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Shaping of Conditions for Raising the Level of Competition and Market Discipline in the Russian Banking Sector

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ABSTRACT

The article reviews the main aspects of the impact of the state and legal instruments of banking business regulation on raising the level of competition and market discipline in the Russian banking sector. The basic concept of the state policy aimed at improving the competitiveness of the banking sector was defined; the basic results of changes in the level of competition both for the banking sector in general and for the stability of a particular banking institution were defined. The experience of foreign countries in shaping of the competitive and supervisory relationships in the banking sector was reviewed. Certain elements of this policy that should be adapted to the respective national practices were identified. International subjects of legal regulation of market discipline in the banking business, including Basel Committee on Banking Supervision, were reviewed. The characteristics of the regulatory requirements of the Basel Accords and peculiarities of their introduction into the banking sector were given. Recommendations on introduction of foreign experience in raising the level of competition and market discipline in the Russian banking sector were formulated.

Keywords: Competition, Merger, Acquisition, Banking Sector, Legal Instruments of Regulation
JEL Classifications: G21, G28, O21

1. INTRODUCTION

A banking system that generates various cash flows able to ensure economic growth plays an important role in the harmonization of reproductive economic processes of the society. A reliable and efficient valid banking system is one of the most important prerequisites for the development of the Russian economy.

Shaping of the conditions for raising the competitiveness of the banking sector is an essential task of the state policy, the implementation of which has impact on the development of the financial and real sectors of the Russian economy. Competition, through regulation of which the target parameters of the banking concentration are achieved, plays an important role in ensuring the appropriate conditions. In this regard, the need in definition of the basic principles of the state policy aimed at maintaining the competitiveness of the banking sector becomes relevant. In the meantime, the regulation and supervision of compliance with market discipline in the banking sector remain no less relevant; the functions of the government control become particularly important, which should play a major role in ensuring the stable functioning of banks and their performance of important public functions.

First of all, there is a need in a scientific rationale for the use of various instruments of banking business regulation to ensure its sustainable development, raise the level of competition and market discipline in the context of financial turmoil and the crisis in the global economy, as improper performance by the banking system of its functions and underestimation of its role carry the threat of the increased socio-economic risk.

The goal of the article is to establish the role and importance of instruments of banking business regulation and their impact on raising the level of competition and market discipline in the Russian banking sector.

2. METHODS

Macmillan dictionary of modern economics states that "instruments are figures that are supposed to be under the control of an agent who makes decisions (e.g., government) and gain values or corresponding to the relevant policy objectives or those that optimize the welfare or loss function" (Macmillan Dictionary of Modern Economics, 2003. p. 202).

To determine the regulatory environment of the banking sector in the context of ensuring the competitiveness of the banking sector, it is important to proceed from the following considerations. Firstly, raising competition in the banking sector increases the volume of risk undertaken by the banks. Competition reduces the banks' margin, prompting them to conduct riskier transactions and making them vulnerable to negative manifestations on the market (Repullo, 2004). Another negative consequence of the increased competition is the banks' attempt to focus on maintaining the market share without paying enough attention to the analysis of the borrower's ability to repay the loan (Dell'Ariccia and Marquez, 2006). On the other hand, the positive effects of competition for the economy occur in the banking sector due to reduction in the average interest rate, easing the borrower's debt burden and reducing the default risk (Boyd and De Nicoló, 2005).

Secondly, excessive competition may significantly reduce the stability of the banking system (empirical research shows that competition is measured through the margin or concentration of banks, while the stability is evaluated through the quality of debt and reliability of bank failures) (Dick, 2006). There is strong evidence that excessive competition undermined the quality of loan portfolios during the financial crisis of 2008-2009 (Dell'Ariccia et al., 2012).

Thirdly, lack of competition may also undermine the stability of the bank. This effect arises from the disproportion of the development of large banks. Large banks become more diversified, and this allows them to increase the risks of their portfolios (Boyd et al., 2006). In addition, large banks become hostage to the internal inefficiency and higher operational risks (Laeven and Levine, 2007). There is a problem of very large or systemically important banks.

At the same time, theoretical models and practical results do not give a clear answer to the relationship between competition, assumed risk and stability. However, it can be concluded that the optimum level of the banking competition is average, i.e., at which there are no barriers to new players' access on the market on the one hand and no uncontrolled banking competition on the other hand.

Fourthly, the issue of the extent of possible use of active state intervention in the competition policy in the banking sector remains undetermined.

3. RESULTS

The recent financial crisis has exacerbated the need to reconsider the role of competition policy and antitrust authorities on the financial market. The need for effective use of antitrust rules and competition approaches in the process of consolidation and nationalization in the banking sector requires the improvement of such rules and relevant institutions.

Despite the fact that mergers and acquisitions in the US financial sector are subject to government control, the criteria for such control are more lenient than those for non-financial companies. The value of the Herfindahl index for the banking sector in mergers and acquisitions where the state does not interfere in the agreement is usually higher than in other sectors of the economy. Besides, mergers and acquisitions are analyzed by relevant regulators (The US Federation, The Federal Deposit Insurance Corporation, The Office of The Comptroller of the Currency of the US Treasury). Such agreements are also reviewed by the US Department of Justice that can appeal the decision of the regulators.

The competition policy in the European Union (EU) banking sector has been considerably strengthened at the national level, but a lot of barriers have been eliminated over the past decade. For example, since 2005, the competition policy in Italy's banking sector has been implemented not by the National Bank of Italy but by the competition agency that deals with competition in all other sectors of the economy. In the Netherlands, the competition Act 1998 applies to the banking sector just as to ordinary companies from the non-financial sector. In Portugal, the antitrust authorities consider mergers and acquisitions in the banking sector along with other sectors. In France, the practice of application of general antitrust regulation to the banking sector appeared after the 2003 Supreme Court decision on the merger of credit Agricole and credit Lyonnais.

However, there are still some features of regulation of the banking sector in comparison with the non-financial sector through the interdependence of financial stability and competition policy in the banking sector. According to Article 21 (3) of the European regulatory rules on mergers, the EU member states have the right for anti-competitive behavior if the stability of the functioning of the entire financial system is at risk. Thus, the policy of promoting competition dominates the EU policy, except for crisis situations where the stability of the system comes to the fore.

In Canada, the exception of the merger of financial institutions from the control of the antitrust authorities is possible if the Ministry of Finance believes that such an agreement would be beneficial for the entire financial system. In the Netherlands, the decision of the Minister of Economy will prevail over the decision of the special competition authorities if it is in conflict with the supervisory authorities (i.e., stability is more important than competition). In Switzerland, the supervisory authority may approve the merger of banks instead of the antitrust authority if it is necessary for the protection of lenders' rights.

Fifthly, the creation of a new banking system is based on the need to improve banking supervision and regulation.

At the international level, one of the main subjects of banking supervision and regulation of the banking activities are the Basel Committee on Banking Supervision and the International Accounting Standards Committee.

Signed in 1988, the first Basel accord defined the bank's capital adequacy standard at the level of 8%, which was called the cook ratio. This requirement significantly increased the financial stability of banks and became a factor of economic growth. However, the Basel Committee in 1996 has developed new requirements for the management of banking risks and allowed banks to apply their own risk assessment methods.

New Basel Accord "Basel II" was adopted in 2004 in order to ensure consistency between the minimum capital requirements and the new banking risks. Basel II is structured in three components:

1. Updating the minimum requirements for banks' own capital;
2. Application of effective banking supervision;
3. Compliance with the effective market discipline as a result of increasing the transparency of banking business.

New requirements for the formation of bank reserves to cover losses were recorded in the first component. The main idea was that the banks were given the right (in case of meeting certain conditions) to calculate their reserves to cover losses independently, relying on their own risk assessment. It is also important that the improvement of the banking risk assessment methodology has impact on the value of reserves. The instruments to mitigate risk were also used in the first component: The list of financial instruments was expanded according to which risk weighting is allowed; requirements to cover losses from operational risks were set, the requirements to asset securitization transactions and transactions of the trading portfolio were mitigated.

The process of the bank verification by supervisory authorities was adjusted in the second component: It was assumed to establish higher reserves for some banks if the bank reserve level doesn't correspond to its market profile; supervisors were granted the right to interfere in the activities of banks in order to avoid reducing the capital below the minimum value; the need to ensure a constant and active contact with the banks was highlighted.

The requirements for compliance with bank financial statements were disclosed in the third component: The increased efficiency of the market discipline of banks was provided, as well as regularly informing of the supervisory authorities of the risk and capital structure.

However, Basel II did not only failed to prevent, but also gave rise to the financial crisis of 2007-2008. After all, the weighted equity multiplier was designed for an economic model with a very high level of leverage, i.e., a high risk of bankruptcy in the event of sudden changes in market conditions, which can be seen during a crisis. In other words, all the banks were dictated a business model with a very high level of leverage by application of rigid standards (Lavrushin, 2011).

The Basel Committee published new recommendations for improving capital adequacy and liquidity regulation in 2009, which are now referred to as Basel III.

The Basel Committee believes that the main causes of the financial crisis include the banks in many countries allowing for excessive imbalance between their own assets and off-balance sheet liabilities, i.e., excessive financial leverage. At the same time, the size and quality of the banks' own capital decreased. Under these conditions, the banks appeared unable to sustain significant losses on lending transactions and off-balance sheet to withstand large risks. As a result, a number of governments were forced to make massive injections to maintain liquidity and increase the share of banks' own capital. Under these conditions, the role of state regulation of the banking system increased, and therefore the Basel Committee proposed the following anti-crisis measures:

- Improving quality, stability and transparency of the banks' own capital;
- Stricter requirements to risk capital coverage, in particular to market risks and securitization of counterparty credit risk arising from derivatives, repos and financing of operations related to securities;
- Taking the leverage indicator into account in calculation of credit risk to meet the standard of capital adequacy, as well as a number of indicators to ensure the formation of capital reserves in the favorable period of time, which will be used in times of crisis;
- Introduction of a universal standard of the lowest level of liquidity for active banks that includes the liquidity ratio (up to 30 days), indicators of long-term structured financing, a set of tools for supervisory authorities to identify and analyze risk trends both at the level of an individual bank and at the level of the banking system.

International auditing and accounting standards, in particular the International Financial Reporting Standards (IFRS) developed by the International Accounting Standards Committee, play an important role in the legal regulation of the banking business. For example, IFRS 30 "Disclosures in the Financial Statements of Banks" and IFRS 39 "Financial instruments: Recognition and measurement" encourage banks to increase the level of transparency of banking institutions and minimize the risks in general.

The lack of effectiveness of the existing regulatory instruments forces the state to fundamentally reconsider the objectives and mechanisms of competition and supervisory policies in the banking sector.

Here the case is primarily about the possibilities of the digital economy. For example, the development of IT technologies and data analysis methods has led to a substantial transformation from the traditional to the modern type of the bank in the banking sector over the past decade (Haldane, 2012).

The basis of the functioning of the traditional bank is information that cannot be described in figures and analyzed. The case is about establishing good relationships with the customers, availability of the history of such relationships; the concept of "trust" becomes particularly important. For example, in the case of a lack of financial viability of the customer from a formal point of view, the bank, which works with the customer for a certain period of time, may provide a loan even under such circumstances, given the positive history of relationships.

New technologies and methods for measuring the solvency of customers gradually lead banks to applying the analytical approach in transactions, developing loan ranging through mathematical models, while concepts of trust and regular clientele in today's banks are becoming less important. First of all, such a transformation is caused by the emergence of a large number of reliable information, i.e., the one that can be verified.

The transformation of the banks has now led to a decrease in profits, increased competition from other banks, increase in the share of non-interest income in total income, but most importantly - to the ability to quickly enter new markets and get new customers through the use of reliable information. However, most of the banks, especially those with the underdeveloped banking system, use both approaches and may not be referred to as modern banks in this regard.

Escalation of value of the reliable information and its use by the banks forms the basis for a new regulatory policy, which would take into account a market-based approach to banking business. The intensification of competition in the conditions of transformation for a new type of bank changes their business model: Margin decrease (from the 1990s to 2007, net margin on loans in the US has decreased from 4.0% to 3.25%; the EU saw roughly the same drop in margin) and the absence of regular customers have forced the banks to increase the share of risky operations in their portfolios. In addition, banks can aggressively grow, including through mergers and acquisitions, because reliable information helps quickly expand the customer base without focusing primarily on regular customers. This is compounded by the possibility of using market mechanisms in major mergers for rapid expansion. Thus, modern banks have both motivation and opportunities for a significant increase in risk.

4. DISCUSSION

Thus, the regulatory policy in the banking sector should use a more powerful prudential component. The areas of such regulation include:

- Preventing the formation of very large-scale financial institutions and effective solution of the problem of existing of very large-scale institutions. This problem occurs because of the possibilities of modern banks to rapidly grow in size. The instruments of the regulatory policy should be used to limit the growth of large banks. Moreover, such a policy must mitigate the distortions of competition created by very large-scale banks, because cheap funding becomes available for very large-scale systemically important banks.

However, the problem of very large-scale financial institutions is one of the key challenges for regulators. It is believed that the special provisions of Basel III for the reserve capital for systemically important banks will solve this problem. However, there is concern that these measures will not be sufficient, because Basel III provides for the reserve capital of up to 2.5% of risk assets (Gambacorta and van Rixtel, 2013. p. 412). The cost of reservation of the additional capital may be offset by a decrease in the cost of external funding for the systemically important bank, and thus the reserve capital will not give the bank the necessary motivation to reduce the assumed risks.

There are two key approaches to the solution of this problem by methods of regulatory policy - quantitative and cost-based approaches. The concept of a quantitative approach is the use of the instruments of state policy in the field of competition for immediate prohibition of the bank growth. This can be achieved by restrictions on mergers and acquisitions, forced sale of the assets, etc.

The problem for the use of this approach is justification of bases, because today the banks operate in a competitive environment and can be very effective due to economies of scale, despite their size. In this situation, an effective tool of the regulatory policy may appear its emphasis on the segments of the systemically important banks' operations where the size may hinder competition. It is known that large banks typically lose to the average ones when working with small borrowers, such as small businesses, where there is not enough reliable information for analysis. The policy aimed at equal access for different layers of borrowers to lending (including those whose solvency is difficult to estimate) can motivate the systemically important banks to reduce size or spin off individual parts to work in retail banking.

The cost-based approach focuses on the correction of disproportions caused by the existence of systemically important financial institutions. A key disproportion is that the large banks have access to cheaper funding in comparison with small banks. This disproportion is a permanent mechanism of competition disruption, creates a barrier to entry the market, as well as economically unjustified incentives for the growth of banks. The direct mechanism for such a policy could be the introduction of a progressive tax scale for large banks to sterilize the income received thanks to an unfair competitive advantage.

4.1. Structural and Competition Policy

Modern banks have the ability and motivation to assume too much risk in the form of new market of financial instruments; in addition, the problem of competition experienced by the banking institutions from the non-bank financial institutions needs to be solved. The regulatory policy should complement the initiatives aimed at structural adjustment of the banking sector to that part.

Structural policy in this context is understood as a set of prudential measures aimed at limiting the banking and non-banking business, which increases the systemic risk for the financial system. The recent financial crisis has demonstrated the connection between the systemic risk and the specific activities of financial intermediaries. Many banks have gone bankrupt in result of operating activities: Investments in securitized debt, emission of securities backed by a pool of mortgages, margin trading. At the same time, the "bubbles" in the real estate markets have arisen through loans that were provided by non-bank financial institutions and were not subject to enhanced supervision (Dagher, 2012).

Structural mechanisms for addressing systemic risk issues belong to the competitive environment, and therefore should be considered in conjunction with competition policy. The problem can be solved by restrictions on margin trading for banks and division of the banking activities for core and non-core. Non-core activities are more risky and have a lower margin, so limitation of this activity would enhance the sustainability of banks. Meanwhile, the division of the banking activities for core (weakly competitive) and non-core (highly competitive, including international) will allow a differentiated use of the instruments of competition policy for each segment of the banking sector.

Another way to reduce competition is ban on borrowing operations by non-bank financial institutions. At present, the availability of reliable information on borrowers allows a large number of financial and mortgage companies to compete directly with the banks in the lending field. The recent crisis has demonstrated that bank loans are more reliable on loans of non-bank institutions (Hasan, 2013), because they were not subject to the regulatory supervision and assumed more risk. Besides, the lack of regulation of non-bank institutions gave them additional competitive advantage due to the lack of capital requirements and other prudential rules. Competition policy can help prudential supervision create equal operating conditions when non-bank financial institutions are able to compete directly with the banks only under equal regulatory standards.

4.2. Crisis Management and Competition Policy

The effective resolution of banking crises requires measures that temporarily upset the balance on the market and undermine competition (e.g., nationalization or partial state control over banks, growth in bank concentration). The competition policy must have the instruments to restore the competitive environment of the banking sector after such anti-competitive manifestations.

The recent financial crisis has revealed the potential conflict between the competition policy and crisis management. The competition policy usually defends the principle of minimal government intervention in banks to save an equal competitive field between the state-owned banks and all other banks. At the same time, the need for crisis management may require an exceptional state intervention in the property of the bank or granting the bank state guarantees to preserve financial stability or ability to continue lending. In addition, the government can take control of the bank to carry out a forced restructuring. In such cases, the competition policy must be consistent with the need to save the banking institutions and cannot ultimately advocate the preservation of equal rights for everyone. The competition policy can also involve a temporary increase in concentration in the banking sector when it is necessary to restore confidence in the banking system during the crisis or, on the contrary, to help reduce the banking sector that had been too expanded in previous periods.

It is also important to foresee the peculiarities of application of the regulatory policies, especially in times of systemic financial crises. For example, the antitrust authorities in many countries facing the intense inception of the public sector in the banking systems - the industry regulators, governments and central banks - is the widespread practice. Aside from the introduction of numerous measures to support the financial markets, the regulators around the world have turned to direct participation in the rescue of the key financial (primarily banking) institutions, the most famous of which are Bear Stearns, Morgan Stanley, Northern Rock, Fortis, ING, IKB, West LB, hypo real estate, etc.

All these measures were due to fears of a transfer of the crisis of one financial institution to the others and the emergence of a systemic collapse of the global financial system, which could cause damage to confidence of all types of investors in the financial system. The degree of involvement of the state in aid to the financial and banking institutions during the acute phase of the financial crisis has been unprecedented. At the same time, antitrust authorities around the world did not intervene in the anticompetitive actions of the governments, and now the question whether to adopt the general competition rules for the financial market, in which, unlike other sectors, systemic crisis may arise, is updated.

4.3. Nationalization of the Banking Institutions

In this case, the measurement of the effectiveness of this approach compared to others in terms of the impact on competition in the short and long term is somewhat complicated. On the one hand, the nationalization is a transparent procedure in comparison with subsidies or recapitalization, and the presence of control over the bank provides the state with additional levers of control over its improvement.

On the other hand, the state control reduces the effectiveness and competitiveness of the bank. The advantage of nationalization in the times of credibility gap is important; however, limiting the motivation makes banks lose effectiveness that can lead to an increase in the time required for recovery of the financial institution and increases risks. In addition, the state-owned banks usually resolve political issues rather than issues of improvement of the bank efficiency. Companies that borrow money from state banks generally pay lower interest rate, which makes these banks less profitable and more risky. Thus, nationalization is effective for a temporal resolution of the crisis situation in the bank, so the state should not own such banks for a long time.

5. CONCLUSION

Government intervention in market processes in the banking sector is advisable in times of acute crisis processes, but the level of the degree of such intervention remains controversial. Certain experts believe that competition policy should be suspended for the period of the acute phase of the crisis, and the state should focus on maintaining the stability of the financial system. Others, on the contrary, emphasize the need to establish clear rules on competition in the crisis period for a harmonized approach of the state to the subjects of the financial market and for preventing a situation where different countries give uncontrolled subsidies to inefficient banks in order to maintain the competitiveness of their banking sector. An advisable level of banking competition can be achieved through the implementation of measures aimed at creating a market structure of the banking sector (e.g., concentration), namely:

- Entry and exit rules for banks;
- Policy of consolidation (which is especially important during and after the crisis, when the governments can directly decide on the acquisition, nationalization, reorganization);
- Setting restrictions on certain types of financial activities (non-lending activities of banks, "banking" activities of non-bank financial institutions - insurance companies and pension funds).

The implementation of the progressive EU experience based on the existence of various forms of competition policy is expedient for Russia. An example of mechanisms of regulation of the competition policy and state intervention in the financial sector that need to be implemented in Russia is the Regulation developed by the European Commission and designed to avoid excessive changes in the level of competition on the financial market in case of the provision of state aid. Relevant measures eliminate the spread of crisis situations between individual financial institutions and the EU member states in times of crisis. The regulation distinguishes between supporting individual financial institutions (systemically important banks) and general support schemes. Support for individual financial institutions is also divided into two types depending on the problem, namely:

- Caused by the situation on the market resulting in restricted access to liquidity;
- Caused by internal factors related to the company's business model.

In the former case, the support for the financial institution is guaranteed, because it does not lead to formation of excessive risk; but in the latter case, the state aid can only be made in accordance with the general rules of state aid.

The schemes of recapitalization of banking institutions can only be used to support fundamentally sound banks. In order to prevent distortion of the competitive environment, the Regulation provides for the availability of guarantee schemes and the possibility of recapitalization for all banks that conduct their business on the national financial market. Subsidiaries of foreign banks have the same rights to the guarantee as national banks.

At the same time, Russia should take into account the shortcomings of the EU regulation, which does not solve the problem of limiting the negative effects, since a significant number of financial institutions are international, but the guarantee schemes are available at the national level. In addition, there is a problem when the nation states will in practice try to help their banks under the canopy of the need to help the financial sector in general in order to prevent systemic collapse.

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