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).

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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.

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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

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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?
COMPETITION AND STABILITY IN BANKING

THE ROLE OF REGULATION AND COMPETITION POLICY

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A question of balance