Financial Services Liberalization, The Regulatory Framework and Financial Stability

Presentation for WTO Workshop on:

Trade in Financial Services and Development

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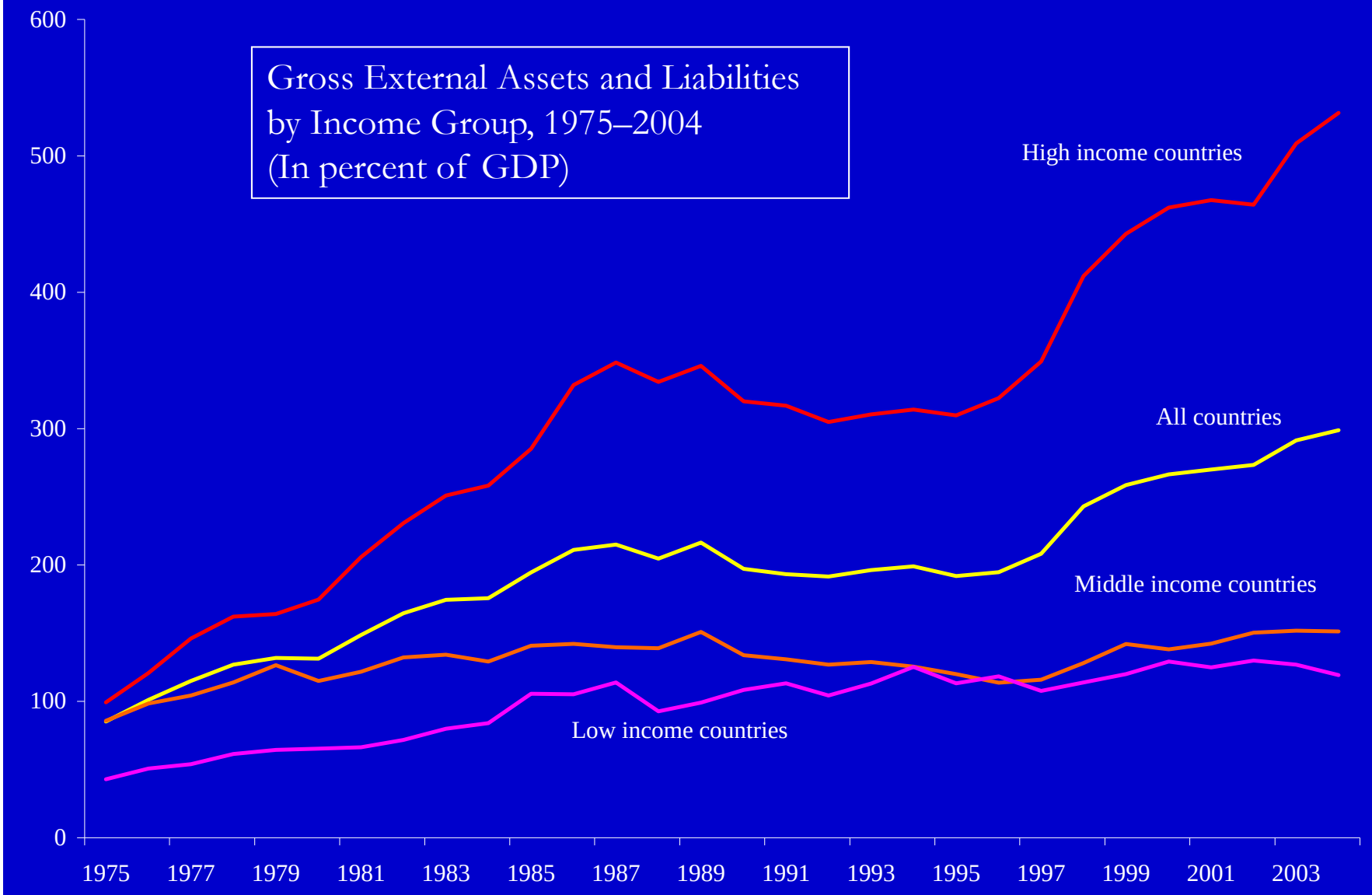
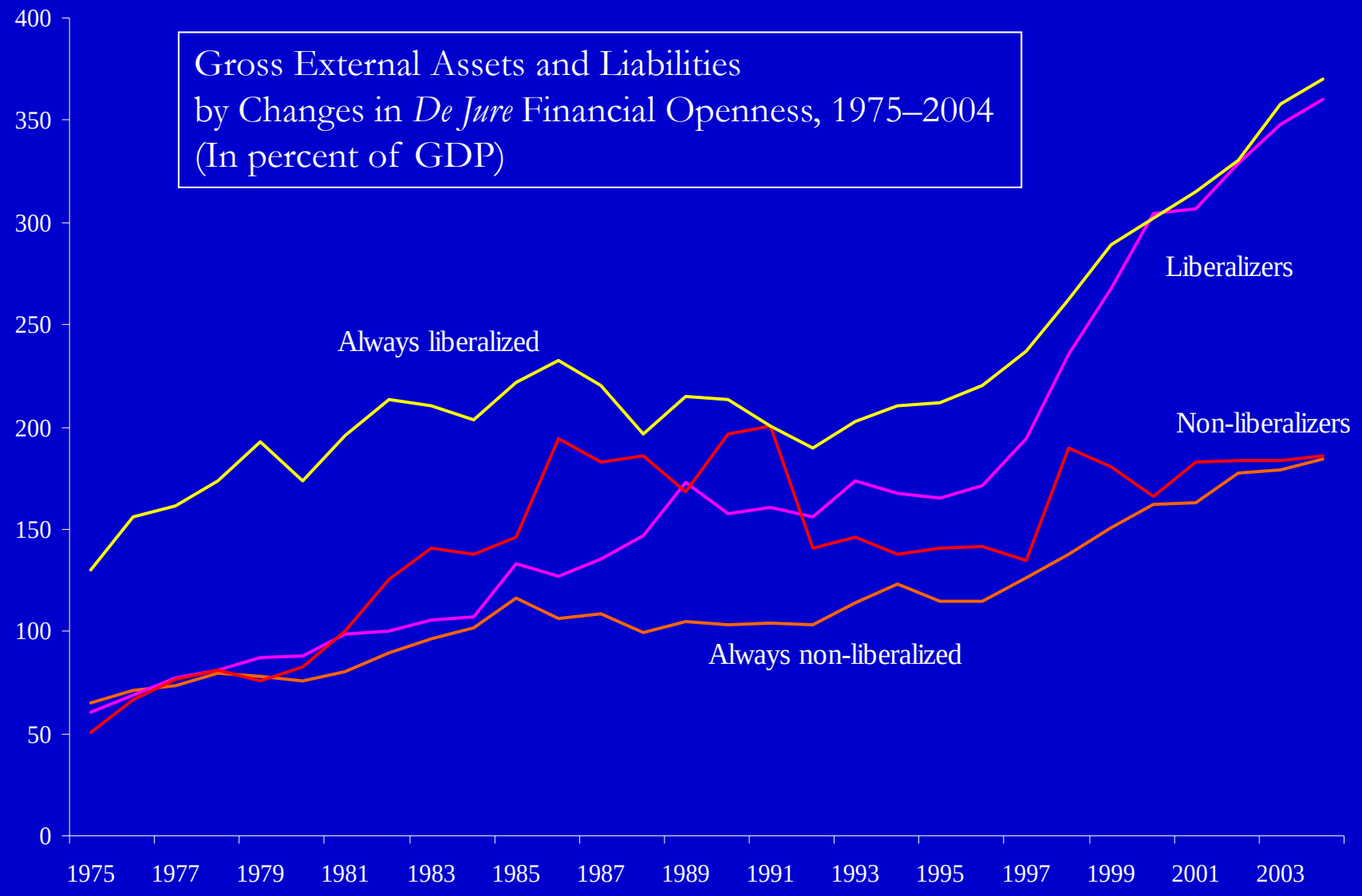
Structure of Presentation

- The Changing World of Financial Services
  - More globalization, increased cross-border finance
  - With benefits but also risks, including financial crises
  - But with much variations by country and other factors
- Implications for Public Policy
  - Revisit competition policy (I)
  - Enhance international architecture, cross-border resolution (II)
  - Role for macro-prudential policies (III)
- Special Issues of/for EMs and DCs (IV)

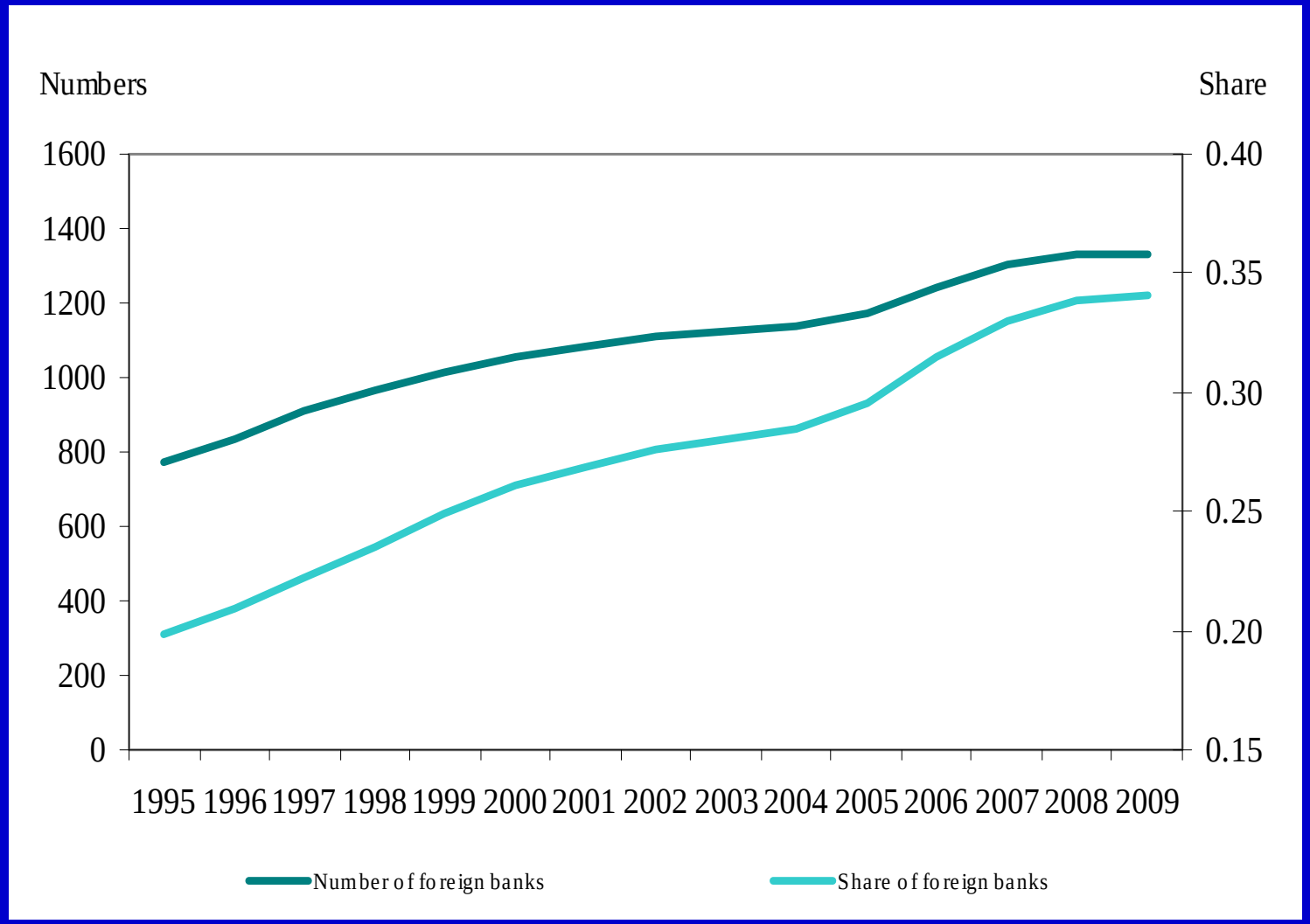
Rising International Financial Flows



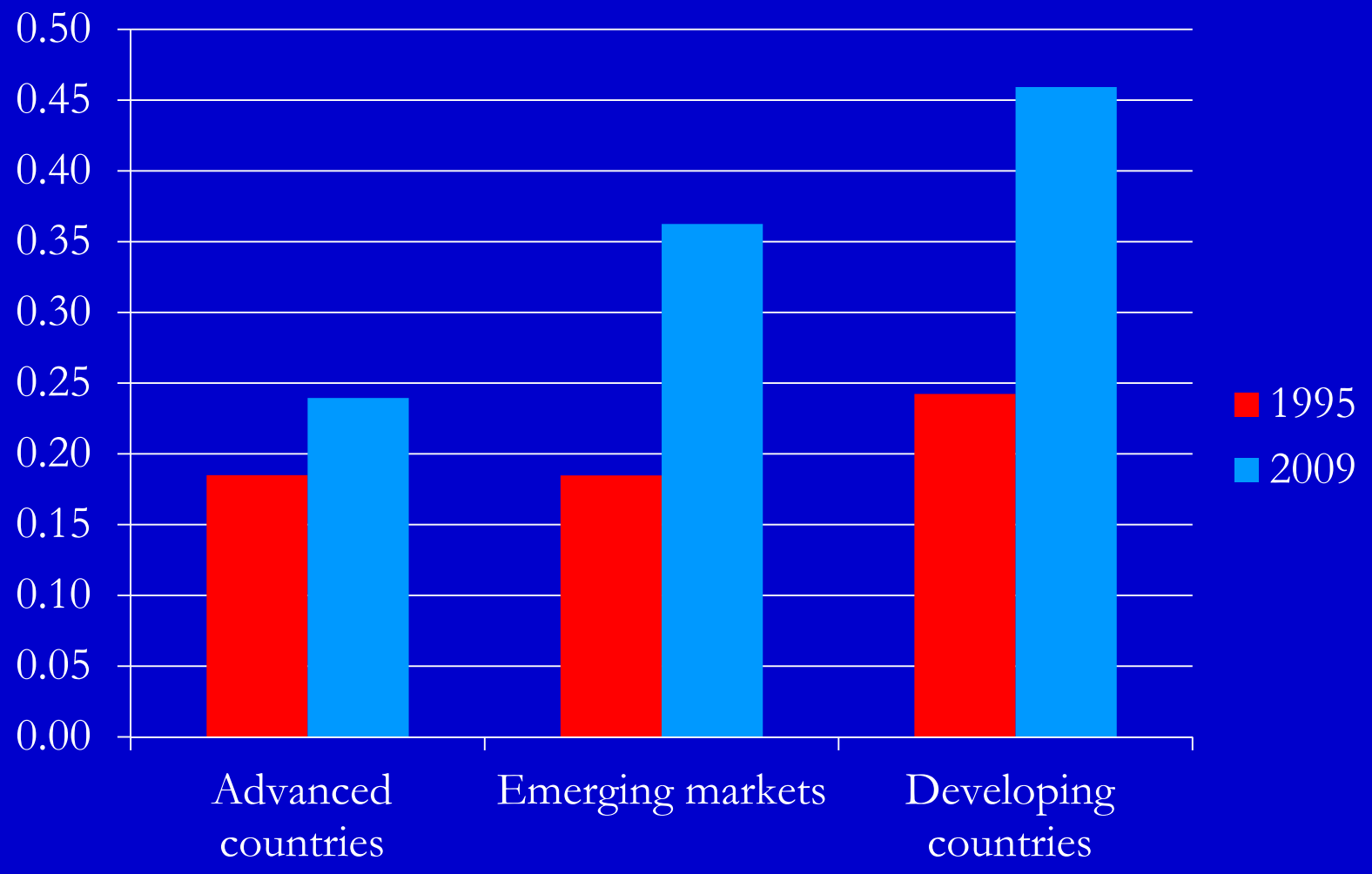
Triggered by Market Forces, but Deregulation Matters too



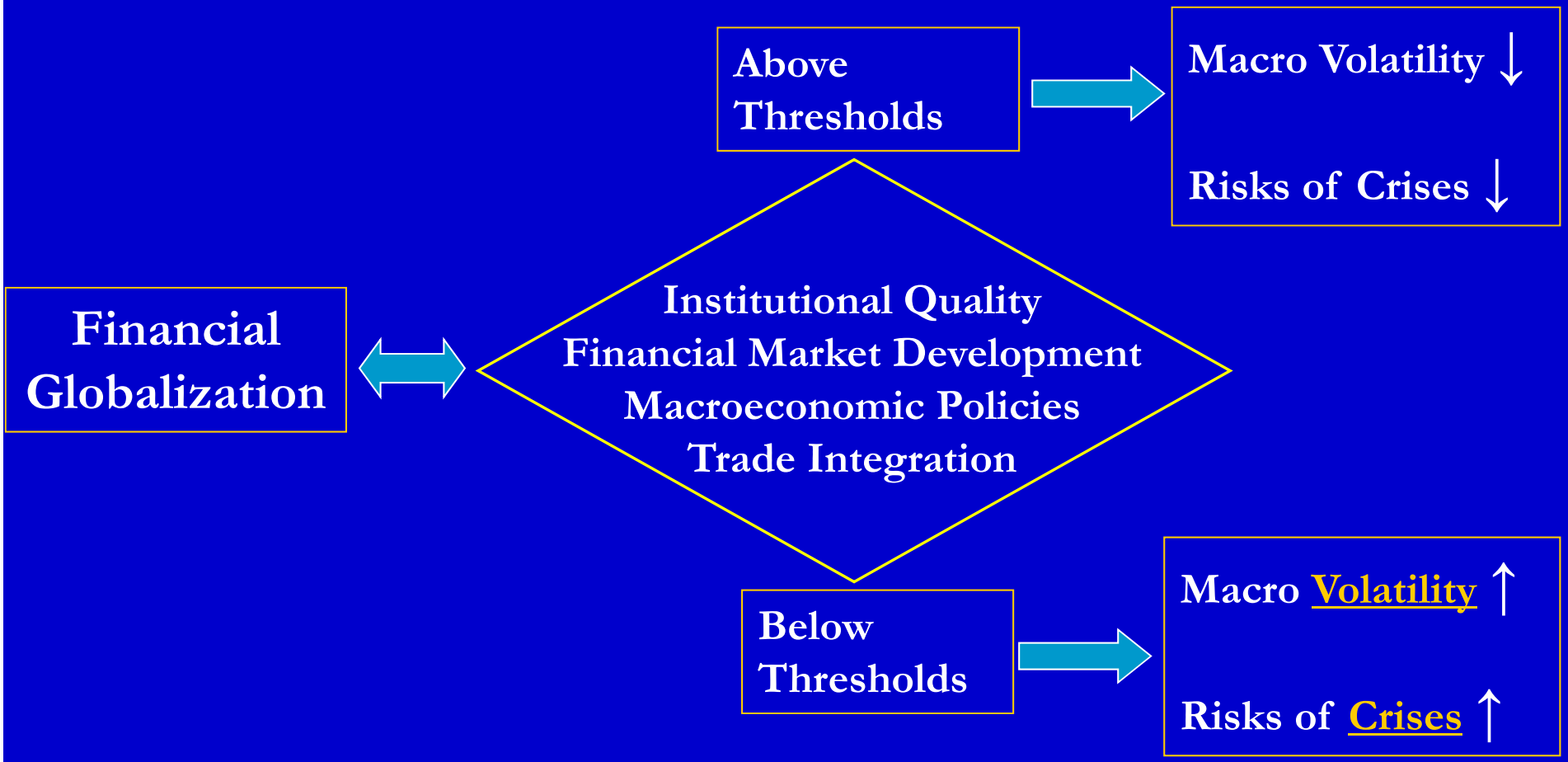
Growing Foreign Bank Activities



Especially in EMs/DCs
Foreign bank shares (numbers)

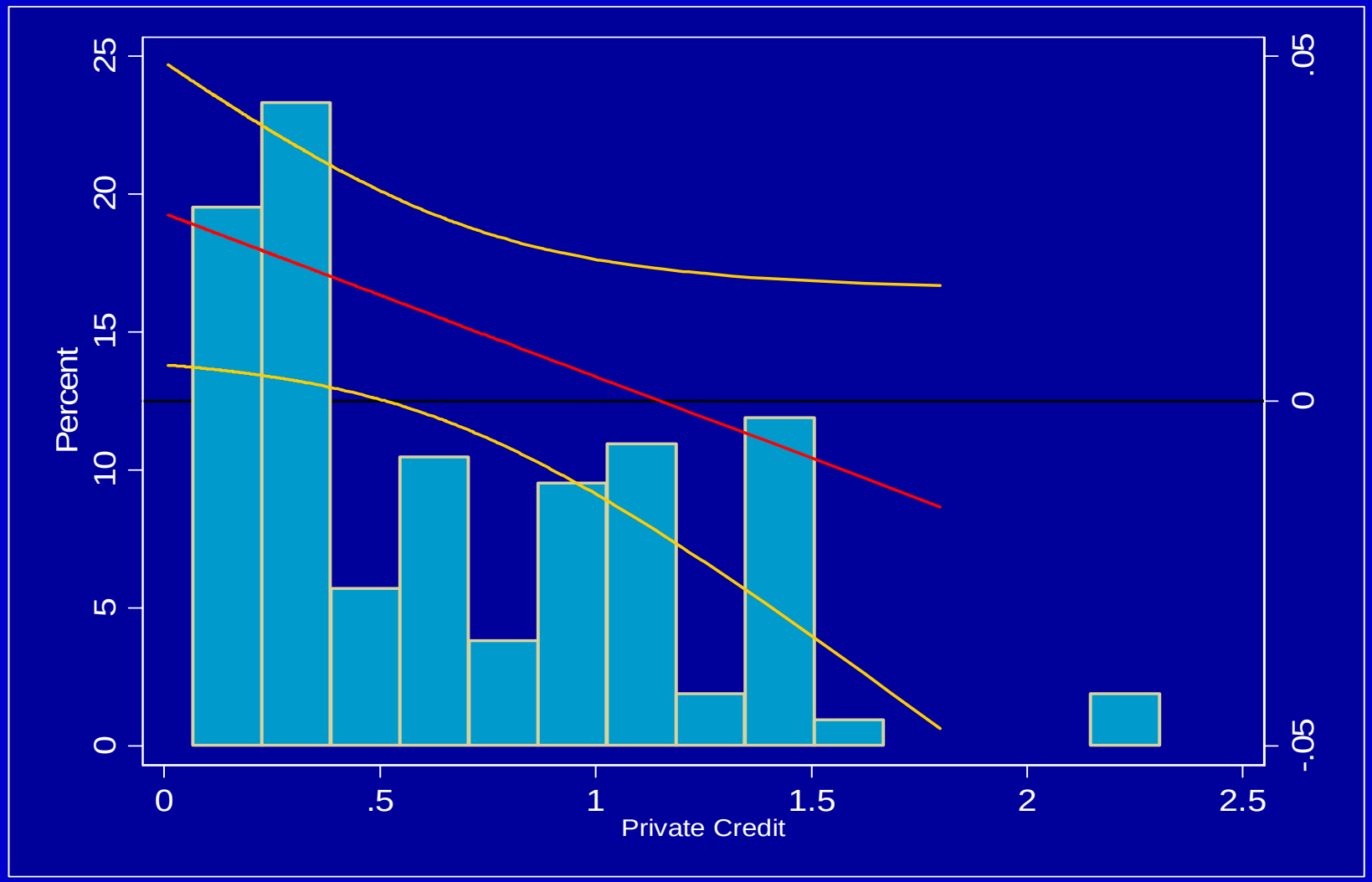


Financial Globalization and Volatility: A Complex Relationship

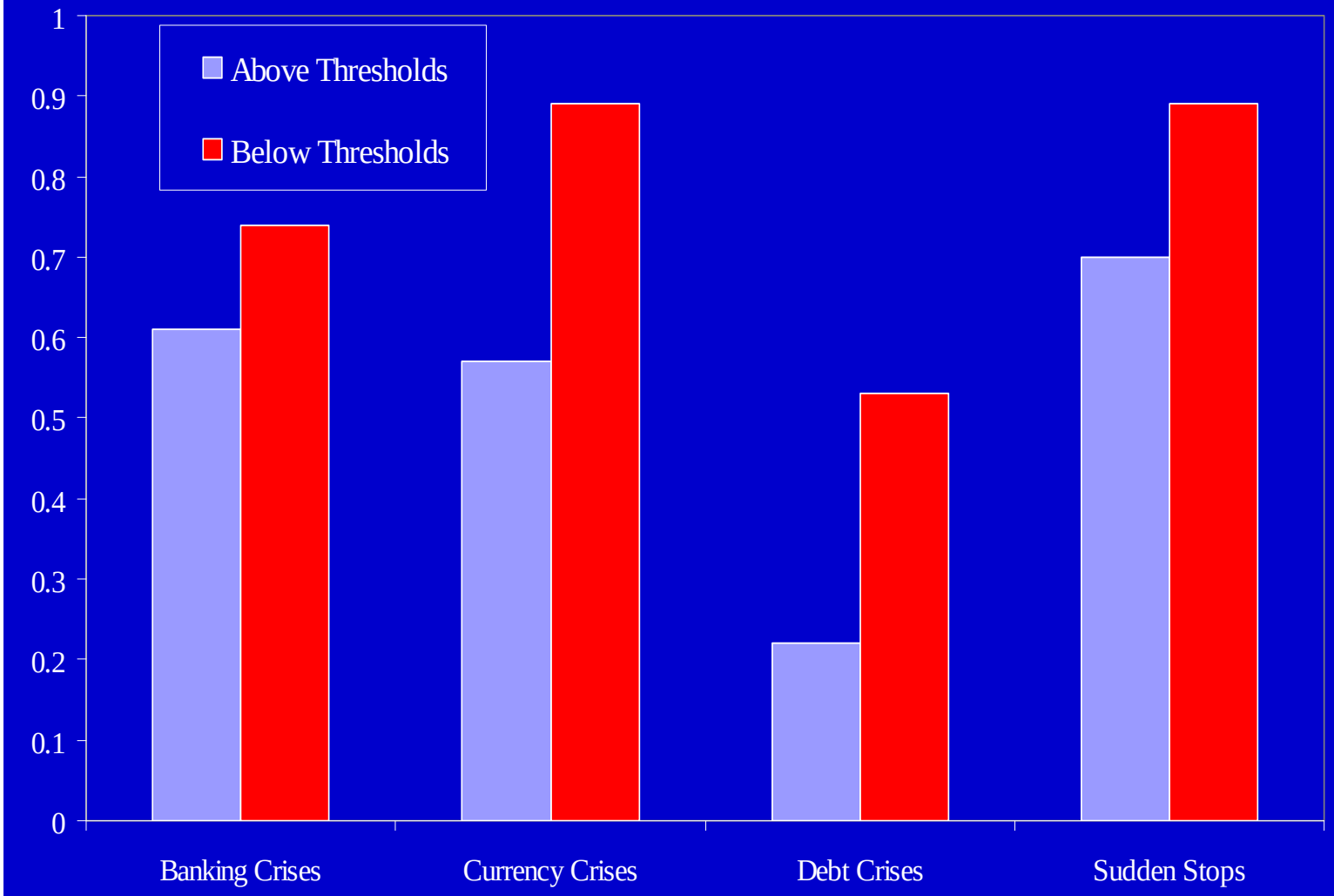


These threshold factors themselves are affected by integration

Financial Globalization and Consumption Volatility



Frequency of Crises in Financially Open Countries: (1970-2004)



Countries above thresholds are above median in at least 3 out of 4 factors.

Evidence on Financial Services Liberalization, Foreign Bank Entry

- Foreign banks differ from domestic banks
  - Different lending profiles, balance sheets, profits
- General positive effects of foreign presence on competition, performance, efficiency
  - But effects vary, e.g., by foreign bank presence
- General favorable effects on financial stability
  - But more mixed in times of stress, and varying

In general benefits outweigh costs

- Foreign banks
  - ✓ Add to domestic competition, lower costs, better quality of financial intermediation, lower rents, accelerate reforms
  - ✓ Increase access, enhance performance of borrowers
- But effects can depend
  - ✓ Lower general development and barriers can hinder
  - ✓ Threshold effect: with limited entry fewer spillovers
  - ✓ Larger foreign banks: greater effects on access for SMEs
  - ✓ Healthier (parent) banks: higher credit growth
  - ✓ Foreign can "cherry pick" borrowers in low-income countries

Mostly positive impact on stability

- ✓ Risk-sharing comes with positive and negative effects
  - ✓ Global banks support subsidiaries when stress in host market
  - ✓ But (funding) shocks to parent banks can transmit to subsidiaries and negative impact their lending
    - ✓ In 2009, foreign reduced lending 6 pp more than domestic
- ➢ Substantial differences though across types/markets
  - ✓ Did not cut compared to internationally-funded domestic
  - ✓ No difference foreign/domestic when foreign dominate
  - ✓ Lower decline when deposit-taking (foreign) bank

Lessons so far and Policy issues

- Heterogeneity crucial. Types of banks and circumstances matter for impact/stability
  - Larger, closer banks, greater share: more stability
    - Consider types, seek "greatest commitment"
  - "Better" countries get more benefits
    - Assure adequate infrastructure, e.g., information
    - Revisit competition policy and agreements (I)
- Still aggregate risks remain
  - Need international/cross-border reform (II)
  - Use macro-prudential policies to reduce risks (III)

(I) Revisit Competition Policy Combine Approaches

- Institutional: assure contestable markets by entry/exit of institutions, domestic, cross-border (all GATS modes)
- Functional: assure contestable markets by leveling playing field across financial products (in all dimensions)
- Production: assure efficiently provided and equally accessible and affordable network services (information, distribution, settlement, clearing, payment, etc.)
- Competition policy approach thus to resemble that in other network industries, e.g., telecommunications, but so far only institutional and somewhat functional

Consider Role of International Agreements and WTO

- Global approaches to competition policy more necessary
  - Current crisis can mean nationalistic pressures, need (to signal) openness, also as politics more pervasive in financial sector
- Prudential carve-out alone may not the be answer
  - Invokes a negative signal (in a crisis) and may not prevent crises
  - Rather seek good (cross-border banking) resolution framework
- Pro-competitiveness principles to accompany agreements
  - Additional commitments on transparency, domestic reforms
  - More general, "single market" type approaches necessary

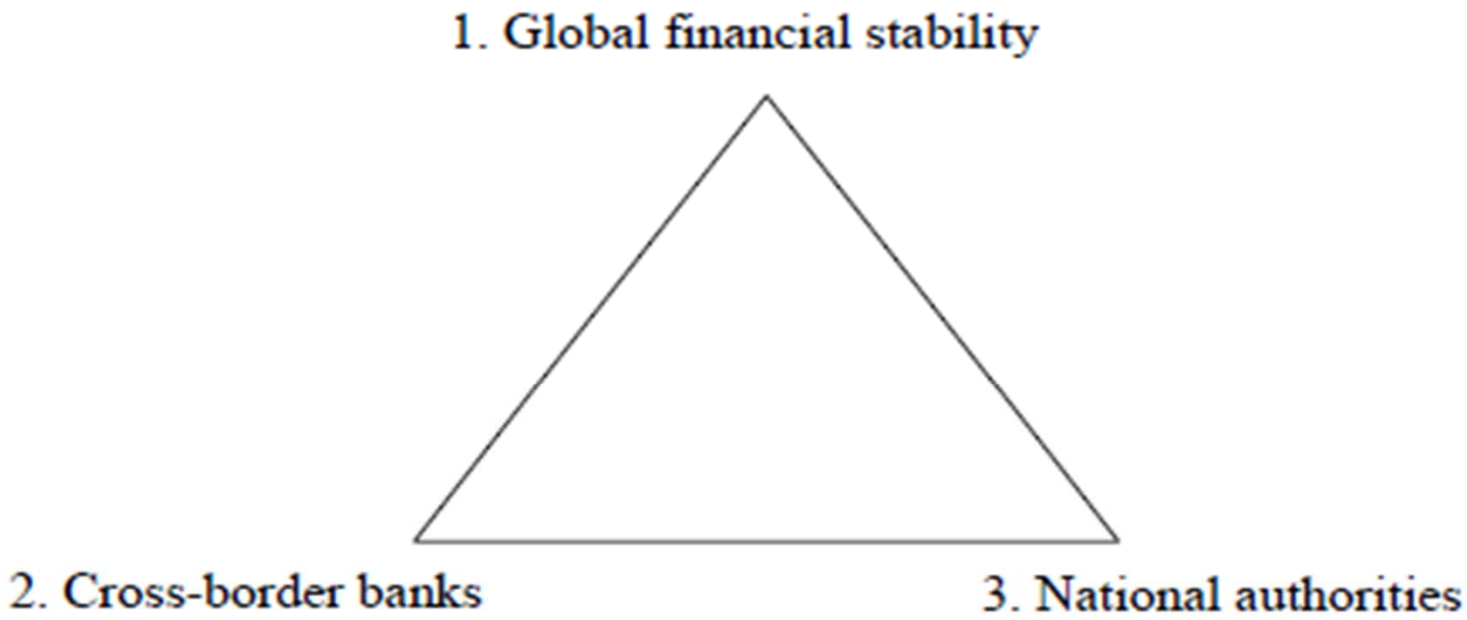
(II) IFA to Better Match State of Globalization

- International financial architecture is behind state of global financial integration
- Example: how to deal with the cross-border impact of failure of SIFIs (and other FIS)?
- Central question to limit spillovers/crises
  - Failure of SIFIs pose national and cross-border externalities, some ignored by national authorities, leading to adverse spillovers
  - Others are addressed ad-hoc, creating poor/perverse responses, and new spillovers

Nationalism: “My country is my castle”

Financial Trilemma: choice to be made

Figure 2.1. The financial trilemma



Two corner, one intermediate approach to trilemma

Two corner approaches

- **Territoriality** (ring-fence activities under one particular domain, undermines open system)
- **Universalism** (equitable distribution of estate, may require burden sharing)

One intermediate approach

- **Modified universalism**

Territorial Approach

- Advantages
  - Fiscal independence, no burden sharing
  - Better incentives for local supervision
- Disadvantages
  - Costs in times of stress (runs, trapped liquidity)
  - No/little concern for global interests/spillovers
  - Less incentives for cross-border supervision
  - Less efficient for financial institutions (sub model)
- Main concern: undermining trends towards open financial systems and political economy risks

Universal Approach

- Universal creates clarity (home authority)
- But does not avoid conflict of interests
  - When sub is systemic in host country
  - When home lacks capacity, resources, willingness
- Still requires burden sharing agreements
- Need to match other aspects
  - SIFI structure, universal best for single entity
  - Liquidity, regulation, supervision, etc.

Universal Approach unlikely soon and unlikely (or wise) global

- Too demanding to expect any time soon
  - Fiscal independence and sovereignty too tested
- Can increase overall burden to share
  - If it leads to free-riding or is too slow
  - Risky governance of world regulator/supervisor
- Yet, some process elements to be introduced
  - Akin to UNCITRAL, WTO, EC DG Competition
  - Sanctions for deviations from certain procedures
  - Not for crisis management (too slow)

Maybe phase in Universal Approach for some group of countries

- Most suited for closely integrated countries
- But cannot be introduced overnight
- A phase-in model: e.g., *(European) Banking Charter*
  - New regime, mainly for cross-border SIFIs
  - Single supervisory authority, with all the tools
  - Including resolution regime/authority
  - Lower compliance costs for FIs plus backup
- Requires <u>good</u> centralized systems though

Can be flexible, enhance regulatory governance, increase cooperation

- Can be flexible and flexibly introduced
  - Differentiate by class of institutions
  - Allow countries to opt in
- Can enhance regulatory governance
  - Distance to political economy increased if managed by one authority (e.g., EBA, ERA)
- Clearer burden sharing enhances cooperation
  - Supervisors to become more incentivized

Can be combined with burden sharing

- Common resolution with burden sharing
  - Ex-ante, perhaps according to a key (GDP, Assets)
  - General or financial institutions' specific
  - Could use existing key (e.g., ECB profits)
- Could be complemented by a (recap) fund
  - Paid in by financial industries and/or governments
  - Multinational, backstopped by governments
- Largely for working capital (in "bridge" phase)
  - And ex-post, potentially, losses

For other countries, pursue the Intermediate Approach

- Less demanding, build on home-host principle
- Already many trends to enhance cooperation
  - Crisis management rules
  - Colleges, financial stability groups
- Steps so far not sufficient, though
  - Focus is still largely on supervision
  - By excluding resolution, do not address incentives
- Especially limited effectiveness in crises

All approaches requires three, complementary pillars

i. Improve the *structure* of SIFIs and enhance ability to *wind down* SIFIs orderly in case of weaknesses
ii. Create greater *convergence* in national rules, including those covering contingent capital, regulatory insolvency triggers and resolution
iii. Negotiate a new *Concordat* focused on crisis management and incentives for collaboration

(III) Use Macro-Prudential Policy

Goal: Financial Stability. Focus: Externalities

- Stability in cross-sectional and time-series view
  - Systemicness of specific institutions
  - Reduce contagion, cross-exposures in turmoil
  - Limit risks in buildup (booms, foreign exchange)
  - Have greater buffers (capitalization, liquidity)
  - Reduce fire-sales and other externalities in bust
- Focus: identify and correct market failures
  - What drives systemic risk? What are externalities? Common risks, such as FX, real estate? Counterpart defaults, credit crunch, or fire sales? Liquidity in times of stress? Cycle itself?

Macro-Prudential: Tools and 'Experiments'

- Tools
  - Banks: liquidity requirements on A/L, surcharges, dynamic provisioning, capital requirements,…
  - Capital markets: margins, haircuts, limit, CCPs
  - Real estate and other: LTVs/DTIs, speed limits
  - Economy: capital controls, taxes, limits,..
- Most 'experiments' in EMs, particularly Asia
  - Discretionary rather than rule-based
  - Aimed as both dis-incentives and buffers

Macro-Prudential Lessons: Promising, but with Caveats

- Some scope for macro-prudential policy
  - Pragmatic and discretionary within existing frameworks, targeted at specific markets/objectives
  - Ensure resilience + avoid boom-bust mutual reinforcing
  - Consider specifically balance sheets/FX-related risks
- Be wary though on effectiveness
  - Some temporary cooling effect and building some buffers
  - But not always sustained and seldom sufficient for bust
  - Rarely explicitly targeted at externalities/market failures
  - Don't know side effects of macro prudential

(IV) Issues for/of EMs and DCs

- Finance in EMs/DCs undergoing similar changes
  - Cross-border entry, consolidation, integration, adoption of best practice approaches occurring quickly
  - (More) rapid migration to new services, to/from abroad
- Generally benefit from liberalization
  - Financial services liberalization, domestic deregulation capital account liberalization can reinforce each other
  - But require consistency and coherence between three
  - Uneven preconditions (regulation and supervision, laws, information, etc.) can limit full benefits

Special Issues in EMs and DCs

- Institutional weaknesses more severe
  - Weaknesses can contribute to financial crises, especially when financially integrating; but also deeper causes (political economy, moral hazard, low pay of supervisors)
- Limits to what regulation/supervision can achieve
  - Governments maybe poor regulators, e.g., more power does more harm if checks and balances are missing
  - Causes of crises are shifting, contagion, tools may fail
  - No fixed, a-priori pre-conditions for success
- May benefit more from commit to pro-competition
  - Credibility more at a premium, competition policy/authorities weaker, more often at conflict with prudential authorities, political economy more adverse

Current State of EMs/DCs' Financial Systems: Helps to a Degree

- Generally higher, better capital, less leverage
- Different concerns about liquidity risks
  - Other deposit and local funding structures
- Lower public debts, more state-owned banks
  - Gives some headroom, flexibility in intermediation
- Sometimes better rules for bank resolution
  - With less emphasis on deleveraging
- More used to macro-prudential approaches
  - Some time-varying rules, general pragmatic approach

Need to Consider Special Circumstances and Risks

- Generally simpler financial systems with more basic forms of financial intermediation, lesser developed capital markets, with narrower investors base
- Notably greater financial and other imperfections, e.g., less hedging tools, lower legal/enforcement
- Market discipline of financial institutions may not work as well, TBFT and state-ownership
- Less adequate disclosure, transparency and inside corporate governance of firms
- Need to consider foreign exchange/capital flows risks

But Risks Become More Like ACs' and Still Need to Adapt

- Financial cycles have become more similar
  - Now also concerns about domestic credit booms
- Exposures, shocks, institutional environment, policies and head-room still differ
  - Notably twists: capital flows, euro/dollarization
- So need to adapt policies and tools
  - Likely more basic tools and approaches
  - Macro-prudential policies, e.g., to include more foreign exchange risk, capital flows management

General Observations

- Financial services liberalization and stability
  - Country factors and type of banks matter
  - Emphasis on needed institutional infrastructure
- Better international architecture, cross-border
- Scope for macro-prudential policy
  - Pragmatic/discretionary, targeted at FX/balance sheets risks, help ensure resilience and reduce boom-bust cycles
  - Tailored to country circumstances
- But: globalization comes with benefits and risks