Comments: “The FinTech Opportunity” by Thomas Philippon

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Summary of Thomas's Messages

1. The financial system is neither performing well nor improving adequately. This is crucial since finance shapes economic performance.
2. Insufficient contestability and competition help account for this problem.
3. Regulators can implement specific reforms to remove barriers to FinTech.
   - Such policies would spur competition, improve the financial system, and boost growth.

My remarks

1. The changing quality of finance

2. Research supports Thomas's argument that contestability would boost the quality of finance.

3. Beyond removing barriers to competition and boosting the quantity of capital:
   - Quality of capital

① Changing quality of finance

- Finance is not simply about quantities.
- It is mostly about which activities are funded.
- This is hard to measure with quantities and prices, especially in technologically innovative economies
  - Screening biotechnology is different from railroads
  - “Swimming upstream” (Laeven, et al. 2015)

② Contestability improves finance

- US regulators created local monopolies.
  - Lots of banks. High profits.
  - Little contestability or competition.
- Persisted for most of the 20th century
  - Created influential constituency
- It did not change because policymakers realized they were protecting an inefficient system.

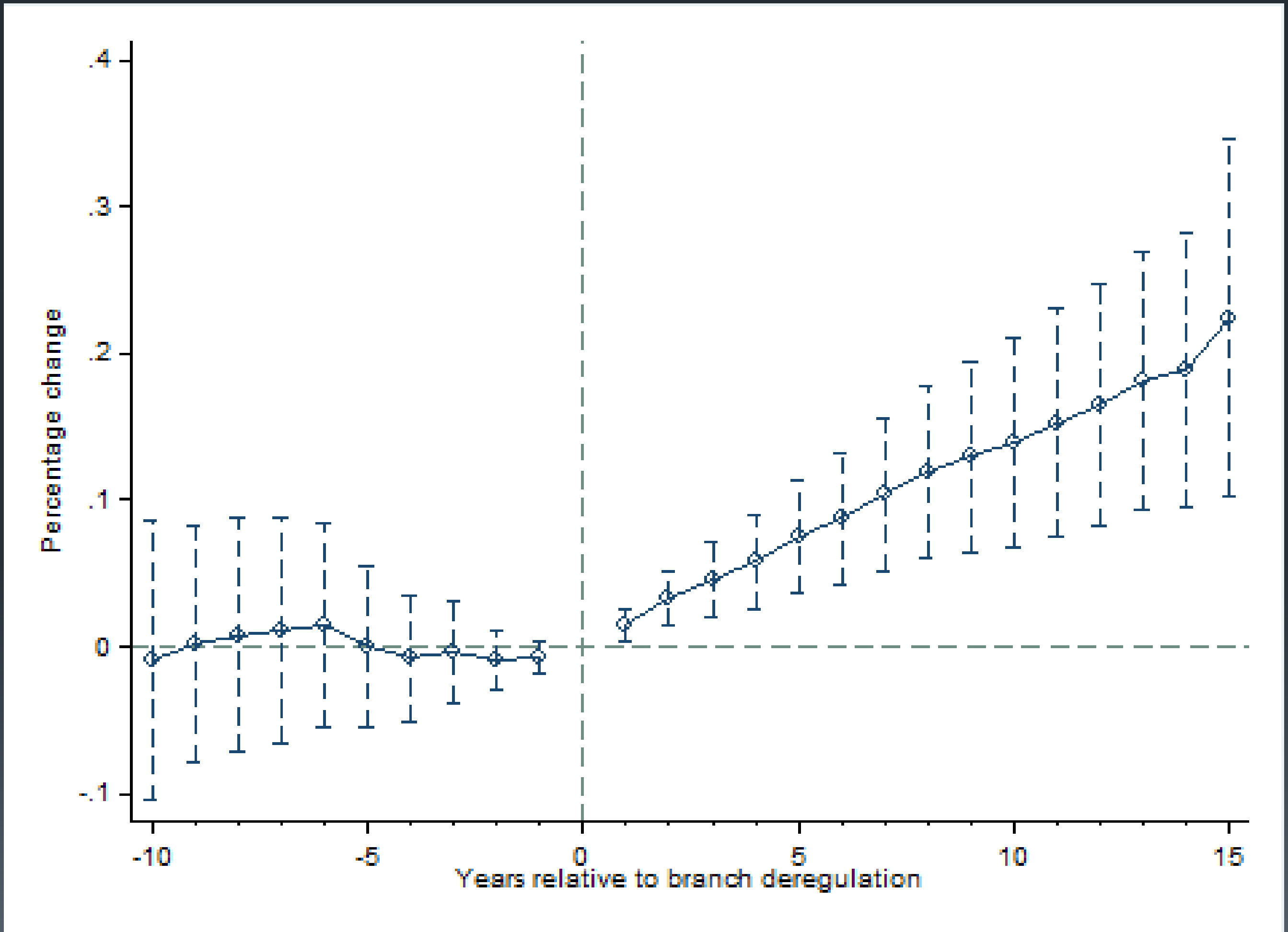
What changed?

- Technology changed.

What happened?

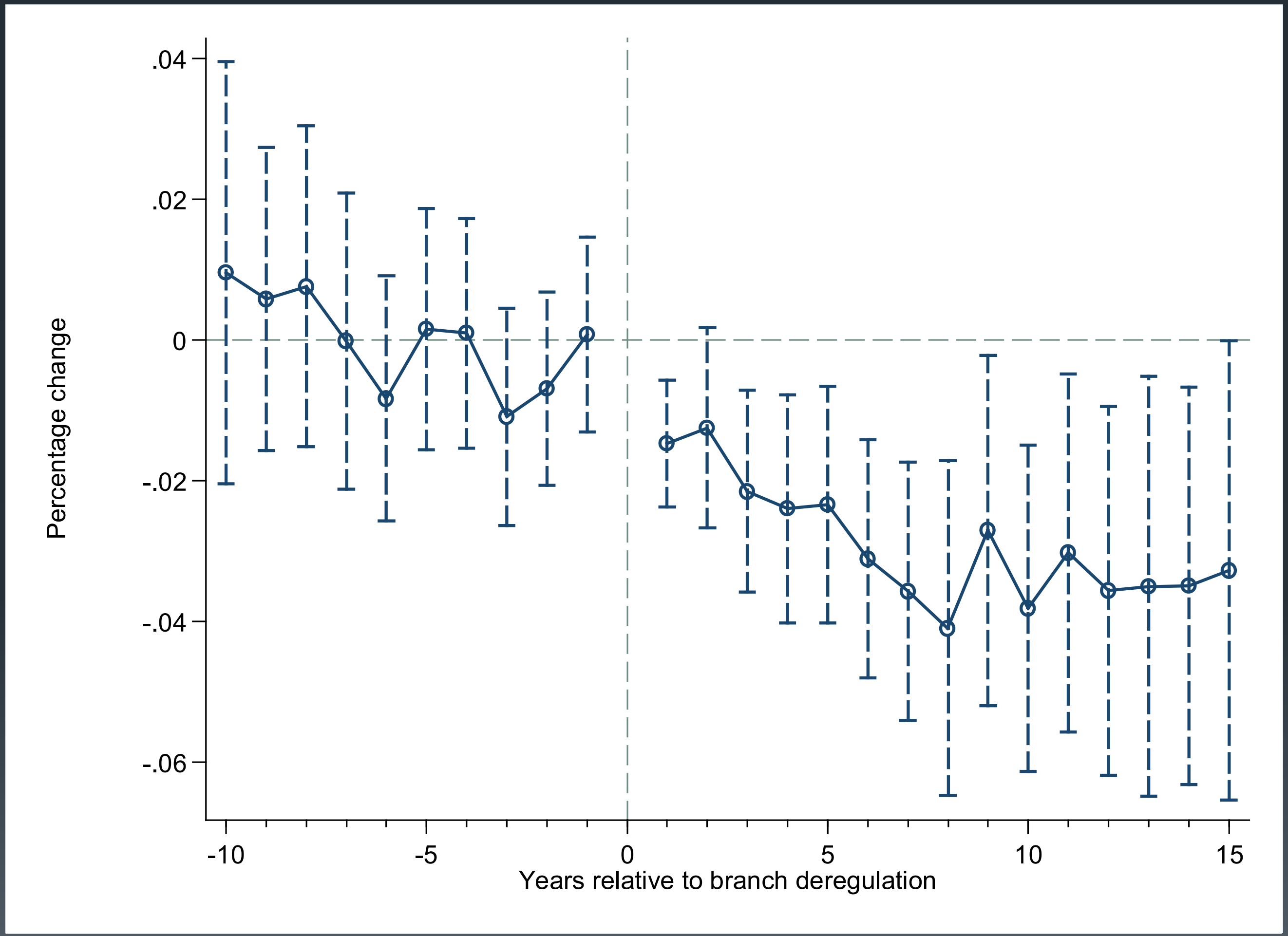
- US states removed prohibitions on interstate banking in different years.
  - Rhode Island vs. Montana
- Thus, US state banking systems were exposed to an intensification of competition in different years.
- What happened to the economies of those states?

Competition and state growth



$$\log(GSP)_{st} = \alpha + \beta_1 D^{-10}_{st} + \beta_2 D^{-9}_{st} + \ldots + \beta_{25} D^{+15}_{st} + \mathbf{A}_s + \mathbf{B}_t + \varepsilon_{st}$$

Competition & state inequality



$$\log(\text{Gini})_{st} = \alpha + \beta_1 D^{-10}_{st} + \beta_2 D^{-9}_{st} + \ldots + \beta_{25} D^{+15}_{st} + \mathbf{A}_s + \mathbf{B}_t + \varepsilon_{st.}$$

Points:

- Thomas is exactly right to focus on policies, regulations, and taxes that limit competition in the financial services industry.
- Thomas is exactly right to stress the potential fulcrum of technology.
- We should be worried that constituencies will use their influence to protect rents.

③ Quality of capital

- Regulatory and supervisory authorities—and academics—underappreciate incentives.
- Capital requirements do not directly address incentives.
- Goal: Align incentives of decision makers in financial institutions with societal incentives.
  - Do decision makers have much of their personal wealth at risk?
  - Laeven and Levine (2009), Goetz, Laeven, and Levine (2016)

Quality of capital

- Consider a CEO, compensated with an option contract.
- Boosting capital requirements will not directly reduce the CEO’s risk-taking incentives
  - Might occur, indirectly, through improved governance.
  - But, no evidence that it does.
- In fact, higher capital can increase risk-taking, as shown by Laeven and Levine (2009).

Quality of capital: Policies

- Goal: Align incentives of “bank” decision makers with societal incentives.
  - Move beyond capital cushion.
  - Policies can focus more on incentives
- Possible additional policies
  - Executives to have large, unhedged equity stakes.
  - Banks to have larger, individual shareholder with a large proportion of wealth invested in the bank, which would also address TBTF

In sum …

① People would benefit from improvements in the functioning of financial systems.

② Boosting the contestability of financial markets will help generate these improvements.

③ Thomas offers guidance on how regulators can remove barriers to FinTech, with potentially positive effects on competition and growth.

④ We should worry more about incentives and the quality of capital.