Banking, Housing and Urban Affairs, United States Senate, Government Assistance to Chrysler Corporation* (October 10, 1979), p.2.

14 *Id.*, p. 4.

15 *Reindustrialization Policy: Atari Mercantilism?, Remarks of James C. Miller III, Chairman, Federal Trade Commission, Before the Economic Club of Detroit* (April 18, 1983), p. 8.

19. Federal loan guarantees of the type offered to Chrysler in 1980 may have the effect of crowding out private investment, making it more costly for other businesses and consumers to borrow in credit markets, assuming that credit markets are functioning normally and that the economy is at full employment. In addition, had Chrysler been forced into bankruptcy, the resources under their control could have flowed to more efficient automakers or to more efficient firms outside of the automobile industry. Job losses from a Chrysler bankruptcy in 1980 were estimated to be over 720,000.[16] The federal bailout of Chrysler likely saved some fraction of these jobs -- but not all -- in the short run. Subsidizing an individual failing firm within a larger industry, in the form of loans, loan guarantees, or otherwise, has the effect of preventing the movement of resources to more efficient uses and may result in higher prices for consumers.

3.2 Rationalization Cartels: U.S. Experience and Economic Effects

20. The National Industrial Recovery Act of 1933 ("NIRA") was passed in response to the industrial decline that took place during the depression of the 1930s.[17] The NIRA allowed for direct price and output controls, which had been illegal under U.S. antitrust laws, by firms organized into trade associations. It was intended that the price and output controls would stabilize prices at profitable levels but not at joint profit-maximizing levels. It is widely believed that the NIRA was anticompetitive and contributed little, if at all, to economic recovery.[18] The NIRA was declared unconstitutional, and therefore illegal, in 1935 but the anticompetitive effects of the Act were felt long after it was no longer in force.[19]

21. There are very few exceptions to the *per se* rule against price-fixing in the U.S. Apart from the brief period of the NIRA, industry distress has never been viewed as a legitimate reason for granting a permanent – or even temporary – exemption from the *per se* rule. Allowing collusion as a policy response to failing firms prevents the movement of both labor and capital to more efficient uses outside of a distressed industry. As a consequence, consumers pay higher prices both for the goods of the distressed industry and for goods produced outside of the distressed industry.

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16 *Supra* note 10.

17 This summary of the NIRA is drawn from M. Frankena and P. Pautler, *Antitrust Policy for Declining Industries*, Bureau of Economics, Federal Trade Commission (October 1985).

18 *See, e.g.,* J. Taylor, "The Output Effects of Government Sponsored Cartels During the New Deal," *Journal of Industrial Economics* 50 (March 2002): 1 – 10.

19 *See*, *e.g.*, *United States v. Socony-Vacuum Oil Co*., 310 U.S. 150 (1940) (striking down rationalization cartel originally established under the NIRA).