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Finance and Regulation

Working paper summary

Regulation, competition and banking markets

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Key Concepts/Themes

competition; bank funding; bailouts; wholesale; GFC; debt guarantee; depositors; borrowers; insolvency; cost of capital; free money; capital structure; risk; levy; entry requirement

The onset of the global financial crisis (GFC) in 2008 prompted a funding cost shock to the Australian banking system.

The shock motivated this study, which looks at how an external financial crisis can increase bank funding costs in countries that rely heavily on global wholesale capital markets. Australia is one such country.

The study presents a model to show how an untoward rise in the cost of wholesale funding can trigger a crisis in an otherwise healthy banking sector.

The study also examines a range of government policies, such as 'bailouts', that may be deployed to prevent such a crisis. Moreover, there is a specific focus on the implications of such policies for the structure of the banking sector, and on the level of competition as reflected in the respective rates paid and received by borrowers and depositors in 'normal times'.

Significantly, the policy measures introduced in Australia in the wake of the GFC are found to have had varying success.

A debt guarantee may temporarily allay fears of a bank failure and so prevent a run on the banks. However, an excessive and extended reliance on artificially cheap debt may eventually distort the banks' capital structures and magnify potential losses when funding cost initiatives go awry.

The study's results are relevant to the issues being considered by the Financial System Inquiry, chaired by Mr David Murray AO.

The findings are also timely for the Federal Government, and key financial regulators such as the Australian Prudential Regulation Authority (APRA) and the Reserve Bank of Australia (RBA), in the context of the design of longer-term policies for dealing with potential insolvencies in the financial sector.

The study starts from the assumption that banks will choose to minimise the cost of their capital structures, even though that may involve the possibility of insolvency.

However, from a government perspective, a scenario of bank insolvency is unconscionable due to the associated social consequences.

In a direct policy response to the GFC, the Federal Government implicitly guaranteed the commercial banks through deposit and wholesale guarantees. The study finds this policy has prompted a broader expectation among bankers that government aid will automatically be forthcoming if ever and whenever anything goes wrong.

However, by receiving what is essentially 'free money,' bankers become motivated to place an undue emphasis on debt in their funding mix. The notion of receiving free money may be compared to receiving free insurance. The more debt you take on, the more free insurance the government provides. This applies in normal times and during a crisis.

In terms of its broader industry impact, a policy of 'free money' is conducive to a proliferation of banks. The prospect of the government providing banks with assistance to increase profitability encourages new entrants.

This appears beneficial for competition as the pricing interests of both depositors and borrowers are catered for, and new entrants are encouraged into the banking system.

However, there is an efficiency cost at play because the extra competition is driven by an inefficient capital structure. Therefore, from a broader social perspective the provision of 'free money' is in fact costly and therefore undesirable.

Aside from competition considerations, the study addresses two further consequences of a 'free money' bailout policy. Firstly, if the depth of a banking crisis is measured according to the degree of insolvency of banks, then a bailout policy in fact deepens a crisis. Because banks have an incentive to carry more debt, any cash flow problems they encounter require correspondingly larger bailouts. Secondly, and aligned to this, the presence of a bailout safety net encourages banks to pursue more aggressive capital structuring policies. This results in an increased risk of insolvency, as opposed to the reduced level of risk that policymakers intended.

The study also examines several variations of an ad-hoc bailout policy response to a financial crisis.

One possible variation is the imposition of a levy on banks during good times to raise funds for any potential bailout during bad times. If the levy does not take account of the specific debt mix employed then aggressive capital structuring policies remain the likely result. This is because the levy is fixed but the amount of any bailout payment remains variable. Such an outcome represents an inefficient structuring of capital and, like any other inefficiency, there is an associated cost. In this case, the price is reduced competition. This is because the levy creates a potential entry barrier to new participants. Typically, when new entrants are excluded there is an interest rate pricing impost on borrowers and depositors alike.

Alternatively, a minimum equity requirement may prevent a funding crisis. At first glance, this policy appears superior to an ad-hoc bailout, which can actually encourage a crisis. However, a minimum equity requirement is not cost free because it too results in an inefficient funding mix. Similarly, there is a resultant barrier to entry with associated interest rate cost implications.

Another policy variation is a licensing regime that restricts the number of banks. However, the associated limit on competition has a cost impact for both borrowers and lenders in the absence of a crisis. Restricting the number of competing banks can be effective in preventing the importation of a crisis, but only when banks do not pay for a license. In this case, a 'free license' regime may be regarded as an *ex ante* taxpayer bailout. In contrast, requiring banks to pay for a licence may be uncompetitive as the cost may represent a barrier to entry. Moreover, the effects in terms of reducing the likelihood of a banking crisis appear ambiguous.

In terms of next steps, the study focus moves to smaller financial institutions. Although modelling is not yet available, it appears that small intermediaries act as automatic stabilisers in the system. They add to

competition in good times, but if they are allowed to fail during bad times there is a corresponding reduction of overall competition.