GLOBAL FINANCIAL DEVELOPMENT REPORT **2013**

Rethinking the Role of the State in Finance

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THE WORLD BANK

http://www.worldbank.org/financialdevelopment

Introducing the *Global Financial Development Report*

- **First in a series**
  - Combines new data, research, lessons from operational work
  - Collaboration within WBG and with external contributors
- **Each report will focus on a theme**
  - GFDR 2013: rethinking the state's role in finance, in light of the global crisis
  - GFDR 2014: financial inclusion

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  - Accompanied by *Global Financial Development Database* and several other major databases and surveys, benchmarking of financial systems around the world, a range of underlying case studies and research papers
  - http://www.worldbank.org/financialdevelopment

From Global Financial Development Database

The Little Data Book on Financial Development

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Depth—Financial Institutions
Depth—Financial Markets
Access—Financial Institutions
Access—Financial Markets
Efficiency—Financial Institutions
Efficiency—Financial Markets
Stability—Financial Institutions
Stability—Financial Markets

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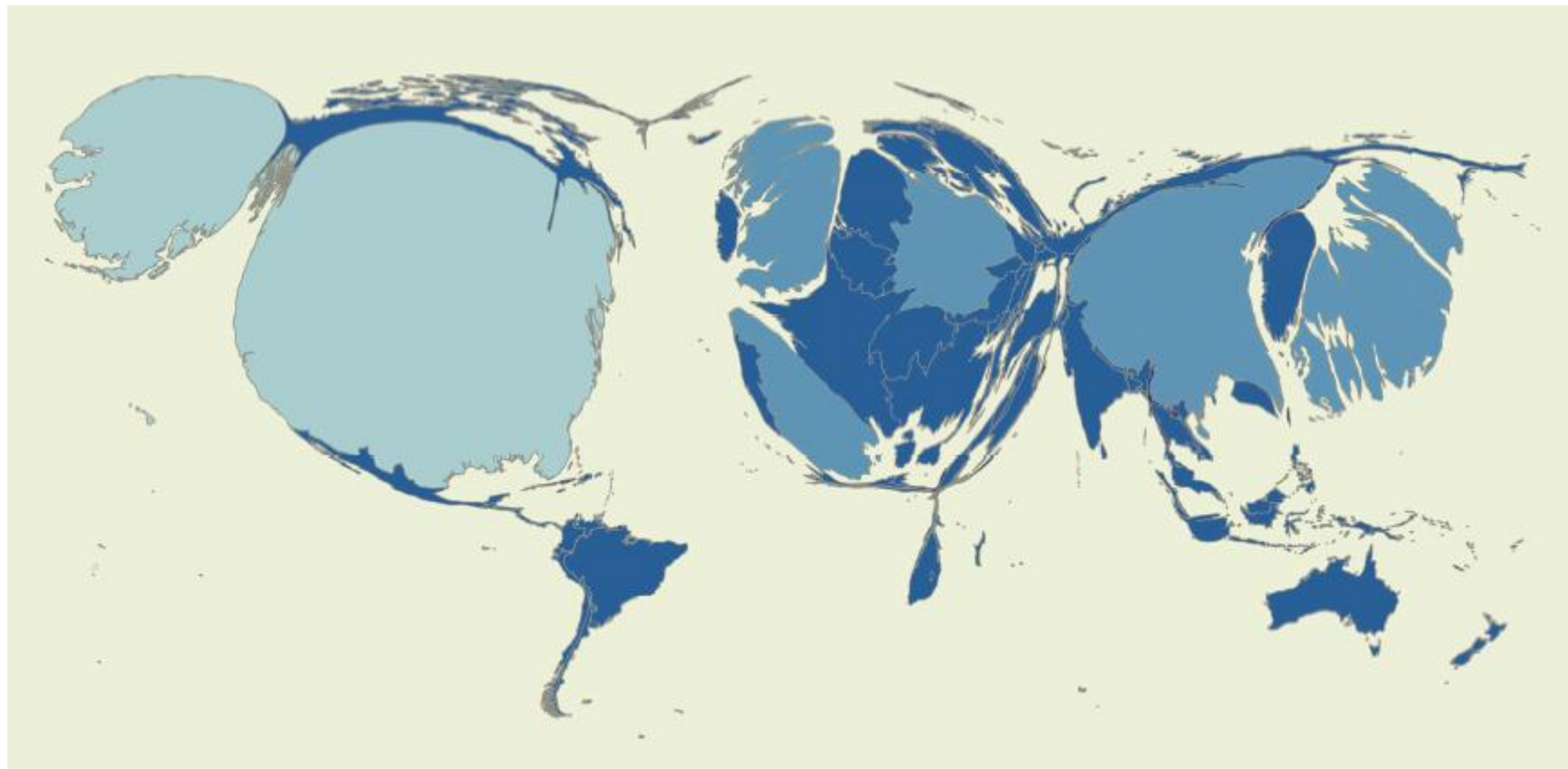
Global Financial Development Database

	FINANCIAL INSTITUTIONS	FINANCIAL MARKETS
DEPTH	**Private sector credit to GDP** Financial institutions' assets to GDP , M2 to GDP, Deposits to GDP ,Gross value-added of the financial sector to GDP, …	**Stock market capitalization plus outstanding domestic private debt securities to GDP** Private debt securities to GDP, Public debt securities to GDP, International debt securities to GDP, Stock market capitalization to GDP, Stocks traded to GDP, ….
ACCESS	**Accounts per thousand adults** Bank branches per 100,000 adults, % of people with a bank account, % of firms with line of credit, % of firms with line of credit, …	**Market cap outside of 10 largest companies** Percent of value traded outside of top 10 traded companies, Government bond yields (3 month and 10 years), Ratio of domestic to total debt securities, Ratio of private to total debt securities (domestic), Ratio of new corporate bond issues to GDP, ….
EFFICIENCY	**Net interest margin** Lending-deposits spread, Non-interest income to total income, Overhead costs (% of total assets), Profitability (return on assets, return on equity), Boone indicator (or Herfindahl or H-statistics)	**Turnover ratio** Price synchronicity (co-movement), Price impact, Liquidity/transaction costs, Quoted bid-ask spread for government bonds, Turnover of bonds (private, public) on securities exchange, Settlement efficiency
STABILITY	**Z-score** Capital adequacy ratios, asset quality ratios, liquidity ratios, net foreign exchange position to capital, distance to default, …	**Volatility of stock price index** Skewness of the index, Price/earnings ratio, Duration, Ratio of short-term to total bonds, Correlation with major bond returns

Examples of other variables in the database: ownership of financial institutions, structure (H-statistics etc), measures of internationalization, features of the regulatory and institutional framework, etc.
For the database, see http://www.worldbank.org/financialdevelopment.

Global Financial Development Database



Source: Calculations based on the Global Financial Development Database (http://www.worldbank.org/financialdevelopment).
Note: For illustration purposes only. Country sizes adjusted to reflect the volume of financial sector assets in the jurisdiction (U.S. dollars, end-2010). Image created with the help of the MapWindow 4 and ScapeToad software.

Expert views: *Financial Development Barometer*

Over 90 % of respondents think that positive effects of financial development outweigh the negative ones. But views are split on important aspects of the state's role ….

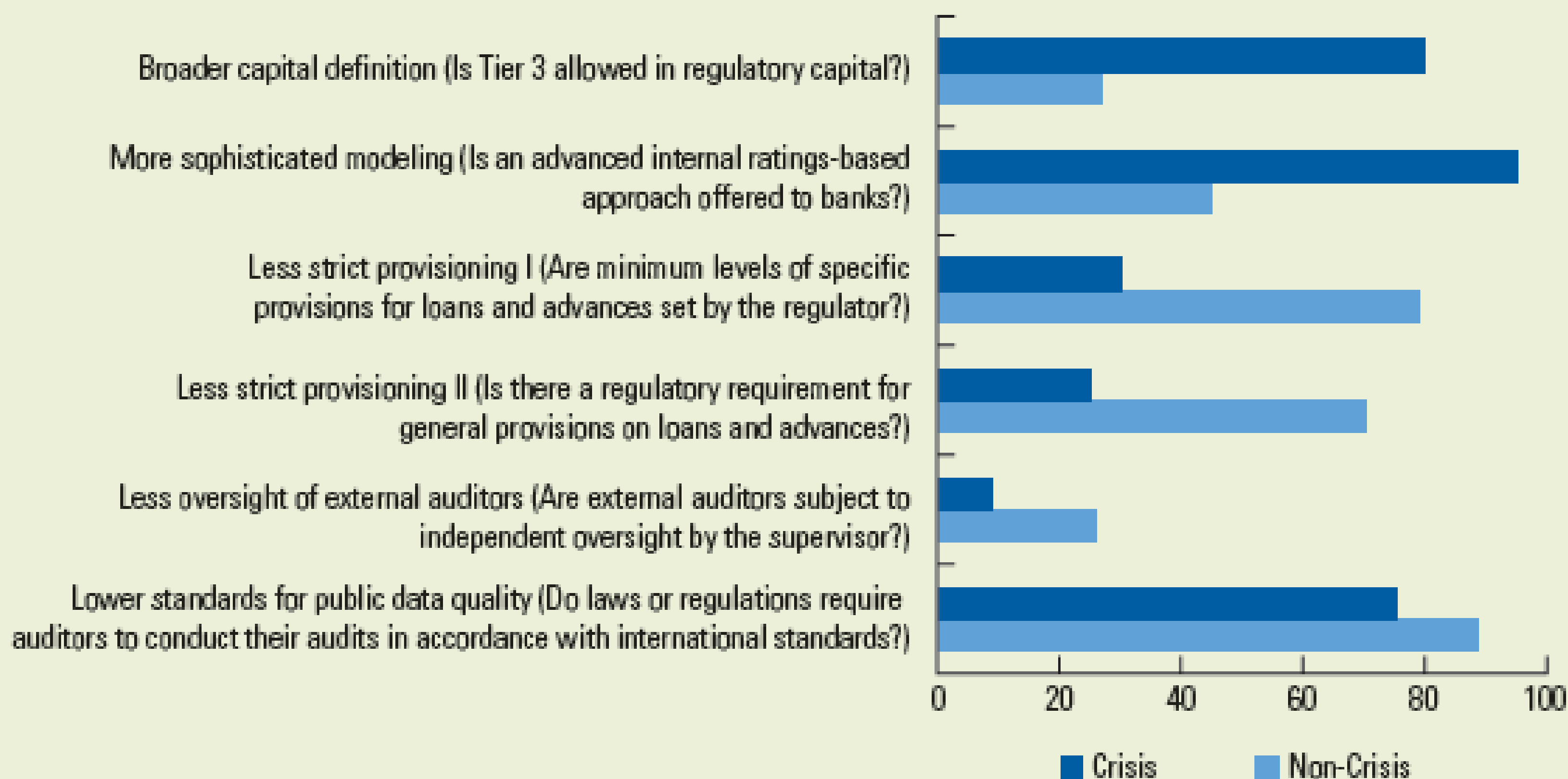
Examples of statements where opinions were split	Agree?
"In view of the global financial crisis, more **stringent** financial sector regulation and supervision is needed."	49 %
"In view of the global financial crisis, there is a need for broadening the **scope** of financial sector regulation and supervision."	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** 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 (http://www.worldbank.org/financialdevelopment). The *Barometer* is an informal global poll of officials and financial sector experts from 78 economies (30 percent developed, 70 percent developing). The response rate was 65 percent. Results are percentages of total responses received.

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 142 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



Source: Čihák, Demirgüç-Kunt, Martínez Pería, and Mohseni 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).

Findings on regulation and supervision

- **Crisis hit countries had weaker regulation and supervision practices…**
  (e.g., less stringent capital and provisioning rules, reliance on banks' own risk assessment)

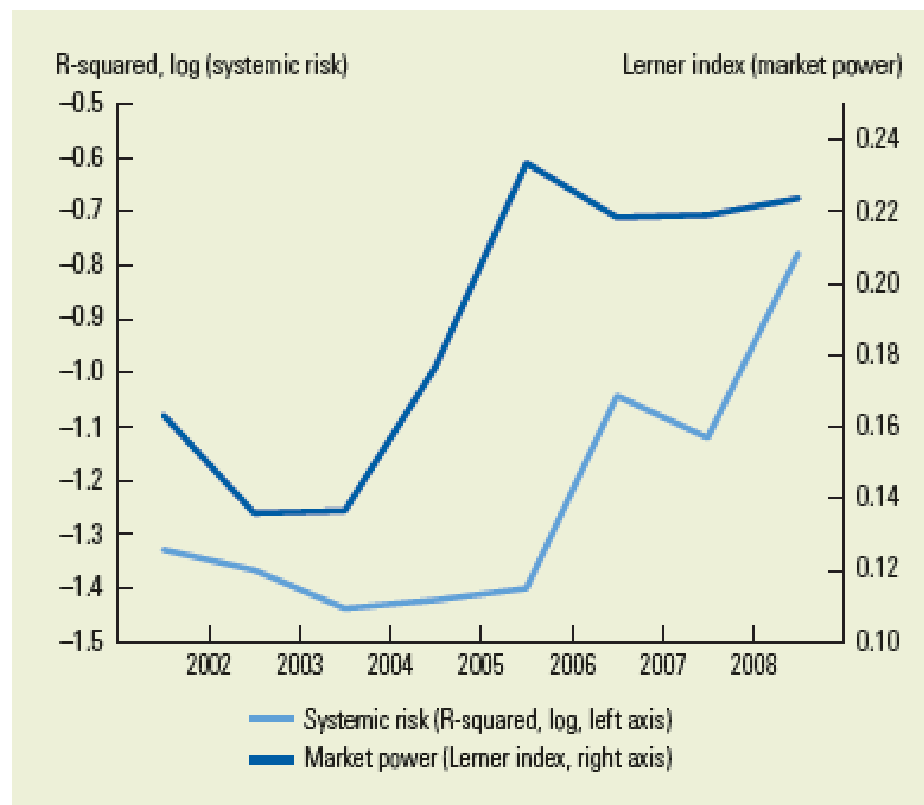
- **… and less scope for market incentives**
  (e.g., generous deposit protection coverage, lower quality of published financial information)

- **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

- **Broad agreement: important to address "basics" first**
  - Simpler but strongly enforced regulation tends to work better
  - Institutional and legal frameworks that enable market discipline complemented with strong and timely supervisory action
  - Many developing economies: supervisory capacity = top priority
  - Challenge: introducing reforms that are incentive-robust (one proposal: "incentive audits")

Role of state in promoting competition

- Excessive competition - a reason for the crisis?
- Competition leads to improved efficiency across banks, enhances access to financial services while not necessarily eroding systemic stability.
- Addressing causes of the crisis requires regulations that align private incentives and public interest (not 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 negative consequences on bank competition.

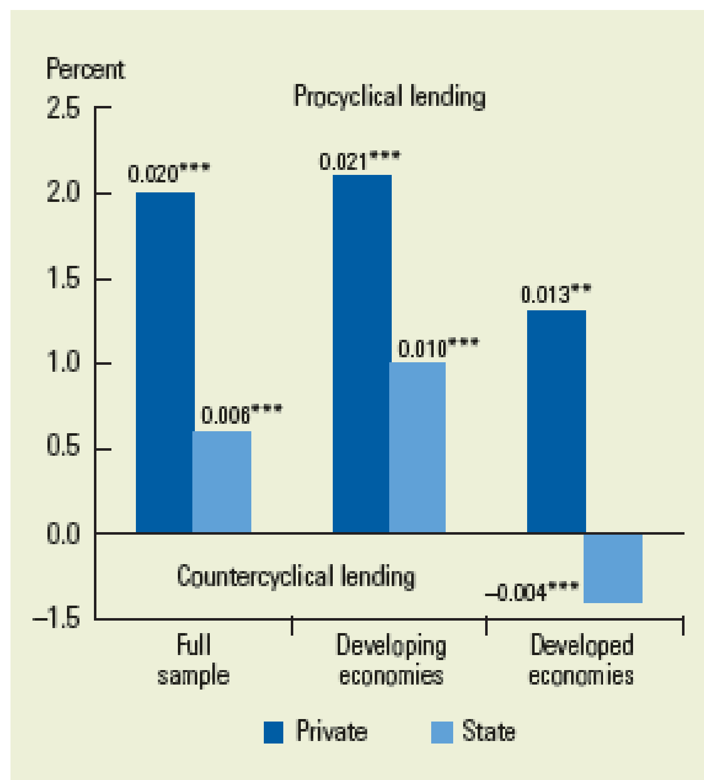


Source: Calculations based on Anginer, Demirgüç-Kunt, and Zhu 2012.
Note: The systemic risk measure follows Anginer and Demirgüç-Kunt (2001) and builds on Merton's (1974) contingent claim pricing. Systemic risk is defined as the correlation in the risk-taking behavior of banks and is captured by the 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



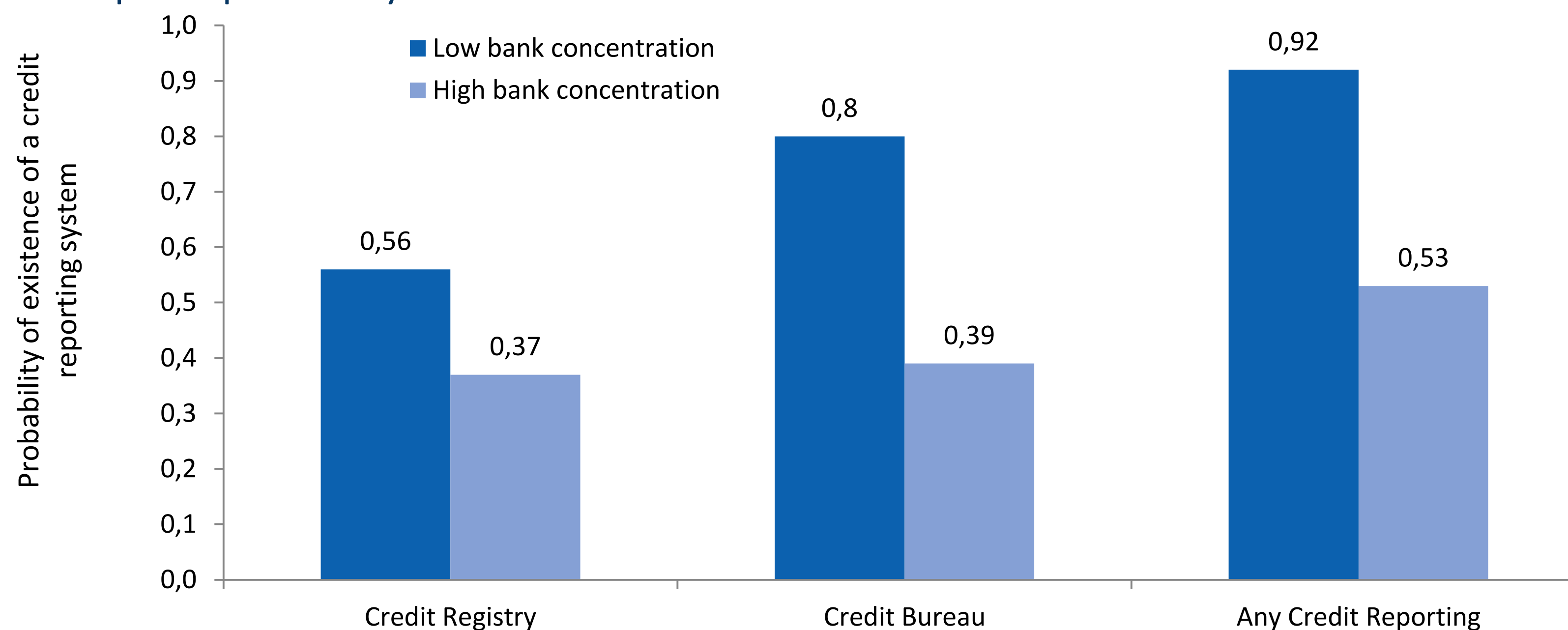
Source: Bertay, Demirgüç-Kunt, and Huizinga 2012.
Note: The figure shows marginal effects from a regression of bank lending on GDP per capita growth and a number of control variables, estimated using a sample of 1,633 banks from 111 countries for the period 1999–2010.
Significance level: ** 5 percent, *** 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
  - Past evidence on longer-term costs 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. This 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

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