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DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
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COMPETITION AND FINANCIAL MARKETS

Roundtable 1 on Principles: Financial Sector Conditions and Competition Policy

-- Note by Turkey --

This note is submitted by Turkey to the Competition Committee FOR DISCUSSION at its forthcoming meeting to be held on 16-18 February 2009.

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1. Financial markets differ from other markets in two aspects. First, the most distinctive feature of financial markets is the existence of asymmetrical information problem. Another important feature of financial markets is the fact that when financial institutions face hardship, actors in the other segments of the economy are directly affected by this. These two features require that financial markets be subject to special regulations compared to the other markets.

2. The concept of stability in financial markets, especially in banking sector, has always been kept in the forefront due to the fact that these markets are characterized to affect other markets directly. Competition in banking sector lies at the center of the policy discussions concerning financial stability. Even though the existence of competition is important for an efficient banking system too, there are also views that excessive competition lead to instability and thus restraints on competition are necessary for the stability of banking system.

3. The relevant literature (theoretical and empirical studies) on the relationship between the stability of banking sector and competition do not seem to have reached a clear conclusion in this respect. The fact that the net effect of the risk resulting from bank consolidations change depending on the case and many types of competition do not threaten financial stability, indicate that there is no clear proven tradeoff between competition and stability. There are many studies in the literature defending both of the arguments.

4. Studies showing that there is a tradeoff between competition and stability state that competition results in banks taking various risks to maintain their profitability when faced with increased competition, eliminating the need to work cautiously, which in turn increase the bankruptcy risks of banks[1]. Increased credit risk in debt portfolio and lack of capital can be given as examples of such risks.

5. On the other hand, there are also many studies to the effect that increased competition in banking sector affects financial stability positively. According to these studies, increase of competition will result in decrease of interest rates in credit markets and thus in decrease of bankruptcy risks and costs of debtors. This will at the same time increase the recycling of the issued loans and therefore bankruptcy risks of the banks will also decrease[2].

6. Foremost among the important issues to be taken into consideration when evaluating the relationship between the stability of the financial system and competition is the existence of an institutional framework. In a banking system where free market rules are in effect and which is supported by the required institutional framework, competition is not harmful for stability, *per se*[3]. Policies for a competitive financial system such as removing the limitations on activities and the barriers of entry and allowing the entry of foreign banks may also ensure stability. However, institutional framework is the indispensable condition for achieving the maximum benefit expected from competition. To explain, though uncontrolled competition may cause fragility in a banking sector with a weak institutional framework, it would be more appropriate, in terms of economic growth, to focus on developing this institutional framework instead of limiting competition, at least in the long-run.

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1 Drummond, Maechler and Marcelino (2007); "Italy—Assessing Competition and Efficiency in the Banking System", IMF Working Paper, European, Finance, and Monetary and Financial Systems Departments, p.27.

2 Jiménez, Lopez and Saurina (2007); "How Does Competition Impact Bank Risk-Taking?" Federal Reserve Bank Of San Francısco Workıng Paper Series, Working Paper 2007-23

http://www.frbsf.org/publications/economics/papers/2007/wp07-23bk.pdf

3 Beck (2008), "Bank Competition and Financial Stability: Friends or Foes?", Worldbank Policy Research Working Paper 4656

7. Even though it is important to ensure stability in financial markets, this should not be the sole purpose of policy-makers. For economic growth, it is also important to establish a deep and efficient financial markets structure.

8. In light of all of these arguments, it is thought that the consideration of the following points would be beneficial[4]:

- Similar to other industries, the level of competition will affect the efficiency of the services, the quality of the products and the degree of innovation in financial markets, as well.

- Another important factor to take into account besides the stability in financial sectors is the effects of the level of competition in these markets on the concentration and economic growth in other markets.

- The first thing to do in financial markets is to create efficient financial markets which could support real markets and achieve the best allocation of the savings of the society, and to establish a regulatory structure which would ensure the above.

9. After these explanations on competition and stability in financial markets, it is important to discuss under this topic the issue of competition and efficiency in financial markets. For further discussion on this issue please see paragraph from 13 to 16 (pages from 5 to 7) of the country contribution prepared for Roundtable II by Turkey.

4 Claessens and leaven (2005); "Financial Dependence, Banking Sector Competition and Economic Growth", World Bank Policy research Working Paper 3481.