Competition and Regulation in the Financial Sector

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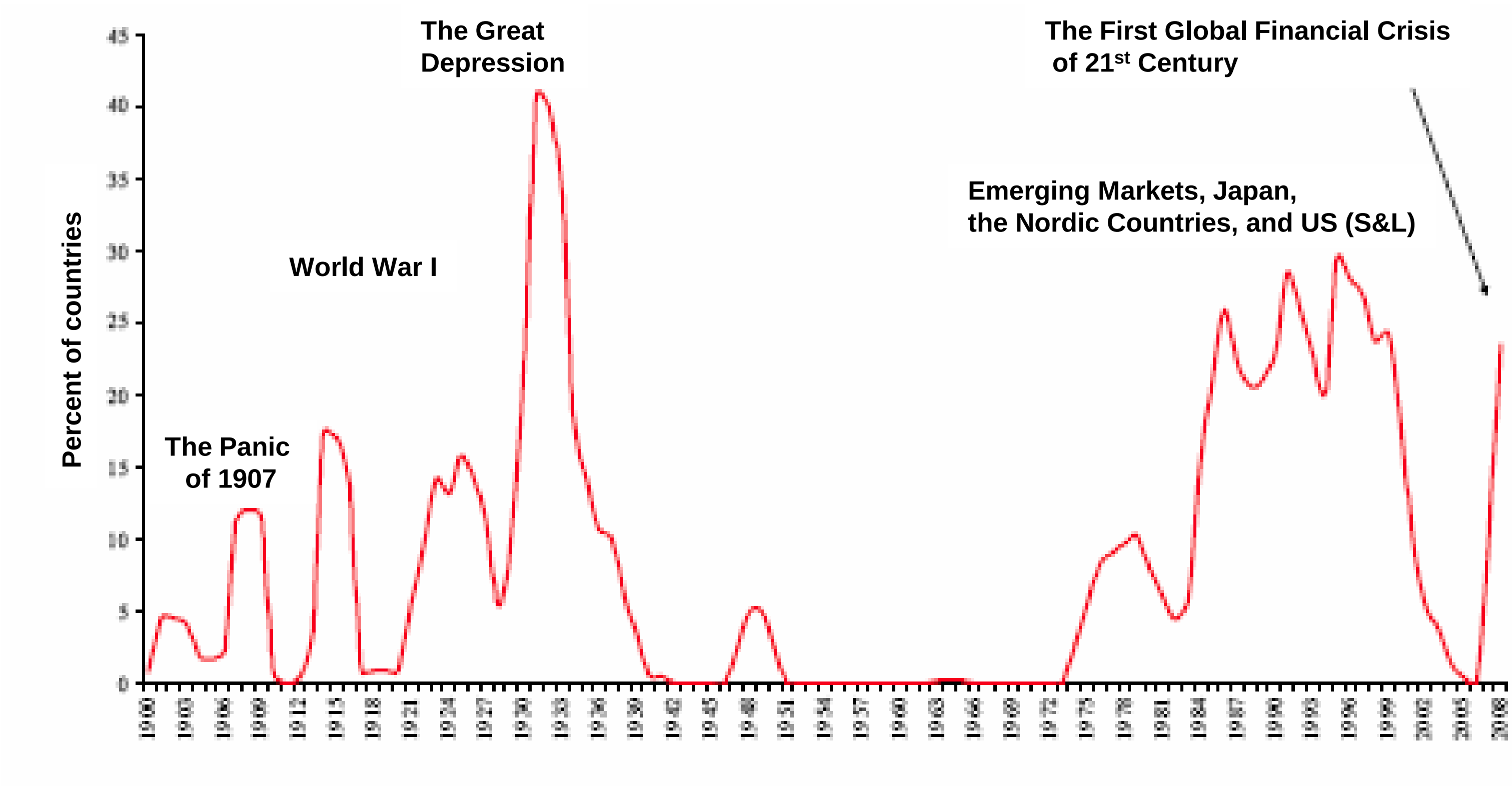
Can we have both competition and stability in banking?

Proportion of countries with banking crises: 1900-2008

Weighted by their share of world income



Source: Figure 1 in Reinhart & Rogoff (2008), "Banking Crises, An Equal Opportunity Menace", NBER WP 14587.

Will we ever learn?

Regulatory failure and regulatory cycle

Outline

- Regulatory failure and the competition-stability tradeoff
- The changing banking business, concentration, and profitability
- Digital disruption

Why is it so difficult?

- Financial innovation and shadow banking
- Political Economy
- Market failures and second best principle

Competition and stability trade offs

Two channels through which competition may increase instability:

By exacerbating *coordination problems* of depositors/investors and fostering runs/panics (externality).

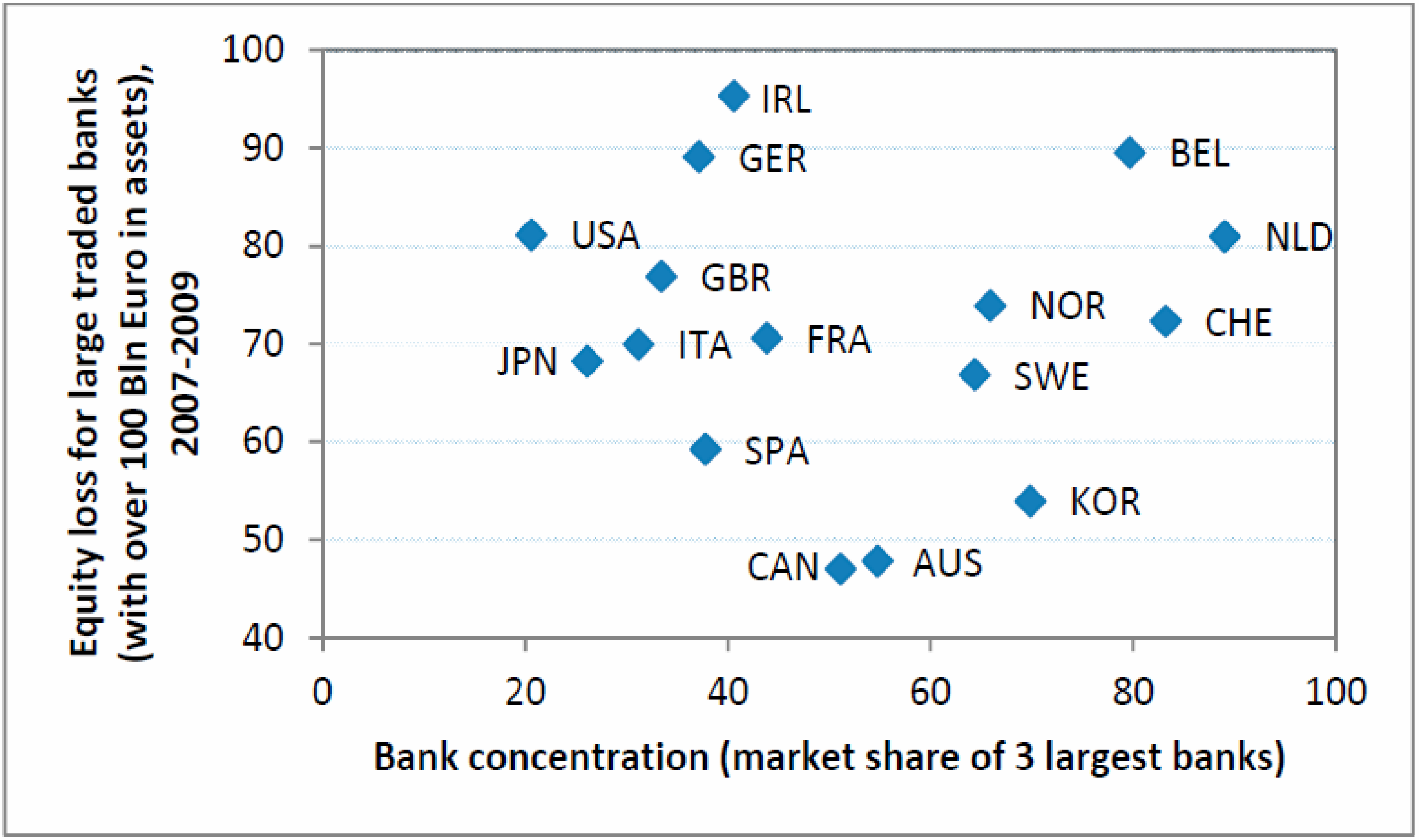
By eroding charter values, increasing *incentives to take risk* and raise failure probabilities (asymmetric information, limited liability, insurance, TBTF).

Summary of evidence

Complex trade-off between competition and stability

- Liberalization without adequate regulation leads to crises.
- Average positive association of market power and bank-level stability but with country variation and some indications that an intermediate level of bank competition maximizes bank stability.
- Mixed results on association of aggregate concentration and stability.

Bank concentration and performance during the 2008 crisis



Source: Ratnovski (2013)

Can we regulate away the competition-stability trade-off?

Regulatory boundary problem,

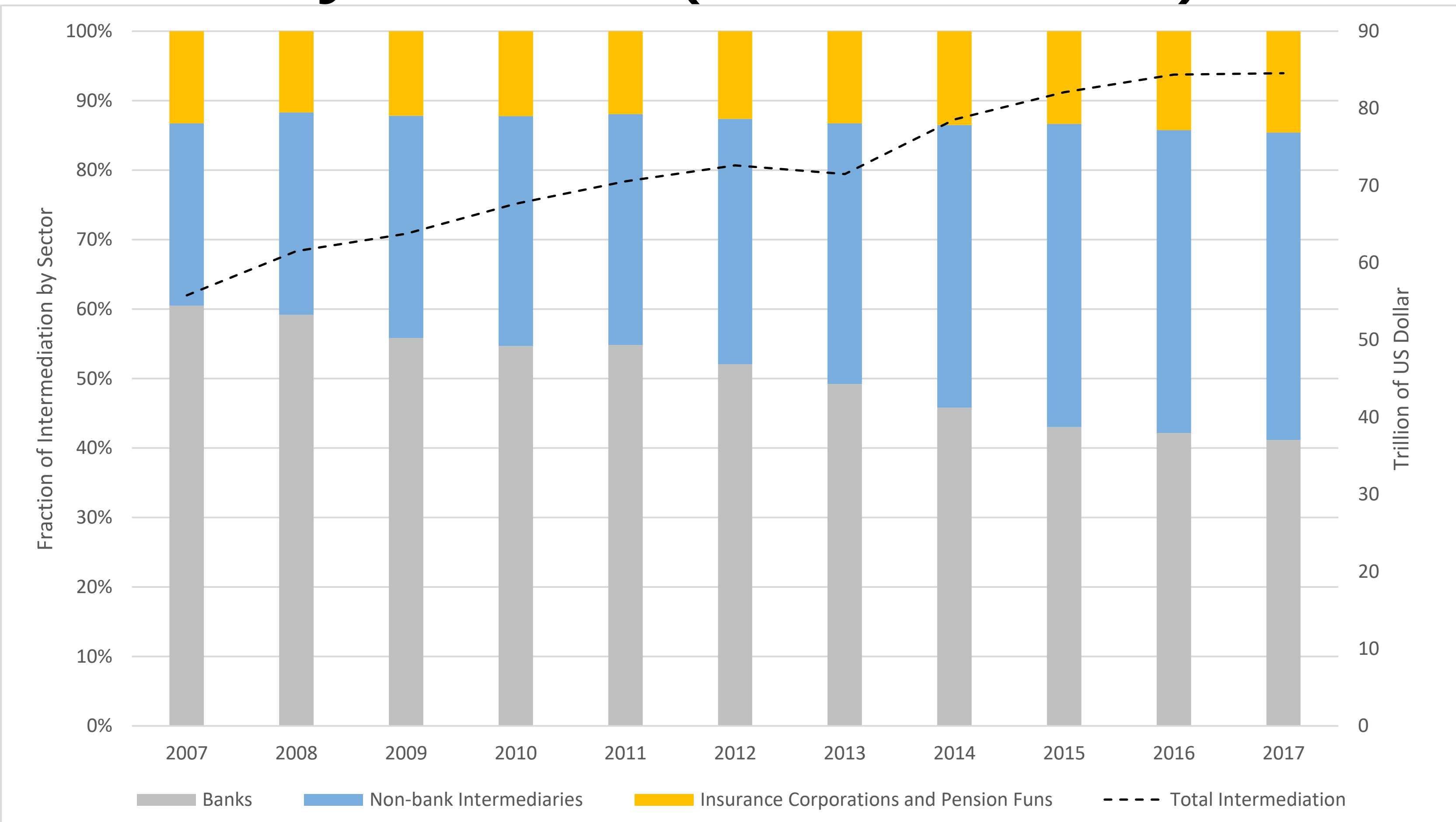
example of US mortgages post-crisis:

- Market share of shadow banks (with high fintech %) almost tripled in 2007-2015.
- 85% of shadow bank mortgages were sold to GSEs after origination.

The changing banking business

- Liberalization and technological change
- Increase in competition from shadow banks/fintech/bigtech
  - Erosion of bank market share in the eurozone
- Result in increase in concentration

Eurozone financial system assets by sector (%, 2007-17)

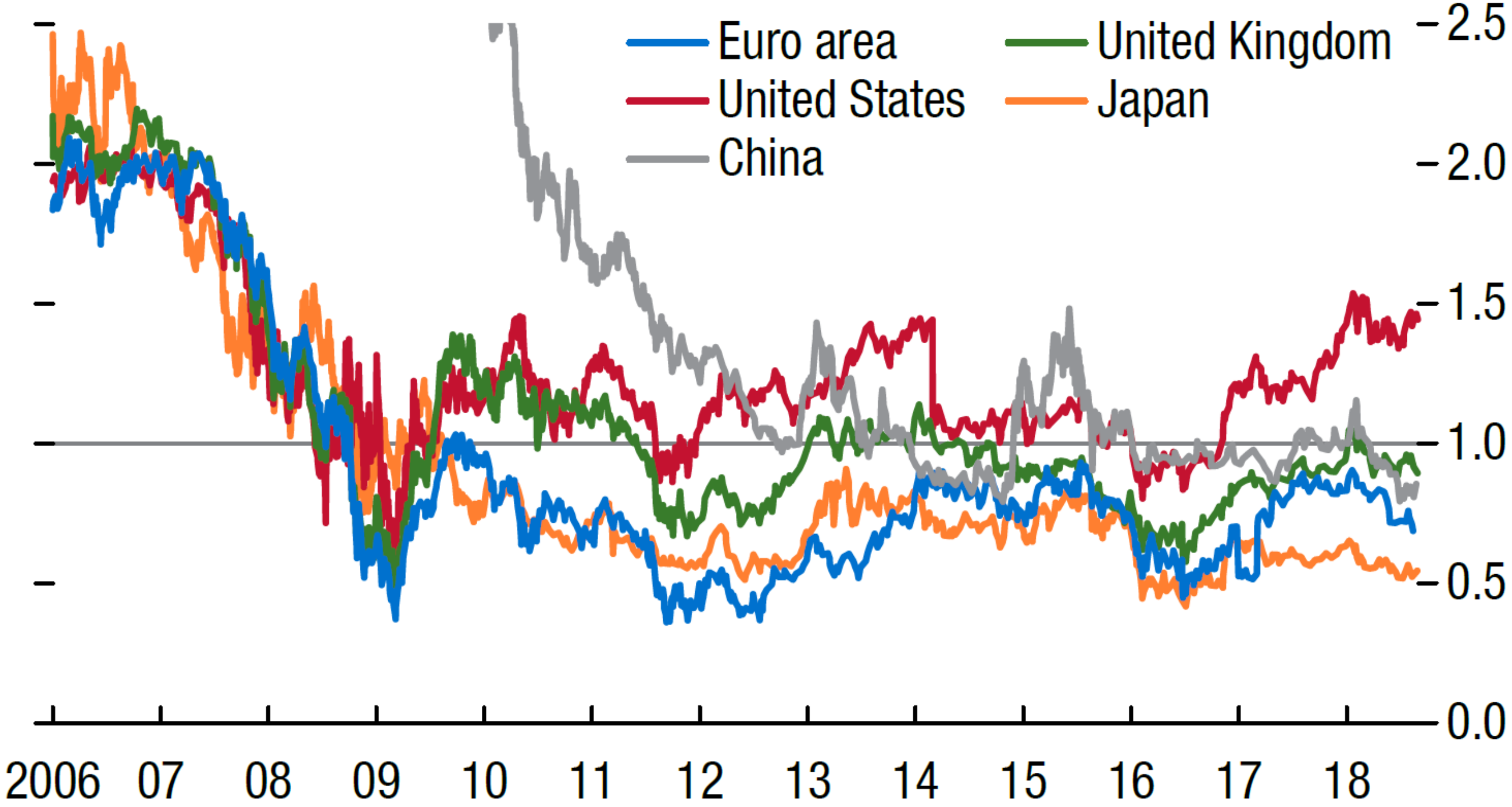


Data Source: FSB, 2017

Low bank profitability

- Legacy of crisis (bad assets, contrast US/Europe).
- Low interest rates, flat yield curve.
- Increase in compliance costs.
- Technological change and new competitors: shadow banks, fintech, bigtech.

Bank Price-to-Book Ratios



Source: IMF, Global Financial Stability Report, October 2018

Digital disruption

Impact of new competitors

Financial stability implications

Impact of digital entrants

- General increase in efficiency and service.
- Incumbents have to update their technological platforms in a low profitability environment and improve standard of service.
- Competition: New entrants, bigtech in particular, will raise competition in the short term but reduce competition in the long term?
  - Platform envolvement strategy to monopolize customer interface
- Level playing field?
  - "Open banking": asymmetry in customer information sharing requirements between PSD2 and GDPR.

Financial stability implications

- New entrants may be lower risk since they have less leverage.
- But increased competitive pressure and cherry picking by entrants will decrease profits of incumbents which may react by increasing risk taking.
- New source of systemic risk: Banks may be dependent on systemic data providers.

Challenges for regulators

- Improve regulation so that we can have more competition without endangering stability.
- Coordinate prudential regulation and competition policy.
- Adapt to the digital world:
  - Keep a level playing field protecting financial stability while allowing the benefits of innovation to permeate the system.
  - Tools:
    - Regulation by activities but entities are those that fail
    - Sandboxes for grown ups?

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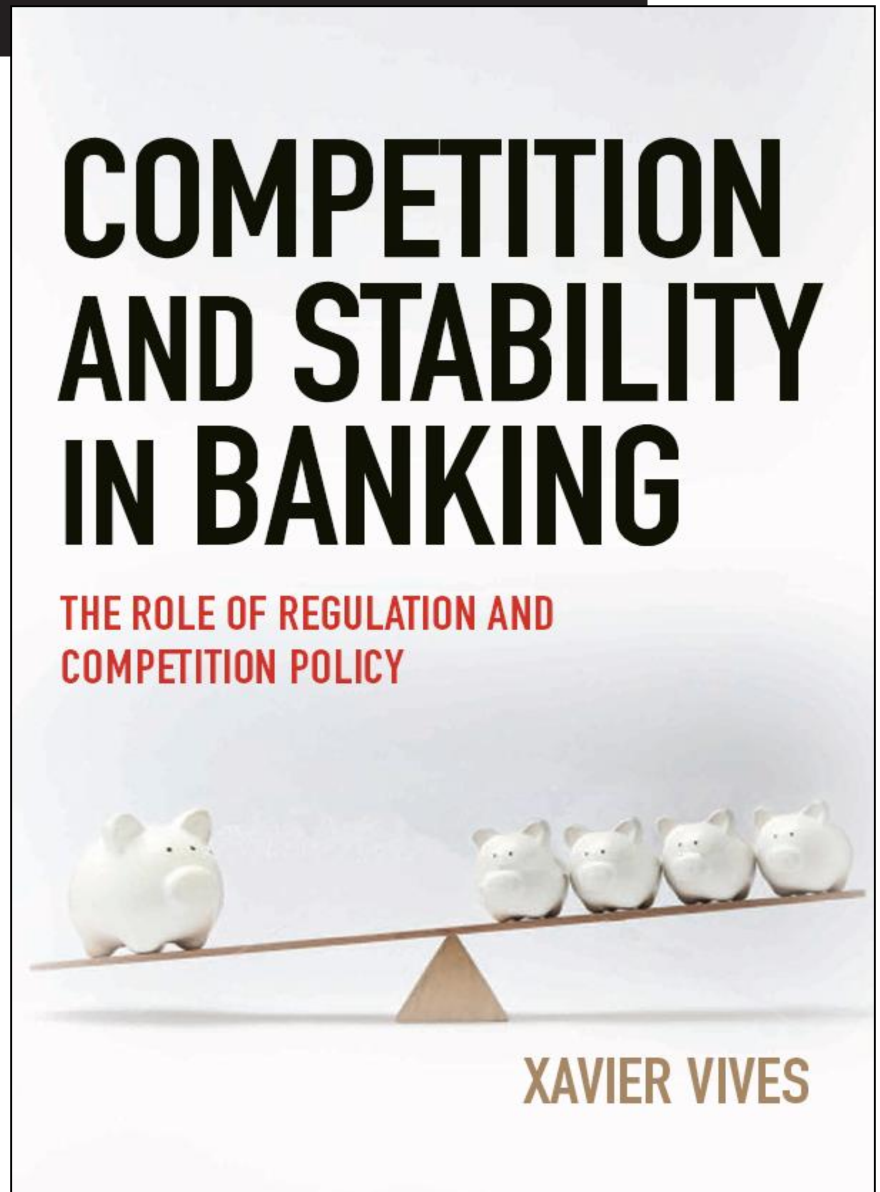

A question of balance