Financial Services Liberalization, The Regulatory Framework and Financial Stability

Presentation for WTO Workshop on: Trade in Financial Services and Development
26 June, 2012 Geneva
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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

(In percent of GDP)
Triggered by Market Forces, but Deregulation Matters too

(In percent of GDP)
Growing Foreign Bank Activities

Number of foreign banks

Share of foreign banks
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 be the 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

1. Global financial stability

2. Cross-border banks

3. National authorities
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., \textit{(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 \textit{good} 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
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

Macro-Prudential Lessons: Promising, but with Caveats
(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