Competition and Stability in Banking: 
The Role of Regulation and Competition Policy

By Xavier Vives

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Reviewed by Urs W. Birchler, SUERF President and University of Zurich

The key question(s)
In the late nineteen-eighties a Swiss bank supervisor observed: “The stability of our banks rests on the weakness of competition.” Soon after, bank cartels fell, profit margins eroded, and a severe banking crisis followed. Is then competition the enemy of stability? Or is stability, achieved through heavy regulation, the enemy of competition? With these general questions in mind I opened Xavier Vives' recent volume. Immodestly, I also hoped for light on a number of other issues: Do economies of scale and scope explain the emergence of big global banks? Can competition policy mitigate the problem of implicit government guarantees? Is capital really expensive for banks (and why)? And: What exactly is a bank? Xavier Vives tackles these questions, and many more, with scrutiny and circumspection. His findings are based on some 600, mostly academic, articles (the references falling thirty pages). While even these represent a selection (given the huge amount of papers on banking written over the last few decades), Competition and Stability in Banking can be said to represent the best of available knowledge.

The structure
The book invites the reader with a transparent and intuitive structure. After an introduction (Ch. 1) and a review of banking trends (Ch. 2) a bifurcation follows. On one track, the author explains banks' fragility and regulation (including shadow banking) (Ch. 3), on the other, he deals with bank competition (Ch. 4). The two tracks meet again for a (theoretical and empirical) analysis of the interaction of both, fragility (or its counterpart, stability) and competition (Ch. 5). After a descriptive insert on bank-related competition policy in different countries (Ch. 6), the author describes the interaction of stability architecture, competition policy, and public intervention during the crisis (Ch. 7). The theoretical and empirical analysis (in Ch. 5) and the international crisis experience (in Ch. 7) constitute the core of the book. The main results of these chapters flow into a summary and the author's policy conclusions (Ch. 8).

What is a bank?
Banks are not quite the same animals from a competition and a stability point of view. From a competition point of view, banks are multi-product firms offering a vast range of services. From a stability point of view, there are two main functions that make a bank a bank: financing (selection and monitoring of) borrowers (Diamond 1984) and the creation of liquidity for depositors (Diamond-Dybvig 1983) which makes banks fragile by definition. This is a very standard starting point; even a leading figure like Xavier Vives does not see any alternative seriously competing with the standard banking paradigm. He also sympathizes with the “global games” approach to avoid multiple equilibria and the related problems of bank liability pricing.

The problem with competitive analysis in banking
For competition theory the banking industry is a snake pit. As Vives points out, market power comes in combination with a number of complications: (i) market failures due to information asymmetries and externalities, (ii) the two-sided nature of many financial markets (like deposits-credits), (iii) network effects (e.g.,
in payment services), plus (iv) the multi-product nature of banking in practice, (v) the presence of deposit insurance or of explicit or implicit government guarantees. Further, entry and exit costs preclude resorting to a contestable markets hypothesis. Finally, bank customers are known to suffer from a number of behavioral biases. For these reasons the relation between competition and stability in banking is intricate. The rich theoretical and empirical evidence can only be presented as a huge - yet incomplete - mosaic of individual small contributions.

**Competition, regulation, stability: The evidence**

The author's task is further complicated by the fact that he writes for both, readers with a main interest in competition and/or stability policy and for students or academic researchers. The first groups, policy practitioners, are likely to look at the mosaic from a distance, keen to see the big picture and to draw the main conclusions. Indeed, they will find - cautiously distilled - answers to the manifold questions (mentioned above) regarding competition and stability. To give a few (excessively simplified) examples:

- **Q:** Do restrictions to competition support banking stability (as the supervisor mentioned above suggested)? **A:** No, but: An intermediate level of competition seems optimal for banking stability (and even overall efficient).
- **Q:** Are there economies of scale and scope explaining the emergence of very big global banks? **A:** There are, but hardly up to the top.
- **Q:** Can competition policy mitigate the TBTF problem? **A:** Not alone.
- **Q:** How should policy responsibilities in the fields of competition and stability be organized? **A:** Separately, but coordinated.
- **Q:** Is bank capital expensive? **A:** Who knows: “We still do not have a satisfactory theory of capital for banks” (p. 49).
- **Q:** Can activity restrictions (like “narrow banking”) increase welfare? **A:** Yes; if pricing risk is not possible, restrictions on bank activities may be a second best (and the two may be complementary).

At the same time Vives tempts the reader to walk closer and to look at those small and sometimes still odd parts of the mosaic. Here, the message is not only that policy makers should never feel too confident with generalizations. The positive message is that academic readers will discover a wealth of issues deserving further study. Future PhD students will hardly fail to find exciting topics if they only put their nose close enough to those tiles. Yet, Vives also presents descriptive material to the benefit of both camps, policy and academia. These are the parts on trends in banking, competition policy around the world, and public intervention in the recent crisis.

**Who should read the book?**

*Competition and Stability in Banking* is an impressive work of one of the leading economists in the field. It is first of all a (rather: the) new textbook on a Master or PhD level. Yet, it should also be mandatory reading to all economists (and lawyers) working in official or government agencies related to either banking regulation and supervision or competition. Despite the demanding subject matter the book is not difficult to read. There are no formulas either. A basic training in microeconomics is of course helpful, but the lack of it is no reason to leave the book aside. Vives is not afraid to disappoint potential readers looking for anecdotes, value judgements, or even finger-pointing. Where others might use stronger language he prefers the understatement. The fact, for example, that in EU countries banks’ holdings of government bonds are subject to neither a capital charge nor concentration limits “is worth noting” and “has been put into question” (p. 135).

**Final remark**

With *Oligopoly Pricing: Old Ideas and New Tools* (1999), *Information and Learning in Markets: the Impact of Market Microstructure* (2008) and *Competition and Stability in Banking* (2016) Xavier Vives has come up with a great book roughly every eight years. This is a promising pace, but it also leaves us enough time to read the current volume as carefully as it deserves before arrival of the next one.