TOWARDS A SERVICEABLE AND STABLE BANKING SYSTEM

REPORT
FROM THE COMMISSION ON THE STRUCTURE OF DUTCH BANKS

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<u>COMMISSION ON THE STRUCTURE OF DUTCH BANKS</u>

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SUMMARY

The Commission on the Structure of Dutch Banks has investigated how serviceability and stability of the banks and the banking systems could be improved. This report is the result of that investigation and also contains recommendations in that context. Serviceability means that all banks active in the Netherlands offer banking products and services in a socially responsible manner and serve the needs of the Dutch economy, citizens and businesses, in their development. Banks play a central role in the allocation of financial resources: they largely determine, guided by the market mechanism, which activities are financed and can thus be executed. The commission uses the term stability to refer to banks and banking systems fulfilling their economic functions effectively and being resistant to shocks.

This investigation has been conducted as a result of banks having been insufficiently serviceable and stable over the past few years. Even before the crisis, there was dissatisfaction regarding the way in which banks served their customers and, in some instances, such as the limited availability of credit, this is still the case. During the crisis, several banks in the Netherlands required substantial state aid. As a result, society has lost its trust in the banking sector. This is a serious issue as banks play essential roles in the economy. Even though a great deal of effort has been made in order to improve the serviceability and stability of banks, further measures are necessary in order to restore trust. To achieve this, the commission recommends that banks set out their vision of the role that they would like to fulfil in society in a social statute.

The Dutch economy and banking systems are very internationally oriented. The European Internal market and legislation are of particular significance to Dutch banks. The banking system is embedded herein to such an extent that developments in this context form the framework for the commission's thinking. The creation of a banking union, among others, is a point of reference in this regard.

In the commission's vision, it is desirable that the Dutch banking sector is as diverse as possible in terms of size, target group, national or international focus, ownership structure and country of origin (whether banks have a Dutch banking licence or not). Diversity provides a guarantee for competition and a wide supply of financial products and services. Next to specialist institutions, universal banks of sufficient size are needed, particularly in order to finance and to provide a wide range of services to the international activities of Dutch businesses, which is a major source of prosperity.

Serviceability
An important condition for serviceability is adequate competition in the Dutch banking market. Competition, however, has been reduced as a result of – necessitated - government interventions, increasing consolidation in the banking system and the fact that foreign parties are withdrawing. Primarily, small and medium sized businesses (SME's) and consumers are complaining about the service provided by banks. These businesses complain that banks no longer know their customers and that credit is insufficiently available, for example for innovation and the transfer to more sustainable production methods. It is precisely the smaller business and consumers that are dependent on the banks for financing their activities and for other banking services. They are vulnerable moreover as a result of having less expertise than the banks and therefore being reliable on sound, customer-focussed advice.

Diversity and competition
In order to improve diversity and competition, the commission has drawn up a number of recommendations. It is thus desirable for the competitive position to be normalized by privatising the banks that are now owned by the State, once circumstances permit, and removing the financing advantages of the system banks as much as possible. The entry of foreign parties can be stimulated by completing the Internal market for banking services with the banking union. Policy and regulation should make room for alternative forms of financing that could supplement the banking finance channel. Better availability of financing for SME's can be encouraged through

measures such as setting up credit unions, organising crowd-funding, developing SME bonds and reigniting the private market for business loans. If so, institutional investors can also play a role in financing the SME sector. Furthermore, banks must be obliged to offer a standard version of complicated financial products that have a substantial and long-term impact on households (mortgage lending and pension savings). Simplicity and standardisation create transparency and comparability, particularly of costs and, therefore, promote price competition.

Stability
The core of this report is made up of recommendations to promote the stability of banks and limit their risk profile. This will come about as a result of a combination of measures.

Sound risk management is the responsibility of a bank. In order to improve governance, supervisory boards must intensify their supervision, have more expertise and experience in the financial sector and pay attention to customer interests and the social role of banks.

The banking union, which is currently being created within the EU, can also contribute towards financial stability in Europe by preventing contagion between bank finance and public finance in the future. It is important that European supervision and resolution mechanisms are simultaneously implemented as far as possible to ensure that responsibilities are at similar levels. Before banks come under the direct supervision of the ECB, there must be a critical asset quality review and, if necessary, this should be followed by forced recapitalisation to the Basel III level. This is not only crucial for a solid banking union; it is also necessary in order to ensure that European banks will once again be able to adequately finance economic activities.

A structural macro-economic problem that concerns banking services to consumers is the huge size of banks' mortgage portfolios compared to their much smaller domestic deposit basis (funding gap). The shortfall in deposits for financing outstanding loans, including mortgages, has brought pressure to bear on the provision of mortgages. In order to revive the mortgage market, the commission recommends transferring guaranteed mortgages from banks to (inter)national institutional investors via a National Mortgage Institute, which is yet to be created.[1] In the longer term, structures that give a role to institutional investors in terms of financing mortgages are required without there being a need for governmental guarantees.

In order to limit the banks' risk profile, it is vital that the maximum norm for mortgage credit provision (loan to value, LTV-ratio) is further lowered. Market parties are critical about the LTV-ratios for Dutch mortgages as these ratios are much higher than elsewhere in Europe. In light of the banks' financing structure, the volatility of the property market and high private debt quotes, the commission recommends the maximum LTV-ratios to be gradually lowered to 80% of the market value upon provision. Such a reduction has far-reaching social consequences. That is why it must be implemented while taking into account the development of house prices, alongside targeted restructuring of the housing market and some form of mortgage savings.

The direct route to improving the stability of banks is the reinforcement of their capital position in order to increase the distance to default. According to the so-called Basel Capital Accord (Basel III), banks must gradually, and fully by 2019, fulfil higher requirements on an international level. The commission recommends that the banks that will be supervised by the ECB as of 2014 should be committed to the Basel capital ratios as of that moment. This should be done in such a way as to avoid to a reduction in credit lending. In an EU context, the commission recommends introducing an un-weighted minimum leverage ratio, but would also like to note that a minimum ratio of 3% of total assets, which is currently being discussed, is too low. Alongside attracting new capital, retained profit is also an important source of extra, risk-bearing capital. Cost-reduction is

[1] This is in line with the Van Dijkhuizen plan for the role of institutional investors for housing finance. See: http://www.rijksoverheid.nl/documenten-en-publicaties/rapporten/2013/03/11/voortgangsbericht-verkenning-rol-van-institutionele-beleggers-bij-hypothecaire-woningfinanciering.html.

also offered in addition to profit retention. The bank levy delays the reinforcement of capitalisation and should therefore be reconsidered.

Systemically relevant banks are not allowed to fail because they are interconnected with other institutions and fulfil vital functions. That is why until recently there has been an implicit state guarantee for this type of institution. It is, however, preferable to limit the banking risk for the state treasury as much as possible and to allow any losses to be borne by shareholders and creditors. For that reason too, the solvency of banks must be increased. An adequate bail-in regime must also be set up. Bail-in is a system whereby certain creditors can be forced to pay towards the resolution and restructuring of a bank, as they would in the event of bankruptcy. Efforts must be made to achieve a well-structured bail-in regime with clear rankings in terms of the liability of creditors and unambiguous conditions for application; this can only be successful within an EU setting. This way, the risk that the state may have to intervene can be limited as far as possible.

The risk profile of the deposit banks must be structurally limited via the implementation of a ring fencing obligation involving trading activities if these exceed a set limit. Trading activities go hand-in-hand with high market risks and can expand rapidly, meaning a bank can accumulate substantial risks in a very short time. That is why banks must refrain from engaging in speculative trading activities (trading for their own account). In order to serve the economy effectively, however, banks must be able to conduct other, customer-related trading activities on a sufficiently large scale. In this context, the commission is following the proposal of the High Level EU commission chaired by Erkki Liikanen. If trading activities exceed the Liikanen limit, they must be protected from the deposit bank and accommodated within a separate legal entity. Banks can thus offer all of the services required by businesses, including risk-management (e.g. interest and currency swaps) and mediate on the capital market, without excessive risks being created.

If a bank is systemically relevant, a disorderly bankruptcy is undesirable. A well organised resolution is the alternative. For that reason, Dutch banks must be set up in such a way that, in an emergency, they can be resolved in such a manner that the critical, system relevant activities can be separated and continued. The fact that banks differ from one another significantly means that the resolution process must be customised per bank. In every case, effective resolution requires a simple and transparent legal and commercial structure, an IT system architecture that guarantees the continuation of the systemically relevant activities and good management information systems. For the resolution of banks, a resolution authority must be set up in Europe, as part of the banking union, that develops resolution plans per bank and which has the competence to impose changes on banks' structure and systems if necessary.

RECOMMENDATIONS

1. Strive for a banking sector in the Netherlands that is serviceable and stable. Serviceability means that all banks active in the Netherlands offer banking products and services in a socially responsible manner and serve the needs of the Dutch economy, citizens and businesses, in their development. Stable means that banks and the banking system can fulfil their roles effectively and resist any shocks. In this regard, banks must be capitalised and structured in such a way as to limit the chance that they must call upon State aid to an absolute minimum. Risks that do not stem from serving the customers must be avoided.

2. Encourage the development of a banking sector that is as diverse as possible, in terms of size, target groups, national or international orientation, ownership structure and country of origin. Diversity is a guarantee for adequate competition and a wide supply of financial products and services. In addition to more specialised banks, universal banks of sufficient scale are required in order to provide a wide range of services. Dutch banks must be capable of financing and supporting the international activities of businesses, innovation and new activities for the transition to a circular economy with more sustainable production methods.

3. Strengthen competition in the Dutch banking sector by:
   a) normalising competition relationships by privatising the banks that are owned by the State once circumstances permit this;
   b) removing financing advantages for systemic banks as much as possible and shifting risks which need to be borne by shareholders and creditors;
   c) completing the Internal Market for banking services in Europe through the banking union;
   d) encouraging new, alternative forms of financing such as credit unions, crowd funding and private market and SME bonds via policy and regulations;
   e) enforcing a standard version for specific, complicated consumer products (mortgage lending and saving for pensions).

4. Strengthen governance within banks by intensifying the supervision provided by supervisory boards. Ensure that there is more expertise and experience in the financial sector available within boards and that they pay attention to customer interests and the social role of banks.

5. Set up a National Mortgage Institute in order to transfer mortgage credits from banks to institutional investors in order to improve the availability and the pricing of mortgage finance. Lower the legal maximum norm for mortgage credit provision (LTV-ratio) gradually and depending on the development of house prices, to 80% of the market value in order to limit the banks' risk profiles. Combine this with targeted restructuring of the housing market and a form of mortgage saving.

6. Improve stability of banks and the banking system as a whole by strengthening the capital buffers in a manner that does not lead to limiting credit provision. Let all banks that will be directly supervised by the ECB, including Dutch systemic banks, fulfil the Basel III capital ratios at that point in time. Limit the leverage of banks by implementing a minimum leverage ratio of over 3% of total assets. Reconsider the bank levy since this works against the accumulation of more banking equity.

7. Strive, within an EU context, for a well structured bail-in regime with a clear ranking for creditors' liability. An effective bail-in regime limits both the risk that the government will have to intervene in the resolution and that the tax-payer will incur losses.

8. Implement an obligation to ringfence the trading activities of deposit banks that exceed a specific limit, for the purposes of structurally limiting their risk profile, in line with the proposals from the EU's Liikanen commission. Dutch banks must refrain from engaging in speculative trading activities (trading for their own account).

9. Ensure that Dutch banks are organised such that in an emergency they can be resolved and that their critical, systemically relevant activities can be separated and continued. Resolution of a specific bank requires a customised approach. Effective resolution requires a simple and transparent judicial and commercial structure, an IT system architecture that guarantees the continuation of the systemically relevant activities and good management information systems. Furthermore, a European resolution authority must be created and resolution plans must be developed. This authority must have the power to set suitable requirements for individual banks so that their structures fulfil these principles.

10. When forming the European banking union, endeavour to implement European supervision and a resolution mechanism simultaneously, to the extent possible. Also state as a condition, before banks come under the direct supervision of the ECB, a critical asset quality review, followed, if necessary, by enforced recapitalisation. A European deposit guarantee system must be the final piece of the banking union.

11. Ensure that banks regain the confidence of society. To achieve this, the commission recommends that banks set out their vision of the role that they would like to fulfil in society in a social statute.