TÜRKİYE CUMHURİYET MERKEZ BANKASI

MARKET-BASED FINANCE:

A NEW VISION OF ECONOMIC GROWTH AND FINANCIAL STABILITY

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15 April 2015, Washington

Distinguished guests; Ladies and Gentlemen,

I would like to thank Babak Abbaszadeh for his kind introduction and the Toronto Centre for inviting me to what promises to be a very stimulating and important conference.

Today I would like to make some remarks on market-based finance. In particular, I will touch upon (i) G20 progress on financial reforms in the nonbank sector, (ii) how market-based finance can support financial stability and growth, and (iii) finally, the agenda of Turkey's G20 presidency in the area of market based finance.

Although eight years ago the Global Financial Crisis first appeared in nonbank entities and activities, the G20 efforts for reforming the global financial system started with banking sector regulations on capital, leverage and liquidity requirements with an objective of building safer, more resilient sources of finance provided by banks to serve better the needs of the real economy. In order to correct the fault lines that led to the global crises, G20 Leaders endorsed the FSB framework for reducing the moral hazard posed by systemically important financial institutions or SIFIs which addresses the too-big-to-fail (TBTF) issue by reducing the likelihood and economic impact of SIFIs failing. FSB also advocated sound compensation practices.

With the near-completion of the banking sector regulatory reform, the recent G20 financial regulation agenda has moved to nonbank credit intermediaries or shadow banking sector that conduct maturity, credit, and liquidity transformation without access to central bank liquidity or public sector credit guarantees. During the global financial crises, market-based finance practices exposed a greater degree of excessive build-up of leverage and liquidity and maturity mismatches than in the banking sector. The G20 reform fixes this by "

(i). mitigating risks in banks' interactions with shadow banking entities;

(ii). reducing the susceptibility of money market funds (MMFs) to “runs”;

(iii). improving transparency and aligning incentives in securitisation;

(iv). dampening pro-cyclicality and other financial stability risks in securities financing transactions such as repos and securities lending; and (v). assessing and mitigating financial stability risks posed by other shadow banking entities and activities"[1]

as well as extending the SIFI framework to nonbank institutions.

It is worth noting that the FSB has also "created a system-wide monitoring framework to track financial sector developments outside the banking system with a view to identifying the build-up of systemic risks and initiating corrective actions where necessary."[2]

It is also essential that G20 not only regulates the excesses of nonbank entities but also takes a broader forward view on the development of diverse and resilient market-based finance, as market-based finance widen participation and enhance diversity in the financial system. This will likely expand funding available to companies in addition to bank lending and diversify the counterparty risk. Indeed, a recent BIS research paper finds that bank-based intermediation and market-based finance foster economic growth in a complementary way in upturns. "But when it comes to moderating business cycle fluctuations, banks and markets differ considerably in their effects. In normal downturns, healthy banks help to cushion the shock but, when recessions have coincided with financial crises, [the paper] finds that the impact on GDP has been three times as severe for bank-oriented economies as it has for market-oriented ones."[3]

The EC Green Paper on building a Capital Markets Union provides the following proof on this point that medium-sized companies in the US, the engines of growth in many countries, receive five times more market-based funding than they do in the EU. Therefore, given the presence of impaired bank balance sheets in some advanced economies and the need for large funding to finance investment projects especially infrastructure projects, it is imperative that G20 member states reduce impediments to the development of diverse and resilient market-based finance. For example, countries need to develop proposals to encourage simple, transparent and well-identified securitization processes and thereby free up bank balance sheets to lend. This may also quite helpful to improving the financing of SMEs.

[1] The FSB progress report on “Transforming Shadow Banking into Resilient Market-based Financing: An Overview of Progress and a Roadmap for 2015”

[2] Ibid.

[3] “Financial structure and growth” by Leonardo Gambacorta, Jing Yang and Kostas Tsatsaronis. BIS Quarterly Review, March 2014.

Among the different facets of market-based finance, the Turkish G20 Presidency prioritises that the financial system is able to provide credible long-term equity capital to companies. We underscore that "committed long-term equity offers a stabilising buffer against the inherent cyclicality of debt finance and the adverse externalities that too high a reliance on debt can bring."4 We also believe that equity markets can play a vital role in providing the financing, especially for small start-up companies that are essential to improve competitiveness and underpin dynamic growth. Corporations' preference for debt financing to equity financing calls for policy work on identifying the cost advantages of debt over equity due to several legal and tax related incentives. These include, for example, seniority of debt to equity and favourable tax treatments of debt financing in the form of the tax deductibility of interest payments under corporation tax codes in many countries. An IMF research5 suggests that abolishing the preferential tax treatment of debt would raise average unweighted equity by 2.2 to 4.2 percentage points for banks. These numbers are sizeable by any measure, especially considering that the proposed Basel III leverage ratio is only 3 %. To this end, Turkey has recently taken pioneering steps that would lead to a lower level of debt financing. They are limits on the tax deductibility of interest payments and provisions on the tax deductibility of additional equity capital.

During its G20 presidency, Turkey will put a firm emphasis on investments as a powerful driver of growth. This is also compatible with the targets of standard setting bodies, which aim to strengthen market-based financing mechanisms that would support investment by providing additional funding sources available for firms.

Being aware of their potential risks, when properly structured, new forms of financial intermediation may lessen the reliance on the formal banking system and strengthen the diversity and resilience of the financial system as a whole. The development of such financing mechanism will help to meet credit needs of the economy, especially the nonfinancial corporates.

Thank you.

[4] "Taking the long view: how market-based finance can support stability" by Dame Clara Furse, External Member of the Financial Policy Committee, Bank of England.

[5] "Taxation, Bank Leverage, and Financial Crises" by R A de Mooij, M Keen and M Oriharai. IMF Working Paper No. 13/48, 2013.