Reconciling stability and competition in banking

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IESE Prof. Xavier Vives examines the tensions that exist between competition and financial stability, and calls for a regulatory framework that meets the needs of the banking system.

Until the 1970s most central banks and regulatory agencies favored a more consolidated banking industry. From the 1980s onward, however, the sector underwent a process of deregulation, and new competition policy was implemented.

Since the financial crisis of 2008, the sector has come full circle, as governments in the West have plowed trillions of euros into the sector and promoted mergers that show no regard for competition criteria.

In a paper on the role of competition in post-crisis banking, IESE Prof. Xavier Vives argues that regulation could serve to ease tensions in the financial markets by blunting the intensity of competition.

One example in this regard would be capital requirements, which should be adjusted according to the level of friction and rivalry in each banking segment.

Coming full circle

Over the past 40 years, banks have moved away from their traditional role of receiving deposits and granting loans, toward providing much broader financial services and products to investors and companies, as well as making equity investments.

As a result, financial margins — the difference between what a bank pays for capital and what it charges its clients — took a backseat to riskier, more lucrative activities, such as engaging in derivatives and the now notorious securitized assets.

In the wake of the crisis, there have been growing calls for a return to traditional banking. Financial margins have seen renewed importance, and traditional banks' participation in financial assets has either increased or continued along the same levels as before the crisis.

Moreover, there has been an increase in the industry consolidation process: Between 1997 and 2007, the number of banks decreased in both the United States (22 percent) and Europe (29 percent).

This restructuring largely took place through mergers and acquisitions. According to Vives, this is an area that must be approached with a view to the long term. Governments, regulators and central banks need to seek optimum levels of consolidation, dynamic incentives for institutional prudence and ease of entry.

There can be no ignoring the fact that these mergers have created institutions that depend on sizable government subsidies and guarantees, skewing the competitive landscape in favor of large, complex financial institutions.

As a result, firms that are deemed "too big to fail" are now enjoying greater market power and lower capital costs than many of their smaller, less complex competitors.

Between competition and stability

There is no doubt that competition reduces production inefficiency and facilitates the allocation of resources while promoting innovation.

However, it may also increase instability. Banking liabilities, meanwhile, exacerbate the problem of coordinating among depositors and investors. With regard to assets, there are greater incentives for risk taking, and thus, a higher likelihood of failure.

While regulation should have helped to mitigate these harmful effects, the crisis has actually exposed the fragility of the three pillars upon which the Basel II framework was built: minimal capital requirements, supervisory review and market discipline.

There have been deficiencies in terms of the provision of information and risk evaluation, while market discipline has proven ineffective due to the implicit guarantee of too-big-to-fail institutions.

In view of this monumental regulatory failure, Vives argues in favor of reforms that would give banks the proper incentives while improving both stability and competition.

He concedes, however, that there is no way of entirely eliminating the tension existing between those two factors.

Inevitable government intervention

While Vives supports the granting of public aid to prevent contagion and protect financial stability, he says that efforts must be made to maintain strong, healthy competition over the long term.

He also highlights the important difference between the aid packages given in the banking industry and those of other industries. Aid for banks usually creates positive externalities for other institutions, given that it limits the expansion of the crisis and protects the system from contagion.

If a troubled bank has solvency issues, it must be restructured and provided with conditional aid, so that competition does not become distorted.

According to Vives, the practice of "ringfencing" in retail banking, which entails setting specific capital requirements within the group, could help ease the problem of too-big-to-fail institutions and, at the same time, allow certain economies of scope in banking activities.

The ultimate role of competition policy in the face of a crisis is to keep the markets open, control the distortion that could result from the bailout packages, facilitate the departure of inefficient institutions and eliminate artificial barriers to entry.

Given the possibility of a prolonged period of stricter regulation in the financial sector, competition policy should play a more central role, especially if the industry hopes to reclaim its role as a driver of innovation and growth.

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