Yaron Amir: Competition in the banking system

Speech by Mr Yaron Amir, Governor of the Bank of Israel, at the Banking Supervision Department conference on competition in the banking system, Jerusalem, 2 April 2019.

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Summary:

- Some of the significant measures and reforms aimed at enhancing competition have already come to fruition, and others are in the process of coming to fruition. There are additional supporting processes that are required now, such as the development and application of financial and technological instruments, and the deepening of the capital market, which will contribute to competition in the credit market and increased consumer well-being as they advance.
- These processes are becoming possible mainly in view of the development and application of advanced technologies that were not available until just recently.
- Removing information gaps, leveraging existing information, and utilizing technological ability for informed analysis and learning in real time about the credit market will enable more correct pricing that is more in line with the risk to various layers of the credit market—households and small and medium businesses—thereby contributing to development of the market.
- The market must be developed while managing risks and developing proper regulation, in order to make sure that, despite the risks, the benefit from these processes will make them worthwhile.
- Two financial instruments that should be advanced in order to make the capital market more sophisticated and deeper, and which will contribute to the continuing increase in competition, are securitization and long-term interest rate derivatives.

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Good morning.

First, I would like to congratulate the Banking Supervision Department on this conference, and welcome the honored guests. The issue of competition in the financial system is one that occupies many people in Israel and abroad. Advancing competition has been a top priority of the public and of the Bank of Israel in recent years, and for good reason. Advancing competition in the financial system, when done properly, has many positive effects on all entities in the economy, first and foremost the broad public. Today, I would like to discuss various aspects that can enhance competition in this market, thereby increasing consumer well-being and economic growth. Some of the significant measures and reforms aimed at enhancing competition have already come to fruition, and we are already enjoying the results. Others are in the process of coming to fruition. And there are additional supporting measures that are now required, such as the development and application of technological and financial instruments, and deepening the capital market. As these are advanced into the future, they will in turn contribute to market efficiency, an increase in the variety of possibilities for competition, and to increased consumer well-being. Financial markets enable a more efficient allocation of sources and create the proper mechanisms for risk-sharing. Therefore, the extent of development and sophistication of the financial markets—such as how deep they are, how liquid they are when necessary, and what mix of instruments is available to the various participants, both firms and lenders, and customers and end consumers—is very important.

I will discuss these in greater detail later on, but first, to the question, “What is competition?" A common approach to defining competition is the equilibrium result where the price is equal to the marginal cost as a result of sophisticated competition. In accordance with this approach, in order to have a competitive market, a number of assumptions must be met, including the free entry and exit of firms, and public knowledge of the market possibilities. As we know, there are significant entry barriers in the credit market, some of which are natural, since the banking system is characterized by economies of scale, and there are built-in information gaps. The Bank of Israel, the Ministry of Finance, and others have dealt with these issues in recent years with the proper amount of caution, and the solutions are now coming to fruition. We will hear during the day about various processes for removing barriers, as well as the implementation of “open banking", “moving from one bank to another with one click", removing technological barriers, and the implementation of advanced technology that was not available until just recently, together with the necessary adaptation of regulation. Each of these is important on its own, and their combination makes a greater contribution than each one could when implemented separately. Together, these processes can increase competitive pressure in the coming years, and support the entry of additional participants into the market. They deal with the removal of information gaps, the leveraging of existing information, and the utilization of technological capabilities in the real-time analysis and informed learning about the credit market. These will enable more correct pricing that is more in line with risk—for various levels of the credit market, such as households and small and medium businesses, thereby contributing to the development of the market.

Technology and the accompanying information contain advantages not just for the private sector, but also for the government. For instance, they enable the transition from paper-based means of payment to more advanced means of payment, enable tracking, and have the potential to reduce black-market activity in Israel. At the same time, they are leading the enhancement of competition by allowing new participants to enter the market and through the development of different business models to provide a variety of payment services and increase the customer’s ease of use.

Another aspect of competition is focused on the dynamic behavior of the supply side. In other words, the market is competitive when its participants are sufficiently aggressive and a competitor has the incentive to improve in order to gain an advantage over other competitors—whether the advantages are the result of improved quality and service, lower prices, additional services, and so forth. These aspects have also undergone many changes in recent years, whether as part of a natural market process, or as a result of regulatory encouragement, in adopting technological advancement alongside significant streamlining, that will enable the creation of the required competition on the supply side.

In this regard, there is an interesting simultaneous link between efficiency and competition among the banks. Streamlining enables the banks to lower prices in order to attract customers, or to provide new and higher-quality services for the same purpose. Accordingly, it is possible that increased efficiency will actually lead to increased concentration, and will therefore be interpreted as a reduction in competition, because more efficient companies will have a higher market share, which will lead to increased market concentration. Our job as regulators over this market is therefore to make sure, as the Banking Supervision Department is doing, that the fruits of streamlining actually roll over from the banks to the broad public.

When dealing with efficiency, many tend to think mainly about the operational efficiency of some organization. However, a significant portion of activity in the credit market depends on the ability of the various participants to use the various capital market instruments to “offer their wares", and mainly to provide credit. The extent of this mechanism’s efficiency, for instance in its ability to allocate sources and optimally distribute risk (risk sharing), has a tremendous effect on the ability to provide products that are relevant to their customers and make them accessible, in such way that they will increase consumer well-being and support increased competition in the credit market.

How can we advance this? Through continued development of the capital market, particularly by increasing the level of sophistication of the market, which will enable the informed application of financial instruments that must be developed to advance the credit market. Thanks to those instruments, it will be possible to allocate sources and share risk more efficiently, increase accessibility to sources of credit, and achieve more proper pricing in the market. In this way, we will improve the state of all participants in the credit market, particularly the end customers—firms and the broad public, which will benefit from increased competition, a greater variety of available possibilities, and more optimal decision-making capabilities. Of course, it is important that all these are done while managing risk and developing the proper regulation, in order to make sure that despite the risks, the benefits from these processes will make them worthwhile.

One mechanism that enables the advancement of various financial-technological developments with the proper controls and balances is the “regulatory sandbox". This mechanism already exists abroad, and there are a number of examples that have come to fruition. For instance, England is the first country in which such a mechanism was created—back in 2016. At the end of the first year of the program’s operation, 75 percent of companies that were active in it had completed the testing they were asked to perform, and 90 percent of them had significantly expanded the market in which their product or service was offered by the end of the program. In addition, most companies that obtained a limited license as part of the program began the process of obtaining a full license once their participation was complete. The sandbox is currently being advanced in Israel, where there is a broad infrastructure of fintech and financial cyber companies. The Bank of Israel is, of course, a partner in this process.

I would like today to discuss two financial instruments that I believe should be advanced in order to make the capital market more sophisticated and deep, and which will contribute to the continued enhancement of competition.

The first is securitization. Naturally, institutional investors’ ability to provide credit directly to small and medium businesses is limited, due to significant operational and collection costs and because there is no developed securitization market in Israel that would allow the expansion of credit with its continued operation by the banks, who have a built-in relative advantage in this market. While the securitization market abroad is similar in size to the corporate bond market, in Israel, it is miniscule, with a value of just a few billion shekels.

The advantages of a securitization market are reflected in the development of the nonbank credit market and less expensive sources of financing. It is a bridging tool between money held by institutional investors and credit consumers in the real economy. Securitization allows for the expansion of institutional investors’ investment horizons, and also makes it possible to free up capital and manage durations in the banking system, so that these sources can be allocated, inter alia, for the financing of small and medium businesses. Securitization also acts to direct sources to the Israeli economy as an alternative to investing abroad. For instance, securitization is a tool that can help finance the separated credit card companies.

It is important to advance the law, with the aim of enabling the removal of barriers to the development of the securitization market in Israel, which will in turn increase competition in the credit market while maintaining financial stability. This should be done by establishing the appropriate legal, taxation, regulatory, and accounting framework for executing only traditional securitization transactions in Israel. I emphasize that the risks in this market are known, and they are addressed in the recommendations of the interministerial team that dealt with the issue. A lot of attention was paid to the lessons of the global crisis, and special emphasis was placed on the changes in regulation of the securitization market in various countries, so that we can benefit from the advantages of securitization while ensuring market transparency and a mechanism for the lenders to jointly bear the credit risk.

Second, we should examine how to expand the use of interest rate derivatives, which are necessary to disperse the risks derived from the various instruments in the credit market, mainly medium- and long-term credit. The absence of these basic instruments creates unwelcome distortions in the market, whether through credit pricing that is too high, or through the allocation of financing from the outset. This may lead to an equilibrium where the quantity of credit declines, difficulties emerge for the real sector, and the rate at which the economy can grow is impaired.

The Bank of Israel is acting to develop and institutionalize the Telbor interest rates as benchmarks of the real interest rate. These rates make it possible to use not only the fixed nominal or daily variable interest rates, but also a rate that varies over longer and predefined periods of time. They constitute an important and central layer in the global capital markets, because they can be used to increase the financing possibilities for the business sector. Benchmark rates also provide infrastructure for the interest rate futures market, where contracts enable businesses and the public to mitigate and even neutralize interest rate risks.

In many economies around the world, there are two common types of financial products based on benchmark interest rates: (1) Deposits, loans, and mobile nominal interest bonds to various periods; and (2) interest rate derivatives. In Israel, unlike many other advanced economies, activity is currently conducted mainly in the assets themselves, and not through derivatives. It is important to note that even though activity in interest rate derivatives has grown significantly in recent years, it is still quite low compared to other countries, mainly in the longer terms. These differences indicate the underuse of financial defenses against interest rate risks in Israel, relative to what is common in other advanced economies.

In order to illustrate how the development of this type of instrument would help the broad public, we can use the example of the early payment fee that is well-known to the representatives of the banking system who are here, and that is relevant to almost anyone who takes out a mortgage in Israel. It is reasonable to assume that if the banks were able to hedge the risk of early repayment of such a long-term loan and better manage their risk balance, this fee would be reduced. The banks would be able to do this by adopting a long-term IRS instrument, which replaces cash flow from fixed interest with variable interest. As a result, the customer would have a greater ability to refinance a mortgage in view of various developments—whether they are specific to that customer or they apply to the entire economy—and would improve his financial state, or what we economists refer to as “consumer well-being".

In contrast with most advanced economies, where a significant proportion of interest rate derivative transactions are settled through a central clearinghouse, such infrastructure still does not exist in Israel. In a central clearinghouse, the risks of various transactions offset each other, and the remainder is transferred to one central entity that manages it through the appropriate collaterals. In order to develop the interest rate derivatives market in Israel, it is important to advance a central clearinghouse that will significantly mitigate the credit risks inherent in such transactions.

There are other advisable measures that it is worth thinking about, which I will discuss at other occasions. To conclude, the Israeli economy has made many steps in recent years to advance competition in the credit market. There are additional possible stems that would complete what is necessary to advance competition in this market, some of which—particularly those that deal with the structure of the financial system—I have discussed this morning. These developments and innovations involve some risks, but they also may open the door for more efficient financial technologies for both consumers and the various supervisory bodies. As such, **financial stability does not necessarily stand in contradistinction to increased competition and increased efficiency. The Bank of Israel will work to improve the efficiency and assiduously maintain the stability of the capital market and the financial system, and will work to integrate new financial technologies and instruments gradually and under careful control.**

I again congratulate the Banking Supervision Department on this conference, and I welcome the upcoming speakers, who contribute much to the advancements in this area and to the important professional discussion of these issues.

Thank you.