

GLOBAL FINANCIAL DEVELOPMENT REPORT 2013

Rethinking the Role of the State in Finance

September 24, 2012



THE WORLD BANK

Motivation: *Financial Development Barometer*

Views split on important aspects of the state's role ...	Agree?
"In view of the global financial crisis, more stringent financial sector regulation and supervision is needed."	49 %
"In view of the global financial crisis, there is a need for broadening the scope of financial sector regulation and supervision."	54 %
"More financial sector competition would help financial stability in my home country."	58 %
"State-owned financial institutions played an effective counter-cyclical role during the recent global financial crisis."	48 %
"Government-backed credit guarantee schemes do play an important role in promoting financial stability."	64 %
"The development of collateral registries can be left, fully or mostly, to the private sector."	42 %

Source: Financial Development Barometer 2011 (www.worldbank.org/financialdevelopment). The *Barometer* is an informal global poll of officials and financial sector experts from 78 countries (30 percent advanced economies, 70 percent emerging markets and developing countries). The response rate was 65 percent. Results are percentages of total responses received.

What did the crisis teach us about financial sector policies?

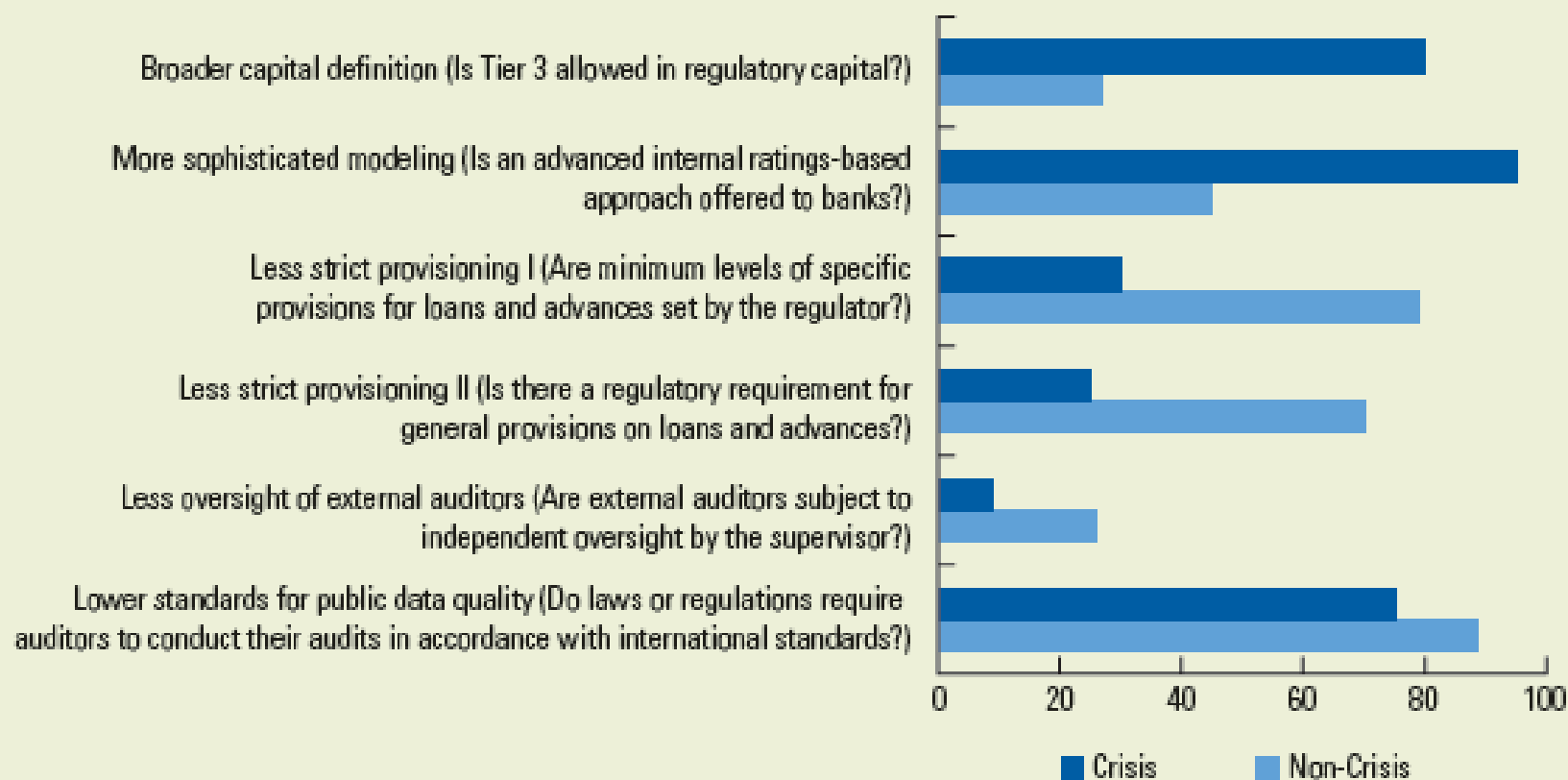
- Four years after Lehman failure is a good time to stop and take stock
- This first report focuses on the role of the state in financial sector and re-examines its role in regulation and supervision, in competition policy, as owner and guarantor, and in promoting financial infrastructure
- What did we know? What did we learn from this crisis?
- More than just a report: provides a major database, helps benchmark financial sectors around the world
 - *depth* of financial institutions and markets, as well as their *efficiency, access, and stability*
 - developments leading up to and since the crisis



State as regulator and supervisor

- **Area where role of state undisputed**
- **Crisis: major shortcomings in market discipline and R&S**
- **How to best ensure that R&S supports sound financial development?**
 - Important trade-offs (too much/too little R&S)
 - Calls for not “more”, but for “right” type of regulation
- **New WB survey of R&S in ~135 countries allows us to investigate two issues and shed new light:**
 - How does R&S and market discipline compare in crisis-hit countries relative to the rest?
 - How did R&S and market discipline change since the crisis?

State as regulator and supervisor: new WB survey



Source: Čihák, Demirgüç-Kunt, Martínez Pería, and Møhnseni 2012.

Note: Percentage of countries that responded "yes" to the question in parentheses. Based on the World Bank's 2011 Bank Regulation and Supervision Survey. "Crisis" countries are defined as those that had a banking crisis between 2007 and 2011, as identified in Laeven and Valencia (2012).

Main findings from the survey ...

- **Crisis hit countries had weaker regulation and supervision practices...**
(e.g., less stringent definitions of capital and provisioning requirements, reliance on banks' own risk assessment)
- **... and less scope for market incentives**
(e.g., generous deposit protection coverage, lower quality of published financial information)
- **After crisis, countries stepped up efforts on macroprudential policy, crisis resolution, and consumer protection**
- **However, unclear whether incentives for market discipline improved**
- **Survey suggests scope for improving disclosures and monitoring incentives**

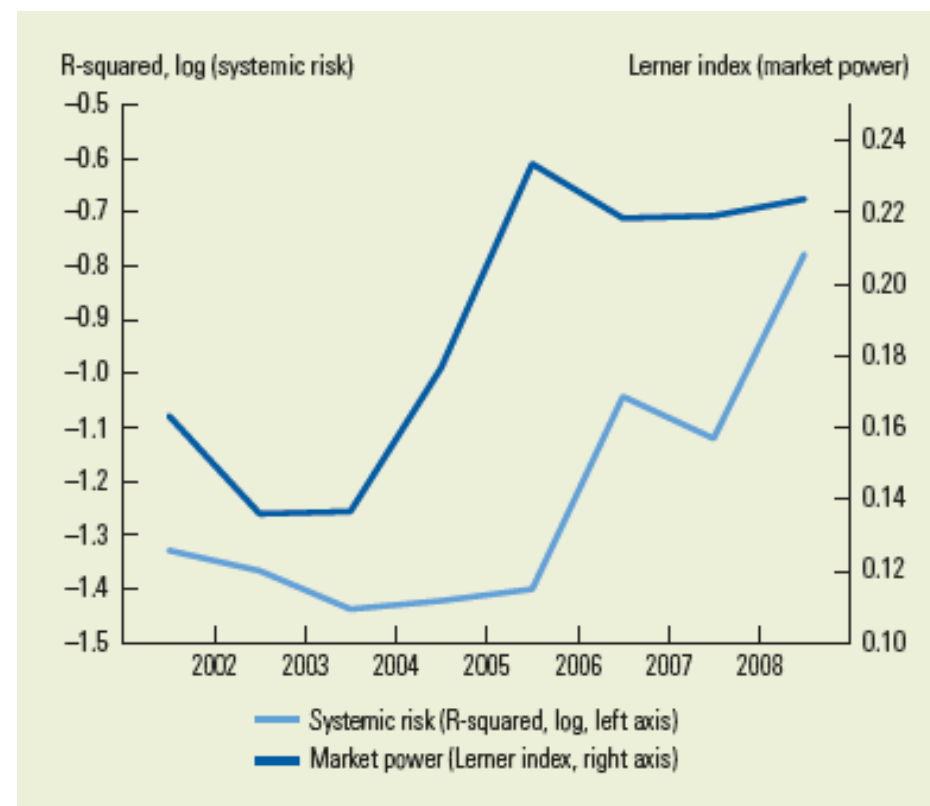
State as regulator and supervisor

- **The report acknowledges progress on global regulatory reforms**
- **Broad agreement: important to address “basics” first**
 - Coherent institutional and legal frameworks that enable market discipline complemented with strong and timely supervisory action
 - Many developing countries: supervisory capacity = top priority
- **Lessons from the crisis**
 - Renewed focus on systemic risk
 - Greater attention to incentives in design of regulation and supervision
- **Ongoing discussion – reform proposals calling for greater emphasis on:**
 - Simplicity, transparency
 - Incentive-robust regulations ...“incentive audits”
- **Positive development: greater debate (regulators, policymakers, academics)**



Role of state in promoting competition

- Was too much competition the reason for the crisis?
- Competition leads to improved efficiency across banks and enhances access to financial services while not necessarily eroding systemic financial stability.
- Addressing causes of the crisis requires regulatory framework that aligns private incentives and public interest (rather than restricting competition)
- Role for the state: Market contestability (healthy entry and exit) and availability of credit information and contract enforcement are important to promote healthy competition.
- Governments should eliminate distortions in risk-taking (e.g., too-big-to fail subsidies) to limit their negative consequences on bank competition.



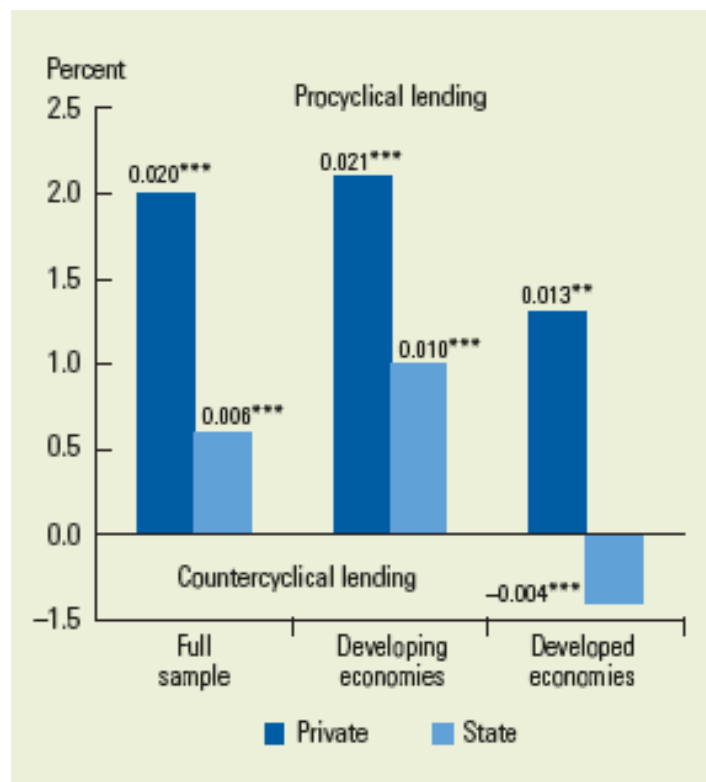
Source: Calculations based on Anginer, Demirgüç-Kunt, and Zhu 2012.

Note: The systemic risk measure follows Anginer and Demirgüç-Kunt (2001) and builds on Merton's (1974) contingent claim pricing. Systemic risk is defined as the correlation in the risk-taking behavior of banks and is captured by the R-squared from a regression of a bank's weekly change in distance to default on country average weekly change in distance to default (excluding the bank itself). Higher R-squared means higher systemic risk. Lerner index is a proxy for profits that accrue to a bank as a result of its pricing power, so higher values mean less competition. The calculations cover 1,872 publicly traded banks in 63 economies (developed and developing).

Direct state interventions

- **Crisis re-ignited the debate on the role of state owned banks**
- **Is the counter-cyclical role of state-owned banks in offsetting credit contractions justification enough?**
 - Pros: additional tool for crisis management in the short term
 - Cons: misallocation and efficiency losses due to politically-motivated lending
- **Array of strategies to restart the financial and real sectors**
 - Lending to private sector by state-owned banks
 - Commercial banks: Banco de Estado (Chile), PKO Bank Polski (Poland)
 - Development banks: BNDES (Brazil), China Development Bank
 - Credit guarantees
 - Mexico
 - Unconventional monetary policies
 - QE and credit policies by central banks (advanced economies)

Direct state interventions



Source: Bertay, Demirgüç-Kunt, and Huizinga 2012.

Note: The figure shows marginal effects from a regression of bank lending on GDP per capita growth and a number of control variables, estimated using a sample of 1,633 banks from 111 countries for the period 1999–2010.

Significance level: ** 5 percent, *** 1 percent.

- **New evidence**

- State-owned bank lending tends to be less pro-cyclical, and in some countries banks played a short-run counter-cyclical role (ECA vs. LAC); but loans were not directed to the most constrained borrowers and lending growth by state continued even after recovery...

- **Trade-offs**

- Governments need to consider benefits of counter-cyclical lending vs. long-term costs on credit allocation; but past evidence on the long run effects question the wisdom of such policies

- **Need to address inefficiencies of state-owned banks**

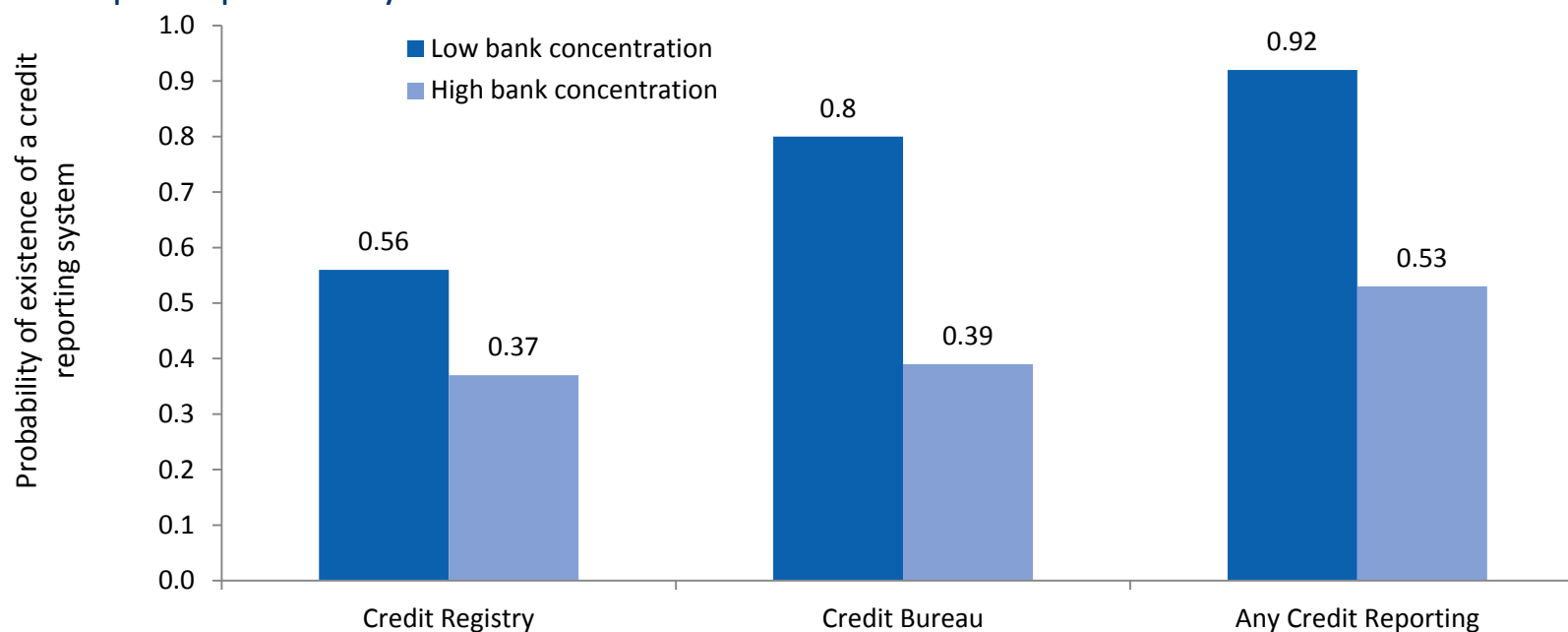
- Clear and sustainable mandate
- Adequate risk management systems
- Sound corporate governance

- **But good governance practices are challenging to implement in weak institutional environments!**

Credit information sharing: some new results

Important role of the state

- promote participation, ensure access and transparency
- particularly in concentrated environments; private information sharing is less likely to emerge when banking systems are concentrated; state also has a role in increasing participation beyond banks to non-banks



Note: The figure shows the percentage of countries with private (credit bureau), public (credit registry) or any credit reporting institutions for countries with high and low bank concentration (above and below the sample mean), respectively. It shows that bank concentration (the asset share of a country's three largest banks) is negatively associated with development of credit reporting.

Source: Based on Bruhn, Farazi, and Kanz (2012).

Main messages

- **Needed: balance among the state's roles**
 - Promoter / owner and guarantor / regulator and supervisor / overseer
 - Right balance depends on a number of factors, including the level of development and the government's capacity.
 - Leads to trade-offs
- **Direct interventions during the crisis:**
 - Evidence that some worked ... partly, in the short run....
 - ... but also robust evidence on potential longer-term harmful effects
- **... as crisis subsides, need for rebalancing towards less direct involvement**
- **Overarching theme: role of incentives in finance**
 - the challenge for the state's involvement is to better align private incentives with public interest without taxing or subsidizing private risk-taking