The GFC and the Legal System

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When I heard about the topic for today's panel I was instantly reminded of an old adage: "never waste a good crisis."

And the global financial crisis is no exception.

To begin, I thought I'd recall for you an incident from that excellent show of the past, *Yes Minister*. It was an episode where Sir Humphrey's past caught up with him and was about to prove embarrassing with documents released under the 30 year rule. In the end, they manage to release no documents at all using a variety of excuses including "documents that went astray in the move to London, other records which went astray when the War Office was incorporated into the Department of Defence, and so on." But the one excuse that is pertinent here was "some correspondence lost in the floods of 1967." Humphrey remarked, "1967 was a bad winter but an excellent one for the Civil Service. All manner of embarrassing documents were lost."

Bad winters provide good fodder for these lessons. I teach my students a case "McMullen & Worby" that asks them to think about how they would evaluate a plant manager's performance. One issue that comes up is that during the year under consideration there was a very bad snow-storm and the plant had to shut down. The issue is whether the consequences of that should be taken off the manager's performance target.

Taking it off as it was literally an Act of God and outside the manager's control seems fair and also potentially efficient as to do otherwise would mean you would have to pay the manager a premium for bearing 'weather risk.' But the issue is not that but what you wanted the manager to do. Let the manager have the storm as an excuse and it is opening a can of worms with regard to excuses for things under her control – motivating workers to ramp up production to make up for lost time, ensuring the plant started up again quickly, etc. In other words, the crisis is the time when you need managerial effort more than others and so to take it off the performance cards would surely undermine the whole value of performance-based management.

Now replace the words snow-storm with financial storm and we arrive at the issue for the legal system today. How are companies today taking advantage of the crisis for legal and regulatory advantage?

This issue has come up in competition policy especially with respect to banking. Prior to the crisis, back in 2007, the major banks comprised 70% of home lending. Today that number is more like 95% and perhaps higher. What changed?

For one, the crisis hit smaller lenders harder who had relied on securitisation – not sub-prime but normal – to source funds for home lending. But this is not the full story. What happened was that instead of just shutting down, these smaller lenders were snapped up by the major banks. And this is not just Aussie Home Loans, Wizard and Challenger but also banks such as St George and Bank West. In each and every case, the GFC was cited as the rationale for the merger with the caveat that if it didn't proceed, the market would be without that lender anyway. And because each one of these chipped away at market share, the ACCC let them through.

The argument is an old-one – called the 'failing firm defence.' And it comes to the fore in financial crises because more firms tend to fail or look like failing then.

The potential relevance of a 'failing business unit' defence is that taking it into account prospectively and allowing a merger may yield consumer and social welfare benefits that exceed those that would arise if the business unit were to simply fail. Of course, that said, if the prospect of failure of the unit were not high, then no such defence would apply and the usual evaluation of horizontal mergers would take place.

Given this, suppose that it is established that the business unit in question is failing. Suppose, hypothetically, also that failure would result in a monopoly outcome in the market. In this situation, if there were no other independent acquirers of the unit's assets, those assets would leave the market and could not even be used by the incumbent firm to expand its own operations. Such a situation would not improve prospects for consumers or social welfare. In contrast, if the incumbent were to acquire that unit, it would be integrated as part of its operations and, indeed, any assets associated with it may enable its operations to be expanded.

On the other hand, should an independent owner acquire that unit and that unit remain viable for the new owner, it would continue to provide competition in that market. In this situation, while the business unit might be failing, the concept behind it may be robust and be able to continue.

One reason why a failing firm defence may be a call for action – not to just "let the market decide" post-failure – is that there is a dynamic consequence. Entrepreneurial entry is risky. If you impose a regulatory caveat that if you challenge an incumbent via entry you are precluded from earning an exit return via acquisition should you fail, such entry may be discouraged.

The flip-side is, of course, that softening the blow from failure can be self-fulfilling. Their may be fight in companies yet and an ability to ride out the storm. But you won't find out if merger policy is too permissive.

So how do you resolve this? The answer is to be more circumspect about how mergers are approved. If a merger's rationale is that a firm might fail and needs a financial lifeline, then temporary acquisition by a competitor may provide both firms with a respite without permanent damage to the structure of the industry. A reviewable merger clearance to see if, post-crisis, the merger continues to make sense may be a better route to regulatory and competition policy than a 'black and white' merge or don't merge decision.

Financial crises like storms require us to be more innovative and more flexible in our regulatory options. We need judicial and legislature that permits this flexibility.