Session 1: Financial System Stability and Competition in the Financial Industry

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Address by Session Chair

Odd Per Brekk

Good morning everybody, and before we start, allow me on behalf of the IMF's Regional Office for Asia and the Pacific to thank both ADBI and the FSA for co-hosting this event with us, and of course all of you for participating and coming here to contribute and participate this morning. We look forward to an interesting day of discussions on a range of financial sector issues, all of which are at the center of the international policy debate today.

The first panel of the conference will focus on stability and competition in the financial industry. To set the stage for the discussions, let us remind ourselves a bit about the broader backdrop for this. First of all, it may be useful to keep in mind through all of the detailed discussions that we will have, that the basic objective of what we are discussing is to achieve stable, long-term economic growth.

In this regard, we know that banks provide important support to a country's economy by transforming savings into productive investment. At the same time, we also know

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that maturity transformation makes banks inherently fragile, that the often opaque interconnectedness between financial institutions makes the sector prone to panics and runs, and also that the "too-big-to-fail" issue tends to exacerbate moral hazard.

So this means that we will be facing trade-offs when we think about policies. On the one hand, high growth may be helped by a competitive and highly developed financial sector, through better mobilization of resources, and better and more efficient allocation of these resources. On the other hand, a more developed financial sector might carry larger stability risks.

What are the policy implications of this? Looking back at the onset of the Global Financial Crisis, a failure of regulation was clearly a major factor in 2008. This is of course a common view and the international community's effort in the subsequent years has focused on policies to bolster stability.

With these considerations in mind, a number of issues arise. Where do we stand on the regulatory reform agenda? What should be the role of competition policies versus regulation? Has the focus on stability come at the cost of growth and recovery? And what are the key steps and priorities going forward?

To make sense of these issues, we are lucky to have a very distinguished group of speakers on this panel who together bring to the discussion a diverse set of perspectives as academics, as policymakers, and also as practitioners.

Financial System Stability and Competition: Do They Complement or Clash?

Ratna Sahay[1]

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 (GFC) has squarely put financial stability at the center stage. Since then, national and international policymakers 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 is now 10 times gross domestic product (GDP) (Figs. 1 and 2).

[1] The views expressed in this presentation are those of the author and should not be reported as or attributed to the International Monetary Fund, its Executive Board, or the governments of any of its members.

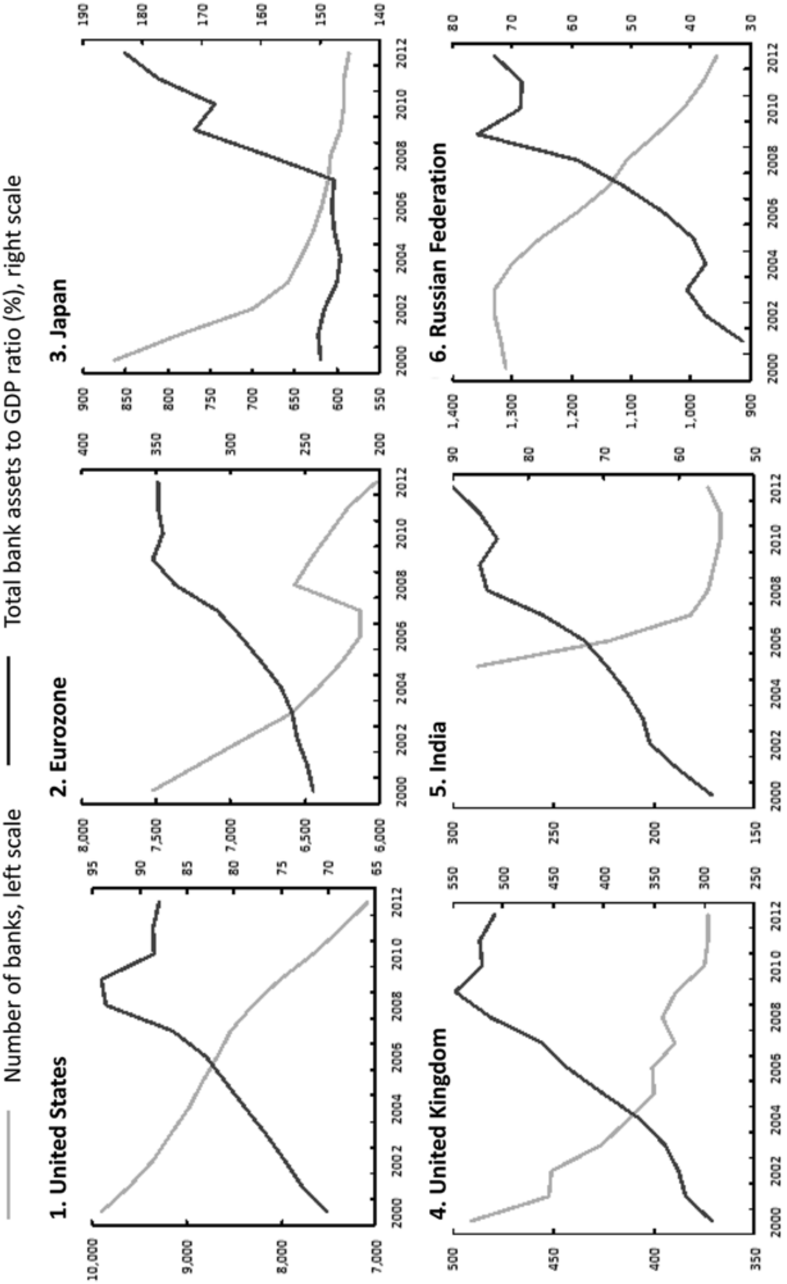

Fig. 1 Number and size of banks in selected economies. *GDP* gross domestic product. (Source: IMF 2013a)

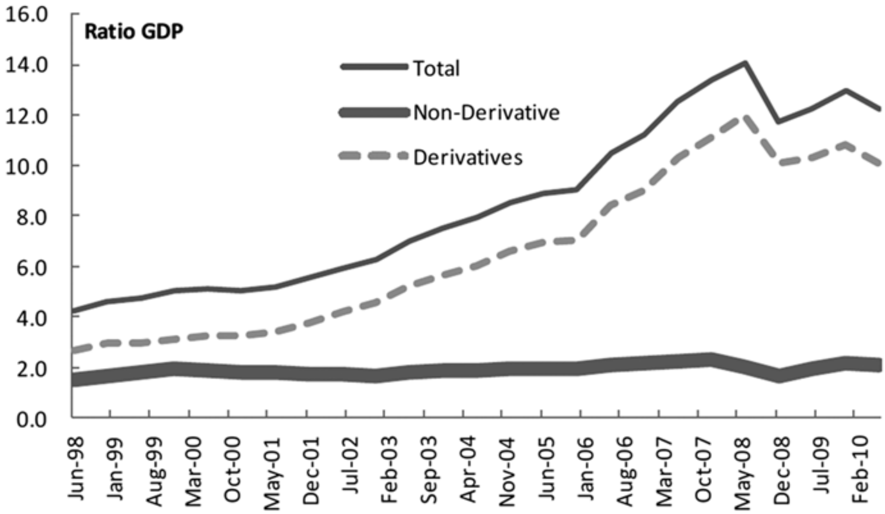

Fig. 2 Global notional derivatives versus primary securities. *GDP* gross domestic product. (Source: OECD 2011, Chap. 2)

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?

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.

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, and 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) found that industrial growth increases with increasing competition in 16 banking systems (see also World Bank 2013).

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.

Link between Competition and Financial Stability

Unfortunately, the empirical and theoretical literature has been ambiguous in its findings and predictions on whether competition is good or bad for financial stability (Claessens 2009; OECD 2011). One concern is the effect of higher competition on banks' incentives 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 a 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 (IMF 2013b). 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 that 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 (IMF 2012a). 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 market itself is making sure that there is a robust regulatory and supervisory framework.

Fault Lines

It is now well accepted that financial systems and instruments became highly complex and the location of risks was opaque, especially for over-the-counter 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 (IMF 2012b). 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 that are often opaque.

When the crisis came, it became evident that to maintain financial stability, these large institutions—the systemically important financial institutions (SIFIs) and the global SIFIS (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 smaller banks (Noss and Sowerbutts 2012). The forthcoming Global Financial Stability Report (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.

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 do the reforms have unintended consequences for competition? In particular, the big question is whether the enhanced capital and liquidity requirements provide disincentives for new entrants in the intermediation landscape, or provide disincentives to banks to become larger and more complex, which should help competition.

A host of reforms are aimed at addressing the systemic risk systemically important financial institutions pose. As a first step, the reforms involve identification of SIFIs. In this regard, the IMF, together with the Financial Stability Board (FSB) and the Bank for International Settlements (BIS), came up with a methodology to identify the SIFIs (IMF et al. 2009). 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 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 underpricing of risk.

Establishing a SIFI framework for non-banks has been a slower process due to differences in business models 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 they will move over to non-banks or they will further concentrate this activity towards ones with an already high share of such business. The shift in activities to non-banks 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 United States (US) banks' proprietary trading, and the Vickers and Liikanen proposals in the United Kingdom (UK) and the eurozone, 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 (Viñals et al. 2013). 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 (Viñals and Fiechter 2010).
- 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.

Where Should Competition Policy Head?

Let me now raise the question of 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 (Ratnovski 2013). In some countries, such as recently in the US, 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 systemically important institutions.

At the very least, strong coordination and consultation mechanisms would need to exist between the prudential and competitive authorities (IMF 2013b).

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 (FSB 2013). Furthermore, less 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 system. 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.

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 accordingly 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, there is a need to address the risks in the nonbank and shadow banking sectors as activity is expected to shift here from banks. We could miss the opportunity for healthy competition between banks and non-banks, 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 Emerging Market and Developing Economies (EMDEs) as regulatory reforms are being implemented. Thank you.

Navigating the Financial Regulator’s Impossible Trinity

Akira Ariyoshi

Good morning and first let me thank the organizers for giving me an opportunity to speak at this very interesting as well as important event. As time is limited I would like to go immediately into the substance of my talk, but before I do, just let me give one disclaimer. After over 30 years in the public sector, I moved to academia some 4 years ago. A lot of my old friends from the public sector asked me how I feel about it. I have a set answer to that question, and that is that one gets freedom of speech, but the downside is that nobody listens to you. And one tends to end up shouting in order to attract attention. So, please bear with me if my talk sounds rather crude and simplistic compared with the more thoughtful and nuanced presentations of my former colleagues.

Now, when something bad happens, you ask yourself what did we do wrong and what can we do to make sure that these things do not happen again? The major lesson that the regulators have drawn from the last crisis appears to be that there was too little capital, both in terms of preventing the crisis and in terms of avoiding a massive cost of cleanup to the taxpayers. This looks on the surface like a reasonable lesson, as capital adequacy rules have indeed been the central pillar of prudential regulation. So if a lot of banks go bust at the same time, that is a prima facie evidence that capital was indeed insufficient.

But I have some reservations about coming straight to this conclusion. For me, the most telling comments that show what lay behind the crisis are the following by the regulator and the regulated:

> Those of us who have looked to the self-interest of lending institutions to protect shareholders’ equity (myself especially) are in a state of shocked disbelief.
>
> Then FRB Chairman Alan Greenspan (Congressional testimony, 23 October 2008)

> …as long as the music is playing, you’ve got to get up and dance. We’re still dancing.
>
> Citigroup then Chairman Chuck Prince (Financial Times, 9 July 2007)

The comment by Alan Greenspan reflects the regulators’ view that, essentially, financial institutions do not want to go bust, so they will manage risk in order to safeguard their solvency.

Chuck Prince’s comment by the regulated, on the other hand, shows that if even they do recognize the risk they may not be in a position to do anything about it.

Competition—stronger competition—actually strengthened this sort of short-sightedness. It forces the institutions to be short-sighted because you may well be driven out of the market if you do not in some sense disregard the risk. This shows that there is possibly some profound disconnect between what regulators think and how the regulated behave.

I would like to illustrate what I mean focusing on capital adequacy rules, although I believe this issue is more general.

As Alan Greenspan noted, financial institutions will indeed maintain a certain amount of capital with or without regulation, since they do not want to go bust at the first downturn. The amount of financial capital that financial institutions voluntarily set aside is often called economic capital.

But the regulators have chosen to introduce capital adequacy rules. If we just look at the actual amount of capital the banks have held relative to the regulatory minimum, we can generally see that the amount of capital required by regulators has been well below this economic capital. If this is the case, what is the point of having these seemingly redundant capital rules? The logic was that it was designed as a minimum capital standard, essentially to catch deteriorating banks before they actually go bust. This was thought to be necessary because banks might resort to gambling for resurrection when their conditions deteriorate, since the downside for the shareholder is limited in such cases. In order to prevent such behavior, the imposition of prompt corrective actions by the regulator is linked to the breach of the minimum capital standards.

It is important to recognize that it was possible to agree on the same capital standards globally despite differences in business models and economic and market conditions as well as credit cultures across countries, because the rules set the *minimum* capital level. The level was well below what the banks would voluntarily maintain under normal circumstances, and therefore was not really binding in their everyday operations. At the same time, the regulators allowed the use of internal models, trusting that banks understand their own risk best, and because they believed that it would help reduce distortions that standardized measurement of risk through regulations might bring.

Of course, there was a possibility that the capital would turn out to be insufficient in some cases, but safety nets for small savers and systemic events were put into place, and things like a 99 % confidence interval for value at risk were introduced to limit the frequency of occurrences, and the resulting regulatory system gave one a feeling that this should work.

In reality, it did not turn out that well. Firstly, the capital adequacy numbers as calculated and reported by the banks significantly lag their true state. The idea that you can catch banks on their way down before they go bust was too optimistic, because by the time you realized that something was wrong, the bank was probably deeply insolvent.

More fundamentally, the problem was that the banks and shareholders have no incentive to set aside capital for tail risk, because economic capital does not anticipate extreme events. Banks would not voluntarily set aside capital, say, to prepare for a risk that they think might happen once in 100 years, and competition tends to drive banks toward shortening that time horizon. In the end, we ended up incurring

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