Statement of

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Before the Subcommittee on Courts and Competition Policy,

Committee on the Judiciary,

United States House of Representatives,

November 17, 2009

Chairman Conyers, it's a pleasure to appear before you and the Committee today. I will address two broad sets of issues: (1) the best way to reform laws and regulations governing the resolution of large, complex nonbank financial institutions, and (2) antitrust issues related to the approval of bank mergers.

I. The Resolution of Failures of Large, Complex, Nonbank Financial Institutions

In the wake of the ad hoc bailouts of AIG and Bear Stearns, and the bankruptcy of Lehman, policy makers seeking to avoid having to make the choice between undertaking taxpayer-financed bailouts of risk takers and permitting potentially disruptive liquidations are struggling over whether and how to improve the resolution process for nonbank financial institutions.

One approach would be just to do nothing, have the government resolve never to assist failing nonbank financial institutions, and let the chips fall where they may. What is wrong with that approach?

Some argue that we learned from Lehman's failure the necessity of being prepared to assist a failing nonbank financial firm in order to avoid the costs borne by others from its failure. Lehman, according to that view, illustrates how a large, complex firm's failure can disrupt the broader network of financial transactions. Such a failure may entail opaque losses on counterparties and creditors of the failed institution, and a scramble for liquidity in response to those opaque losses can ensue, increasing the haircuts set in markets on illiquid collateral and raising demands for cash. This can cause risky asset prices to fall, driving down bank equity capital, and causing counterparties and lenders to contract the supply of contracts and loans, or to become insolvent. Such disruptions can have significant social costs.

People who are skeptical of the possibility of such costs should remember that the London clearing banks voluntarily pooled their resources to bail out an investment bank in 1890 (Barings) just to avoid the potential disruption that its failure might have had on their positions. French bankers orchestrated a similar privately funded bailout of the Paris Bourse in 1882. Bankers put their own money

on the line because they perceived the risks of a liquidity crisis resulting from the failure of a large nonbank financial institution as real.

Whether the costs to the financial system were actually large in the case of Lehman Bros., however, is a matter of lively debate. There was lots of news happening around the time of Lehman's failure, not least of which were the many dire public statements by the Fed Chairman and the Treasury Secretary, which had a palpably negative effect on market sentiment and caused fear to spread throughout the financial system. As many financial experts, including Stanford's John Taylor and, Richard Sylla of NYU's Stern School, have argued, the approach taken to "selling" the nation on the TARP plan displayed a lack of cool-headed leadership, which magnified the effects of financial shocks and encouraged panic.

Furthermore, better financial policies between March and September 2008 likely would have prevented Lehman's failure from occurring in the first place, rendering a bailout unnecessary. Whether or not one supports the bailout of Bear Stearns in March 2008, it was known in March 2008 that Lehman was at risk; financial regulators should have pressed Lehman and other investment banks to raise capital in the spring or summer of 2008, when markets for raising capital were open and when Lehman's and others' stock prices were still high. If policy makers had forced Lehman to raise substantial equity capital in the spring or summer of 2008, its failure could have been avoided. Lehman's decision not to raise capital, and instead to sit on its hands for six months to see whether its stock price would improve, reflected its belief that it would also obtain a bailout. Moreover, if policy makers had been able in March 2008 to credibly commit not to bail out Lehman, Lehman likely would have decided on its own to raise capital in the spring or summer of 2008. It is reasonable to conclude that the Lehman failure was avoidable, and was caused by bailout expectations. Thus, it is hard to argue from that perspective that Lehman's failure teaches us the advantages of generous bailout policies.

Despite these legitimate arguments in favor of the avoiding nonbank financial firm bailouts, there are legitimate reasons to doubt the *feasibility* of such a commitment, even if one believed that it would be desirable to do so. Many

economists, politicians and regulators *believe* that the costs of Lehman's failure were large, and that spillover costs could be similarly large for a nonbank financial firm's failure in the future. It is hard to imagine what evidence could be produced to disprove those beliefs, even if they are wrong. The genie is out of the bottle, and even if it would be better for us to just let the chips fall where they may (and there is a respectable argument that it would be better), under the current rules of the road, worries about "systemic risk" will likely result in more decisions to prevent failure.

This is especially true when one considers the decision making process that produces bailouts; experience has shown that political risk aversion favors bailouts even when they are not necessary. Which politician or regulator will be willing to risk a systemic meltdown on their watch and face the potential political backlash that would accompany it? Creditors of failing nonbank financial institutions are aware of policy makers' risk aversion (demonstrated by the series of bailouts, beginning in 1984 with what is now widely regarded as a political and regulatory overreaction to the failure of Continental Bank – the first example of the application of the too-big-to-fail doctrine); creditors will use that risk aversion to exaggerate their own vulnerability to shocks, as a means to obtain more free protection from the government (i.e., avoiding "haircuts").

Bailouts, as most recently illustrated by AIG's experience, keep counterparties and creditors whole because there is no way short of bankruptcy under current law to force them to bear a loss. In other words, the game of chicken between government agencies and creditors is one that the government is likely to lose (as they did with AIG's creditors) when trying to convince creditors to share in losses, which will mean taxpayers will bear all the losses. The "holding up" of taxpayers by threatening regulators and politicians with the prospects of dire consequences for society if even small amounts of loss are borne privately has large social costs; not only do taxpayers suffer inordinate losses, the incentives from that loss-sharing arrangement lead to excessive risk taking by too-big-to-fail firms in the future.

There is broad consensus that this status quo is not acceptable, and it will not be changed by bold statements alone. We cannot simply pretend that under current laws our policy makers can (or should) commit *never* to bailout insolvent nonbank financial firms. *Reform must create a means to transfer the control of assets and operations of a failed institution in an orderly way, while ensuring that shareholders and creditors of the failing firm suffer large losses. Those outcomes are essential if the resolution of failure is to avoid significant disruptions to third parties, and also avoid bailout costs to taxpayers and accompanying moral-hazard costs.*

Two approaches to addressing the problem have been suggested: (1) bankruptcy reforms that are tailored to the needs of nonbank financial institutions (an approach favored by most Republicans in Congress, and exemplified by H.R. 3310), and (2) the creation of an administrative resolution authority (which is favored by most Democrats). After reviewing the pros and cons of these two approaches, I will show that a hybrid – bankruptcy reform with a resolution authority loophole – may be a superior policy choice than either of the two approaches currently on the table.

Critics of creating an administrative resolution authority rightly argue that placing discretionary authority over resolution in a regulator is likely to institutionalize too-big-to-fail protection, given the aversion to imposing losses on creditors that we have seen over the past 25 years of U.S. bailout history. That insight is central to the argument that bankruptcy reform, rather than the establishment of a resolution authority, is the best means to eliminate too-big-to-fail protection.

But, despite the arguments that I believe favor the bankruptcy reform approach, it is not clear whether the government can credibly pursue a pure bankruptcy approach, even if doing so were desirable. The problem is a political one: An economically defensible, “tough-love” bankruptcy system might encourage (for reasons associated with political risk aversion) *ad hoc* resolutions to occur outside the reformed bankruptcy process (i.e., a repeat of AIG).

For that reason, I believe it would be desirable to establish a hybrid bankruptcy/resolution approach, which pre-defines (and thereby, *constrains*) the way resolution would occur outside of bankruptcy, if it were to occur. If, to avoid ad hoc bailouts, the creation of some form of resolution authority loophole is desirable, it should be crafted, and can be crafted, to substantially limit the risk of taxpayer loss and the adverse incentives consequences that accompany it. Below, I discuss the pure bankruptcy approach, the pure resolution authority approach, and the hybrid bankruptcy/resolution authority approach that I am recommending.[1]

The Pure Bankruptcy Reform Approach: House Republicans have made a good start toward bankruptcy reform in H.R. 3310, but I would add several elements to address shortcomings of existing law as applied to complex nonbank financial institutions. Those shortcomings include: (1) the need for international coordination in establishing jurisdictions over assets (deciding which courts control which assets), (2) proper ways to structure payments on maturing contracts and debts, and debtor-in-possession (DIP) financing, to ensure continuing liquidity in the market for counterparties and creditors, and (3) the need to avoid the gaming of creditors' voting rules due to the hedging of creditors' exposures through derivatives positions.

With these problems in mind, my additional suggested bankruptcy reforms would focus on (1) establishing "living wills" of financial firms, approved in advance by regulatory authorities and governments in the relevant countries, so that locations of assets and jurisdictions are clear, (2) improving the rules governing payment of maturing debts and DIP financing so as to limit damage to third parties from frozen assets (e.g., using conservative valuations of the institutions' assets to permit fractional payouts to short-term debt holders in an amount less than the estimate of their ultimate recoveries, on the condition that they relinquish their claim to additional payments in the future), and (3)

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[1] The hybrid approach outlined below reflects discussions I have participated in as a member of the Pew Trusts Task Force on Financial Reform. The approach is broadly consistent with the proposal put forth in the forthcoming report of the Task Force, "A Bi-Partisan Policy Statement," although the Pew Task Force did not offer details for an appropriate triggering mechanism for administrative resolution.

establishing new voting rules for creditors in bankruptcy that would better encourage efficient renegotiation.

The Pure Resolution Authority Approach: The motivation for a new resolution authority, administered by a financial regulator – which is supported by the Obama Administration and many Democrats in Congress – begins from the premise that bankruptcy reform (especially cross-country coordination) will take time, will be too inflexible, will not prevent financial network disruption, and thus, will not prevent the holding up of taxpayers via bailouts to avoid those disruptions.

I am not convinced that the technical problems alleged by critics of bankruptcy reform would make bankruptcy reform unworkable; I believe that the problems of international coordination are challenging but not intractable, and that it is possible to make significant improvements to the bankruptcy code that would speed efficient and timely renegotiations, while avoiding significant disruption to counterparties and creditors.

But, as I noted before, I see a political risk from relying only on bankruptcy reform: a tough-love bankruptcy regime might encourage regulators or politicians in the future to choose ad hoc bailouts instead of relying on bankruptcy, either because of special-interest pressures, or because policy makers are extremely risk averse about spillover effects. If that happened, then bankruptcy reform would not accomplish its central objective of avoiding taxpayer-funded bailouts.

For that reason, it is worth considering how resolution authority might be helpful as a supplement to bankruptcy reform. The key problem with the resolution authority alternative currently being advocated, however, is that it is likely to be abused, either as the result of pressures from special interests or as the result of the risk aversion of political or regulatory actors in the midst of the crisis. Resolution authority as it has been proposed would be too generous and would institutionalize the too-big-to-fail problem, rather than avoid it.

A Better, Hybrid Approach: Under a proposed hybrid approach (which is closely related to a recent proposal put forward by the Pew Trusts Task Force on

Financial Reform, of which I am a member), the new bankruptcy process would be employed unless strict criteria were met to trigger a resolution process.[2] The resolution process would (1) impose 100% haircuts on stockholders and minimal, significant haircuts on all creditors and counterparties (say, 20%), which would ensure that creditors and counterparties would be more careful in granting credit to high-risk firms, (2) require ex post funding of the costs to taxpayers by the large financial institutions that presumably benefit from the use of the resolution authority (say, the 100 largest financial institutions), up to an amount equal to half of the aggregate net worth of those institutions, and (3) require both that Congress vote to allow the resolution authority to use taxpayer funds to backstop privately funded protection, and that a (value-weighted) majority of the financial institutions that would be liable for the cost of the resolution also vote in favor of using the resolution authority.[3]

A time-honored principle of incentive-compatible bailouts is that government should take a *senior stake* in support of a coalition of private sector firms, who bear the first tier of losses during bailouts. That approach underlay the successful resolutions of the Paris Bourse in 1882 and Barings in 1890. It is also broadly consistent with the rules governing assistance to many U.S. banks from the Reconstruction Finance Corporation (RFC) in the 1930s. RFC assistance forced stockholders of banks receiving preferred stock investments from the government to accumulate additional equity capital (which protected the government from extreme loss) as a condition for receiving preferred stock assistance. In other words, *in crafting its bankruptcy/resolution policy reforms, government can and should rely on the self-interested behavior of market participants to prevent the institutionalization of too big to fail.*

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[2] As proposed by the Pew Trusts Task Force on Financial Reform, "A Bi-Partisan Policy Statement," November 2009, interim liquidity support could be provided for a brief period of time pending the decision over whether to opt for administrative resolution.

[3] It is possible to argue for different voting thresholds. A super-majority threshold could be justified on the grounds that only extremely severe ramifications for the financial system should give rise to the administrative resolution mechanism. A less-than-majority threshold could be justified on the grounds that resolution would prevent others, notably consumers and borrowing firms, from suffering costs of a credit crunch even when the majority of banks would not want to risk absorbing losses to prevent a credit crunch.

The proposed hybrid approach depoliticizes the decision to employ administrative resolution by forcing the private sector to share decision making authority, and *financial responsibility*, for bailouts. If the private sector were forced to pay for bailouts, and were given a role in deciding whether to implement bailout authority, we would be able to avoid politically driven excessive risk aversion when deciding whether a bailout is really necessary and how large the haircuts to creditors should be. This was precisely the logic applied by the designers of FDICIA in 1991; FDICIA required that support to distressed banks by the FDIC beyond what could be justified in a least-cost resolution calculation would have to be paid for by a special assessment on surviving banks, proportionate to their outstanding deposits. That was meant to ensure that the surviving banks bearing both the costs of bailouts and the benefits of reduced "systemic risk" would lobby to prevent unnecessary bailouts from occurring.[4]

II. The Inadequacy of Antitrust Enforcement in Approving Bank Mergers

With respect to the second topic of today's hearing, namely the potential for improving antitrust enforcement of bank mergers, I would stress that current antitrust regulation in banking is inadequate, and that – while expedited approval of mergers during a crisis is desirable – it would be undesirable to permit the proposed expedited approval of bank mergers under emergency circumstances without also substantially improving regulatory oversight of bank mergers.

The Fed and the Justice Department share responsibility for antitrust enforcement when approving bank mergers, but in practice, the Fed has played the dominant role, and both regulators generally have been a rubber stamp. I want to emphasize, lest I be misunderstood, that bank consolidation, deregulation of interstate branching, and the deregulation of bank powers restrictions played no adverse role in fostering risk taking during the recent crisis. Furthermore, for the most part, mergers during the past three decades, and the deregulation of bank powers that has permitted universal banking, have been

[4] My understanding of the logic of the FDICIA special-assessment requirement is based on conversations with my colleagues on the Shadow Financial Regulatory Committee, especially with Professor Ken Scott of Stanford Law School, who is widely regarded as the originator of this idea.

helpful in serving the multi-product needs of bank customers, and in *promoting efficiency and competition* in local bank lending markets, as the research on the effects of bank consolidation on loan pricing has shown.[5] But that has not always been the case.

In one case with which I am familiar, the merger of the only two banks of any significant size in New England, the merger was not desirable from the perspective of many bank customers. In the merger of Fleet and BankBoston in 1999, middle-market borrowers in New England opposed the merger. I was able to show in my analysis of the effects of the merger on the loan market that they were right to do so. My study and affidavit predicted that a merger of the two banks would cause interest rates to rise by roughly a full percentage point for middle market borrowers. That estimate was corroborated by subsequent research that showed that, in fact, the merger caused middle market borrowers' interest rate spreads to rise by more a full percentage point.[6]

I was involved in the Fleet-BankBoston merger as a consultant to the Attorneys General of Massachusetts and Connecticut. Despite the concerns and evidence of anti-competitive effects, the merger was pushed through as the result of political pressures applied to regulators, including pressure from at least one highly influential member of Congress. Justice Department officials, in conversations in which I participated, initially supported action to prevent the merger, or at least to force a carve out of some of the middle market business of the combined entity in a way that would have encouraged another competing bank to enter the market to purchase the carved out assets, which would have included a substantial portfolio of middle-market business loans. Under political pressure, the Justice Department backed down. I was told by one of the state Attorneys General that a member of Congress threatened budgetary consequences for the Antitrust Division if they did not back off, and under the

[5] See, for example, Ricardo Correa, "Bank Integration and Financial Constraints: Evidence from U.S. Firms," Board of Governors of the Federal Reserve System, March 2008, and Isil Erel, "The Effect of Bank Mergers on Loan Prices: Evidence from the U.S.," *Review of Financial Studies* (forthcoming), 2009.

[6] Charles W. Calomiris and Thanavut Pornrojnangkool, "Monopoly-Creating Bank Consolidation? The Merger of Fleet and BankBoston," National Bureau of Economic Research Working Paper 11351, May 2005.

circumstances, the Attorneys General did not feel that they had sufficient authority to stop the merger or materially change its structure.

The Federal Reserve has also been a rubber stamp for mergers, so long as (1) the mergers did not violate the Fed's measure of excessive concentration in the local deposit market, and (2) activist community groups and their allies in Congress did not oppose the mergers. The first, deposit-market-share, condition is not an adequate measure of competition, since it applies only to deposit shares in each neighborhood, not to loans or other products, and it does not distinguish loans by relevant market niches (e.g., large corporate, middle-market, small business, consumer). It is easy to satisfy the local deposit market share condition by spinning off a few branches in a few neighborhoods, and doing so has no effect on competition in the regional loan market for mid-sized companies.

In my experience, the attention paid by the Fed to activist groups largely reflects Fed concerns about offending members of Congress; those concerns gave rise to the infamous use of pre-merger contracts between merging banks and well-organized community activists (e.g., ACORN), which were common during the merger wave. Merging banks paid those groups to support their mergers, whether or not the merger was in the interest of other local consumers or in the interest of small and medium-sized firms. This bribery/extortion racket was a national disgrace.

We need to empower antitrust enforcement of banking mergers by placing antitrust responsibility *entirely* in the Antitrust Division of the Justice Department, and by *ensuring budgetary autonomy* of that Division, which would insulate enforcement from the political pressures that have been applied in support of mergers by monopoly-seeking banks and rent-seeking self-appointed community groups. Once that reform has been accomplished, expediting the merger approval process under crisis conditions would make sense, but until and unless we fix the merger approval process, streamlined approval will just make abuses worse.

Antitrust concerns relating to bank lending to middle-sized firms are especially worrying now, given the small number of large banks that operate in many local communities. Large banks provide unique services for mid-sized

businesses in their states. To ensure competition in lending to these important customers, which are the backbone of the American economy, ideally there should be at least three or four banks of significant size, and with substantial middle market lending capabilities, operating in each region of the country. Our current regulatory structure has produced a different outcome in some regions, and without improvements in the antitrust process, this is liable to become worse.

III. Summary of Opinions

In summary, I believe that a hybrid bankruptcy/resolution approach to reforming the framework within which resolutions of failed nonbank financial firms occur would be the most desirable way forward. That approach would avoid the risk of institutionalizing too-big-to-fail protection (the main risk of the pure administrative-resolution approach to reform), and would avoid the unwitting encouragement of ad hoc bailouts as an alternative to bankruptcy (the main risk of a pure bankruptcy approach to reform).

A properly structured hybrid approach would prevent excessive private sector risk taking (i.e., moral hazard) by credibly allowing nonbank financial firms to fail in most cases, and by imposing substantial losses on their creditors. It would remove the risk of large costs to taxpayers from bailouts, would force the private sector to bear almost all the costs of bailouts, and it would avoid unnecessary bailouts motivated by excessive political risk aversion.

With respect to antitrust policy, while the vast majority of consolidation in the financial services industry over the past three decades has been beneficial to bank clients, there are notable exceptions (the most obvious of which was the anticompetitive merger of Fleet and BankBoston). That merger was pushed through by special interests – monopoly-seeking banks, rent-seeking consumer activist groups, and politicians aligned with them – acting against the broader interests of consumers and firms. In some regions of the country – most obviously, in New England – there are too few large banks able to offer a full bundle of products and services to middle-market borrowers.

We need to improve the bank merger approval process, which has become too politicized to be reliably effective. *We should remove the Fed from oversight of bank mergers and give the Antitrust Division of the Justice Department undivided authority, budgetary independence, and a mandate to avoid the creation of monopoly power, especially in middle-market lending.* Once that is done, it would make sense to permit expedited consideration of bank mergers during financial crises. But until that is done, expedited approval would magnify the politicization of the merger process and the potential for the creation of undesirable monopoly power.

My discussions of nonbank financial firm bailouts and bank antitrust policy have something in common: They begin by recognizing that crafting good policy is not just a matter of resolving technical questions related to economic efficiency; rather, these policies are subject to political risks can affect, and have affected, their implementation. We must design bailout and antitrust policies better than we have in the past, to minimize the potential for undesirable outcomes driven by political processes.