FINANCIAL SYSTEM STABILITY AND COMPETITION: DO THEY COMPLEMENT OR CLASH?

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I. Motivation

Thank you very much for inviting me to speak at this conference; it is certainly a timely topic, especially since the issues are complex and the answers not straightforward. The Global Financial Crisis, or the GFC, has squarely put financial stability center stage. Since then, national and international policy makers have been preoccupied with managing the crisis and designing regulatory reforms to stem future systemic risk.

Not surprisingly, the focus, so far, has been on restoring and enhancing financial stability, with limited discussion on whether more needs to be done to secure competition and ensure access to finance. At the same time, since the GFC, the number of financial institutions has fallen across the globe, even as their total assets have increased and the derivatives market are now 10 times GDP (Figures 1 and 2).

Against this background, two key policy questions arise:

- Are we doing enough to ensure global and national financial stability so that we are better prepared for future crises?

- Are there unintended consequences of the ongoing reforms on the incentives for entry of new financial firms? In other words, would competition in the financial sector and access to finance become collateral damage in our battle against systemic risk?

II. Evidence

At this stage, the reforms are still ongoing and the consequences, both intended and unintended, will naturally evolve with time. But we have accumulated sufficient experience across countries in the last two decades to draw three inferences:

- First, competition is good for access to finance
- Second, the evidence that competition undermines financial stability remains elusive
- And third, the GFC revealed major fault lines in the intermediation structure, notably the Too-Big-to-Fail problem

First, on competition:

It is well accepted that greater competition in financial services improves efficiency and productivity, by lowering the cost of borrowing, improving access to finance, enhancing the availability and quality of financial services and products through innovation. Investment banking and nonbank financial intermediation have increased market depth and broadened access to finance in advanced economies. Cross-border banking has deepened markets in emerging economies. There is also evidence that it has a positive effect on economic

growth—for example, Claessens and Laeven (2005) find that industrial growth increases with increasing competition in 16 banking systems. [1]

Competition authorities use various tools to enhance competition in the financial sector: lowering entry barriers, allowing more banks including foreign bank branches, making markets and products more contestable (such as through credit registries in retail banking), eliminating activity restrictions, and introducing or enhancing new lending markets such as commercial paper or the corporate bond market.

Of course, the process of financial deepening and innovation can bring with it risks that are not fully internalized by financial institutions as the GFC crisis revealed; regulation and supervision were too lax and incentives for adequate risk management were missing. Still, the positive aspects of the deregulation and the expansion in market-based financial intermediation of the past two decades should not be underestimated.

Second, on the link between competition and financial stability:

Unfortunately, the empirical and theoretical literature has been ambiguous on its findings and predictions on whether competition is good or bad for financial stability. [2] One concern is the effect of higher competition on banks' incentives

[1] Also see the Global Financial Development Report, 2013, Chapter 3, World Bank.

[2] See Claessens, 2009 "Competition in the Financial Sector: Overview of Competition Policies," IMF WP/09/45, for a recent literature survey on competition policies and a full bibliography; and OECD, 2011, "Bank Competition and Financial Stability."

for risk-taking and their franchise values. Excessive competition, as one side of the argument goes, can lead to greater fragility and instability as banks take on more risk by competing for market shares. This can lead to weaker lending standards even as access to finance tends to increase during good times.

Thus, we see how potential tensions between competition policy and financial stability policy can arise. For instance, if there was indeed evidence to support that larger number of banks lead to more risk-taking by the banks, then restraints on entry and encouraging larger players would be viewed as necessary to preserve financial stability. [3] But, such policies could incentivize banks to reap economies of scope and scale by becoming even bigger, expanding across product lines and national borders. This, as we well know, reinforced the too-big-to-fail problem which was at the heart of the recent crisis.

The empirical literature has not found decisive links between various measures of competition and financial stability. For instance, our 2012 Global Financial Stability Report found that higher concentration in the banking sector was associated with higher GDP growth in good times, but higher financial stress during a banking crisis.[4] At the same time, banking systems with high concentration ratios had very different experiences during the GFC—Ireland and Iceland had severe banking crises whereas Canada and Australia did not. Of course, measures of concentration may not be related to competition per se. A key message from the crisis is that what matters more than the structure of the

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[3] IMF, 2013, "Key Aspects of Macroprudential Policies," IMF Policy Paper.

[4] Global Financial Stability Report, October 2012, "Changing Global Financial Structures: Can they Improve Economic Outcomes?"

market itself is making sure that there is a robust regulatory and supervisory framework.

Third, on the fault lines:

It is now well accepted that financial systems and instruments became highly complex and the location of risks was opaque, especially for the OTC derivatives and other securitization products. This made it difficult for both authorities and investors to track risks and assess potential spillovers, and to understand the underlying elements of new financial instruments.[5] Assessment of risks by credit rating agencies, on which the official and private sector rely heavily for critical decisions, also became suspect. Aided by technological advances, financial institutions became more interconnected through interbank, repo, and other wholesale markets, both domestically and globally. The upshot of these developments was the evolution of large and complex institutions, performing a wide range of financial services across international borders and offering products, oft times that are opaque.

When the crisis came, it became evident that to maintain financial stability, these large institutions—the SIFIs and the G-SIFIs—were too important to go bust. Public intervention in various forms had created the implicit expectation of future support. This had created a "too big or too important to fail" (henceforth, TBTF) subsidy, with large banks benefitting more from this than

[5] Global Financial Stability Report, October 2012, "The Reform Agenda: An Interim Progress Report Toward a Safer Financial System."

smaller banks.[6] The forthcoming GFSR provides estimates of the value of this subsidy. The subsidy gives rise to unfair competition in the funding markets, and encourages TBTFs to become even bigger.

III. TBTF: are current reforms sufficient?

Let me now turn to answering the questions that I started with—are we doing enough to ensure financial stability, especially on the TBTF concern, and whether the reforms have unintended consequences on competition. In particular, the big question is whether the enhanced capital and liquidity requirements provide disincentives for new entrants in the intermediation landscape, or provides disincentives to banks to become larger and more complex, which should help competition.

A host of reforms are aimed at addressing the systemic risk SIFIS pose. As a first step, the reforms involve identification of systemically important financial institutions (SIFIs). In this regard, the IMF, together with the FSB and the BIS, came up with a methodology to identify the SIFIs.[7] The shared characteristics of SIFIs were size, complexity and opaqueness, with operations difficult to substitute and replace in the event of crisis, and interconnectedness with other financial institutions. The idea of substitutability is related to the entry of new firms, that is, competition.

While dealing with the GFC did exacerbate the problems associated with the SIFIs, some progress has been made on global regulatory reforms—namely, in

[6] "The Implicit Subsidy of Banks" May 2012, Financial Stability Paper No 15, Bank of England.

[7] IMF-BIS-FSB, 2009, "Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations."

imposing higher regulatory capital and liquidity requirements on SIFIs through Basel III, requiring greater supervisory intensity, introducing bail-in resolutions, and allowing for cross border resolutions. Full implementation, which is pending in the resolutions area, of these bank reforms should help address market distortions manifested by under-pricing of risk.

Establishing a SIFI framework for nonbanks has been a slower process due to differences in business model and the heterogeneity of the nonbank sector.

As banks shed costly activities (for instance, the trading and investment portfolios lines as some banks have done), the risk is that either it will move over to nonbanks or it will further concentrate this activity towards ones with an already high share of such business. The shift in activities to nonbanks and shadow banks could be good for competition as long as the risks are monitored and adequately addressed through intensive supervision.

Structural constraints on banks' activities in three jurisdictions have been designed to separate trading activities from the more traditional deposit taking activities, as the former are riskier. The Volcker Rule prohibits U.S banks' proprietary trading, and the Vickers and Liikanen proposals in the U.K. and the euro area, respectively, segregate a wide range of non-core activities into ring-fenced activities. Once core and non-core activities are separated, other policies such as competition policy could be used to deal with entry/exit of firms targeting a market segment.

These structural measures, particularly in tandem with other regulatory reforms (such as higher capital requirements) could mitigate excessive risk taking by the

SIFIs. However, they also have implications for lower diversification benefits and efficiency, making the financial sector as a whole less profitable and efficient. Also, to the extent that these reforms are not global, it would be an uneven playing field for these banks competing against local banks in other jurisdictions. This points to the need for a global cost-benefit exercise encompassing extra-territorial implications of structural measures.[8] This is a big unknown.

Would these reforms, including loss-absorbing capacities and resolvability of SIFIs, be enough to solve the TBTF problem and promote a competitive landscape? I am afraid we have some ways to go before we can say that. I will point to five other areas that need more work to adequately address the TBTF problem:

- Supervision—providing sufficient resources and independence to supervisors needs to match the stronger and stricter regulatory rules.[9]
- Shadow Banks—regulatory standards for banks' interaction with shadow banks are being tightened but national implementation is pending.
- Credit Rating Agencies—reducing mechanistic regulatory reliance on CRAs.
- Accounting standards—harmonizing audit standards which vary across and within jurisdictions.
- Derivatives reform—more progress in dealing with the problems created by the leverage and opaqueness of derivatives revealed during the GFC.

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[8] Viñals et al, 2013, "Creating a Safer Financial System: Will the Volcker, Vickers, and Liikanen Structural Measures Help?" IMF Staff Discussion Note, 13/4.
[9] Vinals and Fiechter, 2010, "The Making of Good Supervision: Learning to Say 'No'," IMF Staff Position Note 10/08.

IV. Where should competition policy head?

Let me now raise the question on whether competition policy could play a more prominent role in addressing the TBTF problem? The argument is that anti-trust actions, such as preventing mergers between banks or breaking up large institutions, or downsizing them by selling part of their businesses, could avoid moral hazards associated with the creation of too large and complex and systemically important institutions. This is an area of growing interest and research.[10] In some countries, such as recently in the U.S., the traditional powers of competition policy, including licensing, take-over control and break-up powers have been vested on the prudential authorities to improve the resolvability of systemic institutions.

At the very least, strong coordination and consultation mechanisms would need to exist between the prudential and competitive authorities.[11]

Finally, let me move on to the question of whether the regulatory reforms would excessively undermine access to finance. This concern has widely been expressed by, in particular, developing and emerging economies**,** but is also valid in advanced economies, for example with regard to SMEs. The new capital and liquidity regulations, may lower banks' ability to provide long-term financing for investment, including in infrastructure.[12] Furthermore, less

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[10] See Ratnovski, 2013, "Competition Policy for Modern Banks," IMF WP/13/126.

[11] IMF, 2013, "Key Aspects of Macroprudential Policies," IMF Policy Paper.

[12] FSB Report to the G20: Update on Financial Regulatory Factors Affecting the Supply of Long-Term Investment Finance.

financial hedging and more risk-retention due to stricter derivatives regulations could also impede long-term financing of projects.

While these are valid concerns, the most important contribution of financial regulation to long term investment finance is to promote a safe, sound, and resilient financial systems. Furthermore, alternative solutions could be explored to diversify the financial system and enhance the functioning of capital markets as sources of long term financing. This can include further deepening the local equity and corporate debt markets; developing securitized markets and the local institutional investor base, as well as addressing gaps in market infrastructure that may be impeding these markets from taking off. The associated financial stability risks could be contained through appropriate sequencing of reforms and upgrading and strengthening the financial sector regulatory and supervisory frameworks.

V. Conclusion

Let me conclude by making three points:

First, there is no doubt that financial innovation has been a powerful force for improving access and reducing the cost of finance and broadening access to new financial products. However, to reap the full benefits from competition, regulations and supervision need to be strengthened in line to capture potential new risks caught up with these developments. Competition policies can play a much greater role in enhancing both market efficiency and innovation in the financial sector once we have strong regulations and intensive supervision in place. Prudential and competition authorities need to closely coordinate with

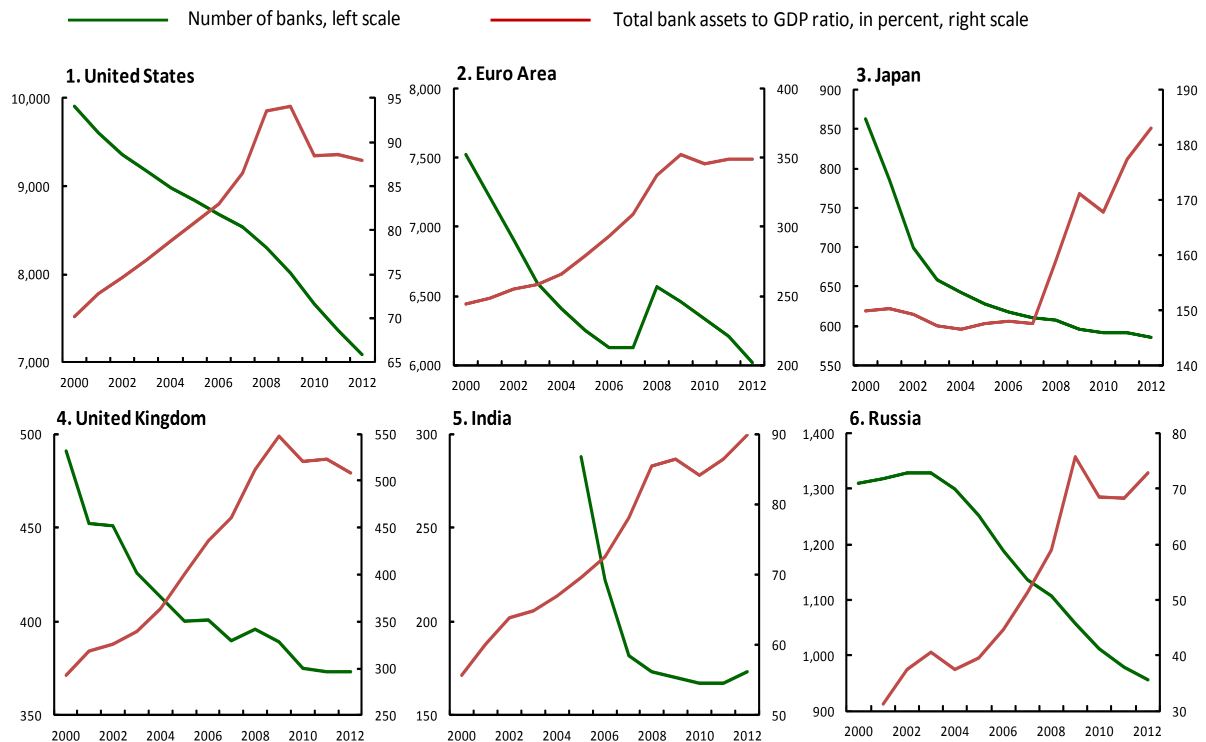
each other, especially in dealing with the TBTF problem or to help facilitate crisis resolution.

Second, is to address the risks in the nonbank and shadow banking sector as activity is expected to shift here from banks. We could miss the opportunity for healthy competition between banks and nonbanks, including shadow banks, due to inconsistent application of regulatory standards between bank and nonbank SIFIs.

Third, there is a case for developing "missing markets" in enhancing access to finance in EMDEs as regulatory reforms are being implemented.

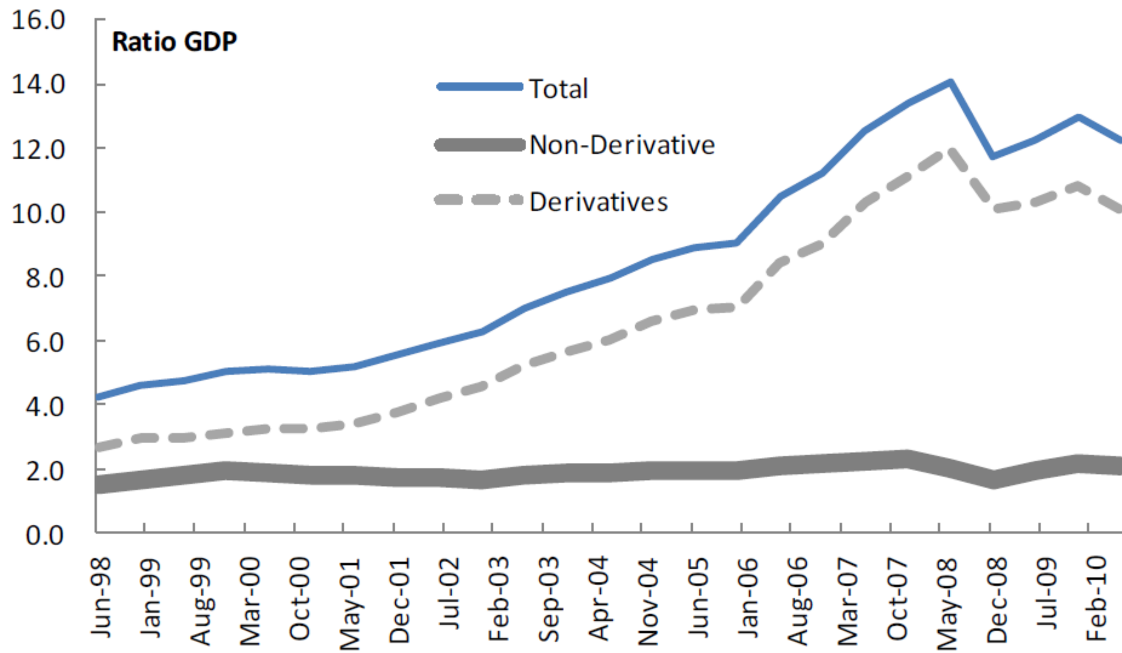
Thank you.

Figure 1. Number and Size of Banks in Selected Countries



Source: Global Financial Stability Report (forthcoming April 2013), IMF.

Figure 2. Global Notional Derivatives versus Primary Securities



Source: OECD, 2011, “Bank Competition and Financial Stability,” Chapter 2.