Reconciling competition and regulation in banking

Fintech, regulation, Brexit. The banking industry faces uncertainty. The best way forward may be carefully coordinated regulation and competition policy.

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Although several years have passed since the global financial crisis of 2007-2009, the banking industry is still besieged with uncertainty. Witness the effects of a potential Brexit. In the U.S., presidential candidates are vowing to break up big banks with legislation. Meanwhile, the world over, upstart fintech firms are disrupting the industry's traditional business models.

Concerns about competition, on the one hand, and regulation, on the other, get to the heart of the 2016 book by professor **Xavier Vives**: *Competition and Stability in Banking* (Princeton University Press). Years in the making, this book makes a strong case for competition policy in banking, to foster growth, coordinated carefully with prudential regulations, for the sake of stability.

From staid to threatening

The book opens with a brief backward glance, reminding us that banking was tightly controlled in the decades that followed the Great Depression. Systemic stability was achieved in the mid-20th century, but tight controls also brought about complacency, inefficiency, high barriers to entry and even collusion in the financial industry.

Deregulation and liberalization started in the 1970s and the industry got hotter. Competition sparked innovation and encouraged efficiency, thus fostering growth. But instability also ensued — a series of banking crises culminated with the global crisis of 2007-2009. Since

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then, new reforms have kicked in. Today, regulators are still trying to learn from the fallout to move forward for a more prosperous, more stable tomorrow. This book aims to help.

Building on his previous work on the topic, Vives argues convincingly, in just under 300 pages, that society is much better off with both competition *and* regulation in banking. The key is that industry regulations must be fine-tuned to fit the current market conditions, recognizing that there is a trade-off between competition and stability. Well-designed regulation can alleviate the tension caused by the inherent trade-off.

The road map to competition and stability

In the opening chapters, Vives introduces the most pressing issues and salient trends in the industry — including the emergence of "shadow banks" engaging in risky transactions and digital-technology-based fintechs, for whom rules are not yet written.

Next, the author turns to what makes banks unique, their role in society, and their fragility. This chapter also includes a look at the regulatory failures leading to the 2007-2009 crisis and a survey of post-crisis reforms. The following chapters contain Vives' core analysis of competition policy in the industry and an examination of the link between competition and stability. "Competition is not responsible for fragility in banking," Vives writes, noting that even a monopoly bank can fall victim to panicked consumers. And yet, fragility is a concern that must be addressed.

In the penultimate chapter, Vives returns to the 2007-2009 crisis, and the roles played by competition policy, regulatory architecture and public intervention. Regulation is never perfect, the author acknowledges, but it can help balance the trade-offs that must be made between competition and financial stability.

Wrapping up

The final chapter contains a concise summary of Vives' findings and policy implications. Vives finds ample evidence to support his view that "competition in banking is good for society, provided that regulation and supervision are adequate." His further contribution is to offer evidence and suggest approaches to coordinate competition and regulation. Getting practical, Vives argues that competition policy and bank regulation should be carried out (and supervised) by two separate agencies with separate missions.

Adorning the cover of Vives' book are five, white piggy banks balancing on a beam and

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fulcrum. The beam is tipped slightly under the weight of one large piggy, lifting up the smaller four, yet none of the porcelain banks are menacing (or broken). The balance isn't perfect; it suggests that ongoing recalibration and rebalancing is required to keep the fragile banks intact. And that will be the work of smart policymakers going forward.

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