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Comments on Financial System Stability and Competition

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Brief Summary of Papers by Dr. Sahay and Dr. Ariyoshi

- Dr. Sahay's main messages
  - Competition improves financial access and reduces financing costs. However, to reap the benefits from competition, regulation and supervision need to be strengthened to capture potential new risks.
  - Regulatory standards have to be applied consistently between banks and nonbanks.
  - Coordination and consultation mechanisms would need to exist between the prudential and competitive authorities.
- Dr. Ariyoshi's main message
  - Detailed regulation and a high degree of calibration is needed to ensure that common global standard can provide a level playing field.
  - Impossible trinity problem among globalization, stability and functionality and efficiency.

Financial Regulatory Reforms after GFC

FSB, BIS & SSBs

❖ **Develop**, coordinate, and monitor implementation of global financial regulations

*** SSBs: BCBS, IOSCO, IASB…**

IMF, WB, MDBs

❖ **Expand mandates and resources**
❖ **Analyze economic situation**
❖ **Support low capacity countries**

G20

Global Forum, FATF, FSB

❖ **Develop peer review process and countermeasures for NCJs**
❖ **Develop capacity building program**

Financial Reform Process after GFC

- **KEY AREAS OF REGULATORY REFORM**
  1. BASEL III Capital Adequacy Norms
  2. Systemic Risk – SIFIs
  3. Shadow Banking
  4. Back to Glass-Steagall? : VOLCKER/VICKERS/LIIKANEN
  5. OTC derivatives market
  6. Compensation Practices
  7. Consumer Protection
- **SUPERVISION** – strengthening national regulatory oversight.
- **RESOLUTION** – Living Wills and Bail in
- **ASSESSMENT**: FSAPs through IMF and FSB

<Issue 1> Benefits and Costs of New Financial Regulations

- It is widely expected that financial reform efforts will bring about substantial benefits by
  - reducing the risk of financial crises,
  - enhancing the resilience of banks and other financial institutions in case crises do arise, and
  - reducing economic volatility and increasing transparency.
- However, it may come at a price of increased costs for financial intermediation.
  - Example: Some research, such as Elliott et al. (2012) estimates that current financial reforms may raise lending rates 18bps in Europe, 8bps in Japan and 28bps in the US in the long run.
- Whether the benefits of financial reform outweigh its costs depends on how well new financial regulations work in reducing risks.

<Issue 2> Relationship between Competition and Financial Stability

- It is true that empirical and theoretical literature has provided ambiguous findings and predictions on the relationship between competition and financial stability.

- However, the many experiences of financial crises in the advanced and developing economies showed that rapid and excessive financial liberalization and market opening without proper financial regulation and supervision weakened the soundness and stability of the financial system, and eventually created crises.

- Therefore, the key question is whether strong and intensive financial regulation and supervision are working efficiently in the economy, rather than the level of competition policies themselves.

<Issue 3> Relationship between Prudential and Competitive Authorities

- In many cases, the objectives and interests of competitive authorities are different and even conflicting with those of prudential authorities.
  - Competitive authorities: more competition, thereby increasing efficiency and competitiveness of financial industries
  - Prudential authorities: more emphasis on stability and soundness of the financial system

- A strong coordination and consultation mechanisms has to be present
  - Particularly during normal times and peacetime with no signs of crises, voices of competitive authorities may be stronger than prudential authorities.

<Issue 4> Need for International Coordination

- International coordination in financial regulation is indispensable to limit the scope for arbitrage opportunities among internationally operating SIFIs.
- International cooperation at a regional level is also important to reduce the risk of cross-border distortion and spillover arising from unilateral actions by neighboring countries.

<Issue 5> Application of the Common Global Standards to EMEs

- Application of common global standards may cause some problems to EMEs that have considerably different financial systems from those in advanced economies.
  - The higher capital requirement rules could prompt banks of EME to raise capital ratios much above the minimum level, which could have negative impacts on loan growth.
  - New liquidity standards may constrain bank lending in EMEs where bank lending is the main source of credit.
  - New rules for G-SIFIs may constrain lending growth in host countries.
- International organizations should take into account EME-specific considerations and concerns in designing new international financial standards and policies.

Thank you