Perspective on the structure of the Dutch banking sector

Efficiency and stability through competition and diversity

DeNederlandscheBank

EUROSYSTEEM

Summary

The Dutch banking sector is relatively large in size, highly concentrated and dominated by a small number of large national banks undertaking a wide range of activities.

To a large extent, this structure results from the mergers that occurred at the end of the 1980s and early 1990s and a number of market distortions and unintended consequences of past policy initiatives. Examples include tax incentives contributing to a large sector size, such as the deductibility of interest payments on mortgages and business loans, as well as competitive advantages and implicit state guarantees for banks already enjoying dominant market positions. Such effects encourage banks to grow larger, while discouraging them from specialising in the areas of their particular expertise. In addition, crisis measures based on short-term considerations can have unintended consequences in the long run. An example is the lifting of the ban on mergers between banks and insurance companies, which was prompted in part by mortgage banks' immediate capital needs at the start of the 1980s.[1]

The stability and efficiency of banking services are best guaranteed in a sector characterised by less concentration and more diversity. The guiding principle of this vision paper is the promotion of a stable and efficient provision of services by the banking sector to its customers. While this principle does not give rise to a single, optimal sector structure, it does point in a desirable direction. In particular, large banks should have less dominant positions within the domestic market, which will benefit smaller banks and foreign players. Dutch banks' expansion abroad must not be discouraged, but should be undertaken primarily to realise economies of scale and scope rather than with a view to achieving potential diversification gains. By encouraging risk management strategies other than diversification, the diversity and stability of the sector as a whole will increase. The *bancassurance* model is history, and banks now focus on providing a smaller range of profitable products instead of a wide spectrum of retail, corporate, trade and real estate financing activities. In such an environment, smaller banks and efficient niche players will have more room to innovate and compete in a successful manner.

1 Van Lelyveld and Prast (2004), New architectures in the regulation and supervision of financial markets: the Netherlands, *DNB Working Paper* 21. An example from the United States is the interest rate ceiling on savings accounts (Regulation Q), which has contributed to the emergence of money market funds.

The European banking union will eventually contribute to the stability and efficiency of banking services, but is no panacea. A stable and efficient banking sector contributes to economic development by providing customer-oriented products and services at minimum, cost-covering charges, and maintaining that service level even in a period of crisis. The banking union brings us closer to achieving both goals by, for example, improving the resolvability of banks and encouraging cross-border competition. Despite its positive influence, the introduction of the banking union offers no panacea for instability or inefficiency of banking services. The European resolution framework is new and has not yet been tested in practice. Hence the need to keep the banking union from unleashing a new consolidation wave that makes banks too large and too complex to resolve, even at the European level. In addition, national differences in such areas as consumer protection, insolvency legislation and taxation continue to impede the integration of the European banking market. The national perspective thus remains important in guaranteeing stable and efficient banking services.

Although there is limited room for manoeuvre, policy options aimed at guiding the sector structure in the desired direction can be formulated along five principles. Post-war legislation offered instruments for implementing policies specifically targeting the sector structure, in line with prevailing ideas on the guiding role of government in the financial sector and in the economy at large. An example is the former ban on mergers between banks and insurance companies. During the 1990s, these regulations were gradually relaxed. In addition, most financial regulation is currently determined at the European level. Nevertheless, it is possible to formulate policy options based on five principles in order to guide the structure of the banking sector in a more desirable direction. These principles are the following.

1. **Remove market distortions and tax incentives that encourage excessive growth of banks and of the sector as a whole**, for example by removing implicit too-big-to-fail subsidies by means of supervision and resolution, further restricting mortgage interest relief and further reducing the maximum loan-to-value ratio on new mortgages once the housing market has sufficiently recovered.

2. **Increase diversity in the banking sector by encouraging banks to take into account the drawbacks of diversification across countries and sectors for the stability of the system as a whole**, for example by focusing more on risk management with prudent lending standards, adequate buffers and a proactive credit control.

3. **Reduce the high market concentration within the sector,** for example by stimulating competition from innovative new market entrants, introducing standard products and, where possible, simplifying regulation.

4. **Encourage market entry of foreign banks,** especially those that are willing to invest in local customer relations and are able to fall back on financially healthy parent companies.

5. **Anticipate developments that could have an impact on the sector structure,** such as the ongoing integration of the European banking market and the increasing role of technological innovation in the financial sector.

Applying these principles in policy making would add to the stability and efficiency of the Dutch banking sector and maximise its contribution to economic development and social welfare.

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Introduction

How has the structure of the Dutch banking industry developed, from a historical and international perspective? How should we view this development in the context of the stability and efficiency of banking services? And what can De Nederlandsche Bank (DNB) and other parties do to guide future developments in the right direction? It is these three questions that this Perspective on the structure of the Dutch banking sector sets out to answer.

The structure of the banking sector is important for a stable and efficient provision of banking services. In its Supervisory Strategy 2014-2018, DNB formulates the three principal challenges for the Dutch banking sector: (1) regaining trust, (2) further strengthening financial resilience and (3) improving the resolvability of large and complex banks. A substantial national and European policy agenda is focused on addressing these challenges. Examples include the strengthening of buffers in line with Basel III and CRD IV, national capital buffers for systemic relevance, the Single Resolution Mechanism (SRM) and the European Bank Recovery and Resolution Directive (BRRD), the European Commission's proposal to separate proprietary trading activities and a greater focus on the integrity and transparency of banks and supervisors. However, no matter how important good supervision and effective resolution are, they alone will not make the banking sector safe.[2] There is a range of factors, such as taxes and prudential regulation, but also financial and technological innovation (see Box 1), that influence the structure of the Dutch banking landscape. This structure, in turn, has consequences for the stability and efficiency of banking services.

This vision paper focuses on the structure of the Dutch banking sector, within the context of the European banking union. The analysis not so much focuses on the structure of banks themselves – such as capitalisation and resolvability – but is primarily concerned with the structure of the sector as a whole.[3] The creation of the banking union and the BRRD are important steps towards a transfer of sovereignty and risk to the European level. This raises the question: which perspective for an analysis of banking sector structure is correct – Dutch or European? The banking sector is in a transitional phase, with the correct perspective depending on the issue at hand. From the customer's perspective, the relevant perspective is often still national. Furthermore, the European resolution framework has not yet been tested in practice. Different approaches of countries in such fields as

2 Good supervision is, among other things, intrusive, conclusive and adaptive. See DNB (2010), Van analyse naar actie (Dutch only), and Viñals and Fletcher (2010), The Making of Good Supervision: Learning to say No.

3 This is why the European Commission's proposal to separate proprietary trading, which would primarily affect the structure of banks themselves, is not considered.

consumer protection, insolvency legislation and tax law are and remain obstacles to a fully integrated European banking market. As integration of the European market for banking services progresses and as there is greater risk-sharing in, for example, the resolution of banks, this perspective can, however, gradually shift towards the European level.

The nature of this report is expressly normative: developments are not just identified, but assessed and followed-up with policy recommendations. Its purpose is not to design a blueprint for the 'optimum' sector structure. However, by identifying shortcomings within the current sector structure and putting forward a desirable direction, it can guide the formulation of policy and decision-making in supervision and regulation. As such, this paper makes grateful use of the many documents recently published on this topic, such as the Cabinet's Perspective on the Dutch Banking Sector, the report of the Wijffels Commission, DNB's Supervisory Strategy 2014-2018 and academic literature.

For ease of reference

Chapter 1 describes the current structure of the Dutch banking sector. This description focuses on (1) the size of the banking sector, (2) the market shares of individual banks, (3) the diversity of the sector and the diversification of banks, (4) foreign banks in the Netherlands and (5) Dutch banks abroad. Although these features are examined individually, we also consider their interaction. Chapter 2 offers an assessment of the development of this structure based on two criteria: stability and the efficiency of banking services. Chapter 3 concludes with principles for policymaking that can help guide the sector's structure in the right direction.

Box 1 Technological innovation and the structure of the banking sector

Technological innovation can be an important force for change in the structure of the banking sector. The influence of technologically innovative companies such as Amazon, Airbnb and Uber is growing. This raises the question what impact such developments will have on banking services. In recent years, there has been much innovation in the area of financial services. Examples include new payment methods (PayPal, Apple Pay and payment by mobile phone), new forms of credit (peer-to-peer lending, crowdfunding and micro credit), digital currencies (Bitcoin) and developments in the area of data management and use (cloud computing and the application of big data). These developments are progressing fast, and in some countries, especially the United States, they are increasingly commonplace.

One possible consequence of technological innovation is an increase in competition in the financial services market as entry barriers are lowered. Increasing digitisation reduces start-up costs for some new competitors because large investments in physical infrastructure (e.g. office space) are no longer required to provide financial services. By using new technology it can as such become attractive for small parties to offer services traditionally offered by banks. Furthermore, for some of these services, such as payment services, no banking authorisation is required, making these players fall within a 'lighter' supervisory regime. Alongside new start-ups, existing technology companies, such as Apple and Google, have also set up payment and other services, on the basis of their existing infrastructure. Some of these services rely on existing bank or credit card accounts (PayPal, Apple Pay), but other providers offer their own payment accounts, operating entirely outside the banking sector. In the former case, there is competition with banks for the profits on payment services; in the latter case there is also competition for deposits.

Other examples of financial services that are taking off on the back of technological innovation are new sources of lending, such as peer-to-peer lending and crowdfunding. At present, these services are very small in scale, but they are growing rapidly and will gain market share over time. Note that, in principle, it is also possible for banks to act as intermediaries on crowdfunding platforms, earning commissions through this form of lending, without incurring any credit risk.

In response to these developments, DNB has launched a study aimed at identifying and analysing the most significant technological innovations and their consequences for the business models and strategies of Dutch financial institutions. This study will involve interviews with various banks, insurance companies, investment firms and payment institutions, as well as other experts and fellow supervisors in the Netherlands and abroad. The results of the study will be shared with the sector towards the end of 2015.

1 Current sector structure

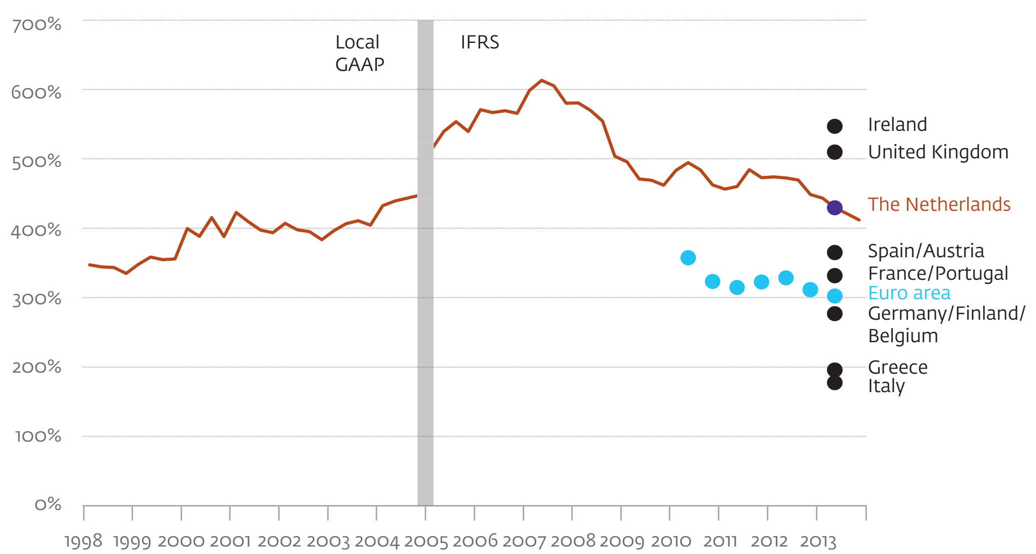
1.1 Size of the banking sector

Since the start of the crisis, the total size of the Dutch banking sector has decreased. Nevertheless, the sector remains large in proportion to the size of the economy from both a historical and an international perspective. Chart 1 shows that the total size of the banking sector equals over four times the value of gross domestic product (GDP). This is rather high from a historical perspective. By comparison, the Dutch banking system equated to around 100% of GDP at the end of the 1970s. Although the strong growth of the banking sector was a phenomenon experienced throughout the western world, the Dutch banking sector is large from an international perspective as well.

The steady growth of the sector since the end of the 1990s is largely due to growing mortgage portfolios, whereas increasing trading portfolios, among other factors, explain the peak at around the time of the crisis (see Chart 2). By the end of the 1990s, total mortgage portfolios (including foreign mortgages) stood at around 70% of GDP and have since grown to almost 120%. This growth is much greater than that in other private sector

Chart 1 Balance sheet total of the Dutch banking sector from a historical and international perspective

Quarterly figures; expressed as a percentage of gross domestic product

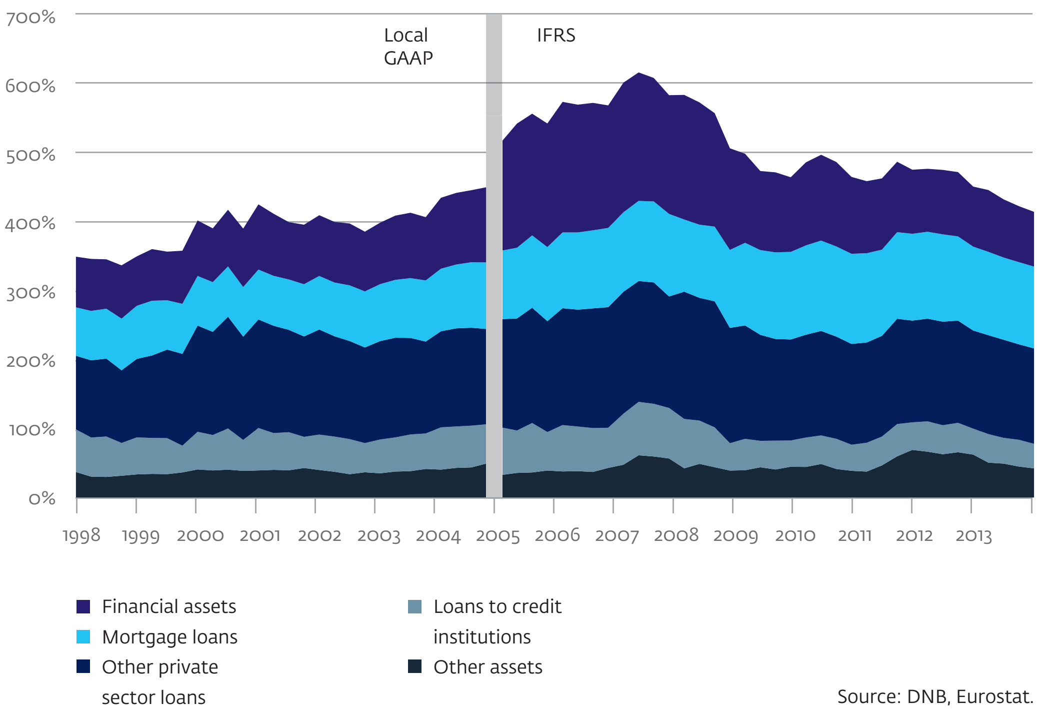


Source: DNB, ECB, Eurostat.

Note: 2005 shows a break in the series as a result of the transition from local GAAP to the IFRS accounting regime.

Chart 2 Composition of the asset side of the Dutch banking sector from a historical perspective

Quarterly figures; expressed as a percentage of gross domestic product



Source: DNB, Eurostat.

Note: 2005 shows a break in the series as a result of the transition from local GAAP to the IFRS accounting regime.

loans which, over the same period, increased from around 105% to 135% of GDP. The peak in the size of the sector shortly before the crisis is explained by the strong growth in financial assets that include, inter alia, trading portfolios. Although this category accounts now, as it did at the end of the 1990s, for slightly less than 80% of GDP, at the start of 2006 it peaked at as much as 190% of GDP. The transition to the IFRS accounting regime accounts for around 40 percentage points of this increase. In particular, derivatives played a dominant role within this category. The peak in the size of the sector coincided with the peak in foreign activities, particularly in Europe and the United States.
This expansion was a European phenomenon: the banking sector within the euro area (especially the twenty largest banks) grew strongly in the years preceding the crisis, during which its foreign claims roughly tripled. Dutch banks have since reduced their financial assets and foreign activities at a rapid pace (see also section 1.5).

As a proportion of the sector's combined balance sheet total, mortgages form the largest asset category. Currently, mortgages represent 36% of the sector's balance sheet total. By comparison, loans to large enterprises account for just 16% of the balance sheet total and loans to small businesses for just 9%. Together, derivatives and the investment portfolio account for 16%.[4]

Competition from non-bank market participants may lead to a downsizing of the banking sector, but this effect is small for the time being.
The stricter standards that banks must comply with since the reform of the regulations and the introduction of European supervision, and the changes to their funding strategy (see Box 2), sometimes work to reduce their share in the lending market to the benefit of other parties. The growing role of insurance companies in the market for mortgage lending is one example of this effect. Furthermore, the loss of confidence in the banking sector resulting from the crisis is encouraging new players to get involved in traditional banking activities. A frequently-cited example is that of investment funds or credit unions set up to finance SMEs. Larger enterprises, in turn, could reduce their dependence on bank credit by raising more funds on the financial markets. Crowdfunding is another activity that may reduce the roles of banks in the future. In terms of size, these types of initiatives are still limited, but they do illustrate how banks nowadays compete not only with each other, but also with non-bank market participants.

4 Cash (4), inter-bank loans (5), reverse repos (8) and other (6) make up the remaining 23%.

Box 2 Is a larger sector balance sheet harder to finance?

The large size of the banking sector is sometimes related to the ability to fund the balance sheet, for example, with regard to the mortgage portfolio. Due in part to the size of this portfolio, banks are highly dependent on wholesale funding. However, the conditions under which this funding is offered vary over time.

When professional market participants lend to a bank, they look primarily at the balance between risk and return on their loans. This risk is currently higher than before the crisis due to lower economic growth and a reduction in state guarantees resulting from improved resolution frameworks. Furthermore, the risk tolerance of investors has decreased, so that they require higher interest rates on their loans. Prior to the crisis, investors were satisfied with much lower risk premiums, and banks made increasing use of short-term funding to fund their mortgage portfolios, for example. In this way, they could reduce their lending rates, so that consumers could take out mortgages with high loan-to-income and loan-to-value ratios and low interim repayments, for the same monthly cost. The higher willingness of individual banks to increase their dependence on short-term wholesale funding thus facilitated a rapid growth of the sector as a whole.

The above illustrates how the current funding problems of banks are the flip side of the funding advantages they enjoyed prior to the crisis. These problems constitute the materialisation of the liquidity risks to which banks increasingly exposed themselves in good times. This willingness to increase liquidity risks can stimulate balance sheet growth, but also banks with small balance sheets can expose themselves to large liquidity risks. The preferred way to prevent bank funding problems in the future and help rein in unsustainable balance sheet growth, is therefore to guarantee by means of liquidity supervision that banks in good times already acquire sufficient long-term funding, rather than becoming overly reliant on short-term funds. The European liquidity standards set out in CRD IV are an important step in the right direction, while the higher standards for capital buffers also limit the risk of sudden funding problems.

1.2 Market shares of individual banks

The Dutch banking sector is characterised by a small number of very large institutions enjoying big market shares. Judging from the shares of the five largest banks in the country's consolidated balance sheet total, the Netherlands has one of the most concentrated banking sectors in the euro area (see Chart 3, on page 18). This is a separate issue from the size of the sector itself: at any rate in the EU, no direct relationship is observed between the size of the sector and the shares of the five largest banks in each country.

The dominance of the big banks is also demonstrated by their large shares in the markets for domestic banking services. In terms of amounts outstanding, Rabobank, ING and ABN Amro control 60% to 80% of the banking markets for mortgages, business loans and savings. In fact, their combined market share in bank mortgage lending has grown since the start of the crisis. In the market for loans to non-financial corporations (including the government), the combined share of the three big banks has remained constant throughout this period. However, concentration rates can vary considerably across segments of this market: for example, the three big banks' combined share in the SME market segment is considerably higher.

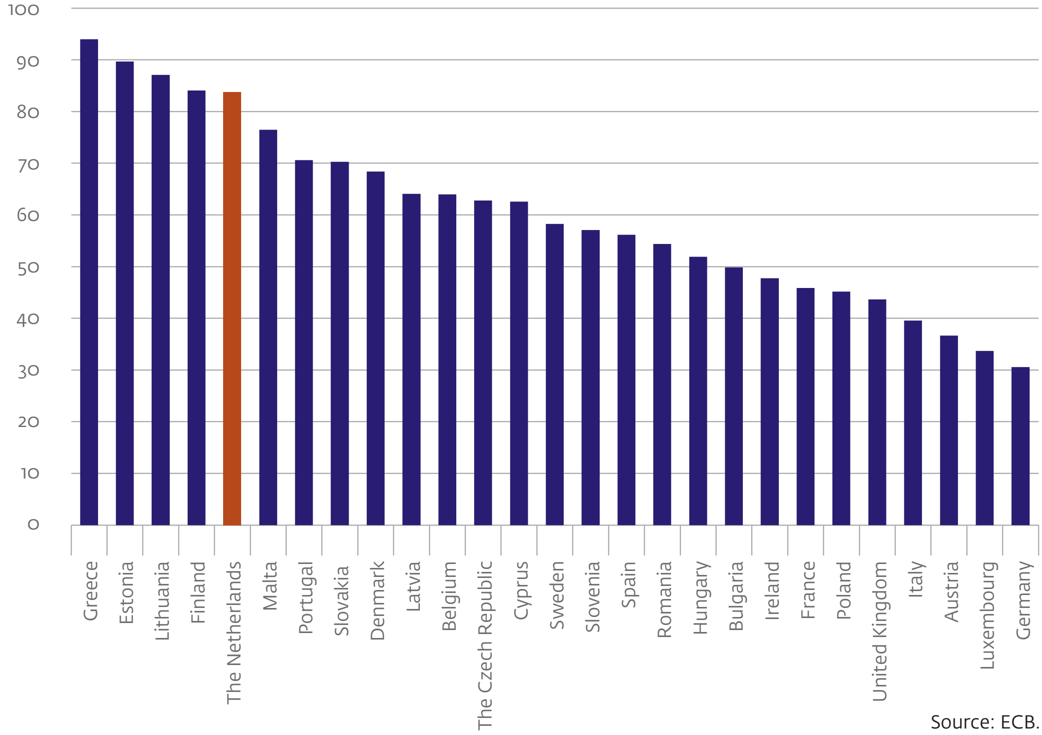
The origin of the high concentration within the Dutch banking sector is mainly to be found in the mergers that took place at the end of the 1980s and early 1990s. During the 1980s, the Dutch banking sector consisted primarily of six medium-sized banks (Postbank, NMB, ABN, Amro, VSB and Rabobank). In a relatively short space of time, this structure changed significantly as a result of mergers and acquisitions, which to a large extent were motivated by the idea that the national market was too small to be able to compete on an international scale. In some markets, this high concentration has further increased over recent years as a result of providers having disappeared or having been taken over, partly due to the financial crisis. For example, Fortis combined with ABN Amro, Friesland Bank was taken over by Rabobank, and market conditions forced SNS to greatly downscale its mortgage business. Foreign players such as Deutsche Bank and RBS entered the Dutch market, but have since reduced their focus on this market or withdrawn altogether. In recent times, the trend towards concentration in the mortgage market appears to have reversed as a result of increased competition from the insurance sector. While the share of insurance companies in outstanding household mortgage debt is still comparatively small, their share in new mortgage loans has risen significantly to approximately 20% in 2013.[5]

5 The growth in the market share of insurance companies is also confirmed in a study by the Authority for Consumers and Markets (2013), Concurrentie op de hypotheekmarkt, *Monitor Financiële Sector*, April.

Small banks operating in the same markets as the big banks are at a disadvantage. They enjoy more limited scale economies and do not benefit from the implicit government subsidies enjoyed by banks that are considered too big to fail. Table 1 illustrates how the likelihood to receive state support provides big banks with a funding advantage, as it increases their credit ratings. For most banks, this increase is equal to one notch; for ABN Amro it is as much as two. In practice, the funding advantage is even greater because the autonomous credit ratings shown in the table concern profit margins, capitalisation levels and market positions as a given, so to speak, even though without this funding

Chart 3 Concentration of Dutch banking sector from a European perspective

Annual figures 2013; share of the five biggest banks in the sector's aggregated balance sheet total

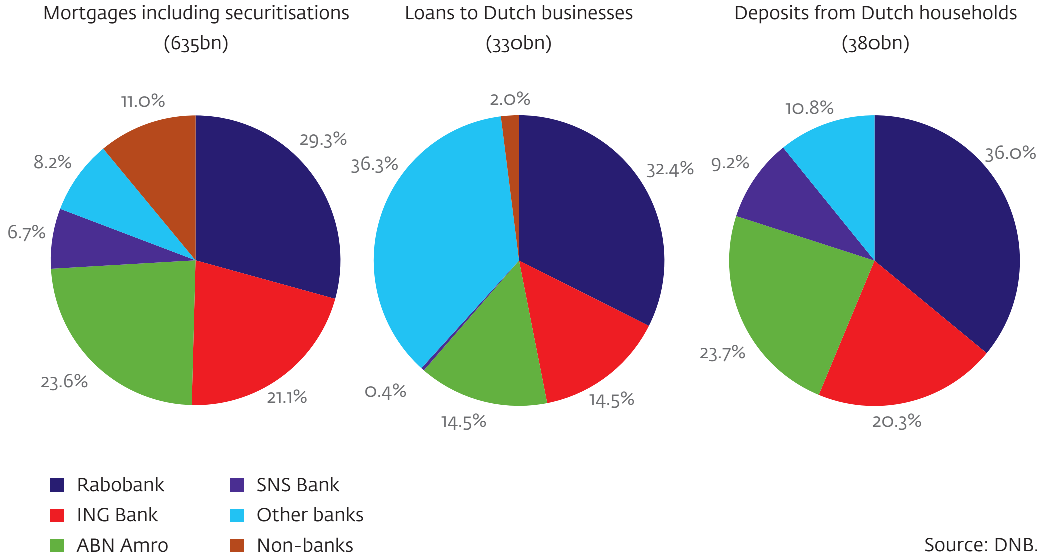


Source: ECB.

advantage these could only have been achieved with greater difficulty, if at all. A recent study by Statistics Netherlands (CPB) estimates the direct funding advantage during the crisis for banks with a balance sheet bigger than 10% of GDP at 67 basis points, and at 121 basis points for global systemically important institutions.[6] The IMF estimated the advantage in 2013 at between 60 and 90 basis points for systemically important banks (SIBs) within the euro area. This is more than in Japan and the UK, and significantly more than in the United States.[7] It is anticipated that future implementation

Chart 4 Market shares in domestic banking services

Figures per year-end 2013; outstanding amounts as a percentage of the whole



Source: DNB.

Note: Securitisations are attributed to the issuing bank

6 See Bijlsma, Lukkezen and Marinova (2014), Measuring too-big-to-fail funding advantages from small banks' CDS-spreads, *CPB Discussion Paper* 268. Although the existence of funding advantages for big banks is widely acknowledged in economic literature, the estimates for the precise magnitude of this advantage still diverge. See also Box 6, which examines how funding advantages lead to an oversupply of banking services.

7 See the analysis of the International Monetary Fund (2014), How big is the implicit subsidy for banks considered too important to fail?, *Global Financial Stability Report*, p. 101-32.

Table 1 Increase in S&P credit ratings due to implicit government guarantees

	Autonomous rating	Increase	Total
ABN Amro Bank N.V.	BBB+	2	A
ING Bank N.V.	A-	1	A
SNS Bank N.V.	BBB-	1	BBB
Rabobank N.V.	A	1	A+

Source: S&P.

Note: Credit ratings increase in line with the likelihood of government support in the event of a bank's instability.

of the resolution framework and the new standards governing systemic importance buffers and other loss-absorbing capacity will reduce this funding advantage, since they add credibility to the claims by governments that they will cease future support to ailing systemically important banks.

1.3 Diversity and diversification

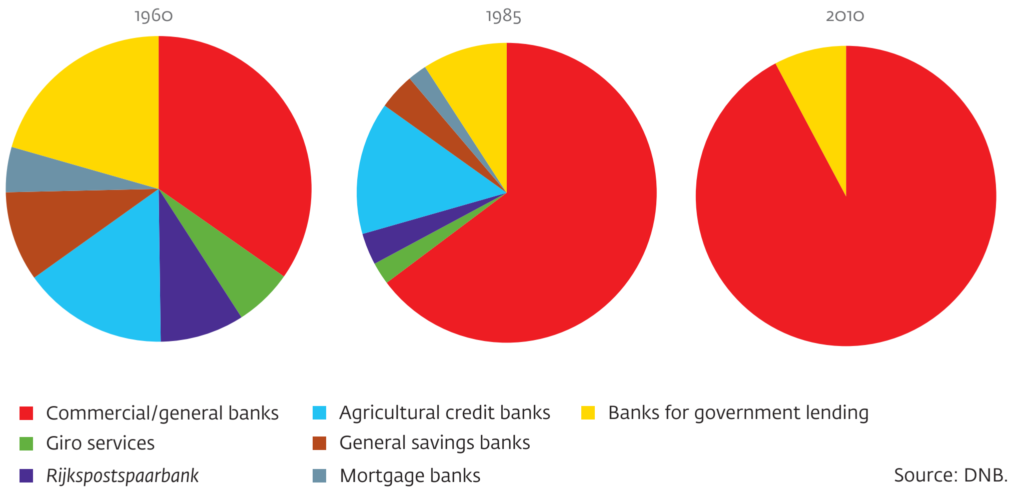
Over the last few decades, the Dutch banking sector has become more homogeneous. Fifty years ago, the sector was still divided into clear segments, such as those of commercial banks, savings banks and mortgage banks (see Chart 5). Savings banks focused on attracting savings that they subsequently invested in safe investments, such as government bonds and mortgages. Mortgage banks funded themselves directly on the capital market, issuing bonds and covered bonds. The differences between the banks partly stemmed from the differences in regulation and supervision.[8] There was also greater geographical segmentation: the activities of a savings bank or mortgage bank in the region of Twente had little influence on those of a competitor in the province of Zeeland. This made the Dutch banking system diverse, but also monopolistic.

Through mergers and acquisitions, the dividing lines between the segments in the sector became blurred, with commercial banks developing into universal banks. This was in line with developments in the real economy. Dutch businesses were growing in size and needed more financial services. Alongside this, the demand from Dutch households for

8 In this way, banks providing public sector loans derived their right to exist from the statutory restrictions on local government to attract funds from the capital market. Furthermore, supervision was not the same for all segments within the sector: some categories were not initially under DNB's supervision. The National Post Office Savings Bank *(Rijkspostspaarbank)* was under the supervision of the Ministry of Transport, Public Works and Water Management, while the savings banks were supervised by the Association of Savings Banks *(Spaarbankbond)*.

Chart 5 Structure of the Dutch banking sector, 1960-2010

Percentages of the aggregated balance sheet total



Source: DNB.

consumer products – savings accounts, mortgages, payment services – also increased. In addition, banks were confronted by the limits set by a segmented system; commercial banks had ever greater difficulty in securing funding on the financial markets, as a result of which they sought to attract savings, while savings banks faced a growing demand from their customers to provide payment services. From the 1980s onward, the process of harmonisation and consolidation quickly gathered momentum, resulting in mergers and acquisitions, and the formation of financial conglomerates. Consequently, the sector structure has become significantly less diverse, as illustrated in Chart 5, although commercial banks can of course still differ from one another.

Over the last few years, the trend towards universal banking has gone slightly in reverse. Since the crisis, Dutch banks have been concentrating more on their core activities, for example by divesting their real estate and insurance activities and focusing more on the Dutch domestic market. In addition, they have placed more focus on traditional lending and less on such activities as investment banking. Their withdrawal from foreign markets may also be seen as geographical specialisation. The focus on core activities is partially a consequence of state support measures during the crisis, reflecting, for instance, remedial actions required by the European Commission. In other cases, this focus comes with the sale of business units to shore up solvency, or reflects a fundamental choice in favour of a simpler business model.

So far, the banks' increased focus on core activities has not made the banking landscape more diverse. Firstly, the development remains modest. For the big banks, being a universal bank offering a wide range of products and services to a range of customer segments will remain the predominant business model. Secondly, it appears relevant that all banks are specialising more or less in the same direction: withdrawals from foreign markets, investment banking and commercial real estate can be seen across the board, albeit with differing degrees of intensity, such that, for example, the extent of geographical spread currently differs. However, there will be no truly diverse banking landscape until banks start to specialise in different activities.[9]

1.4 Foreign banks in the Netherlands

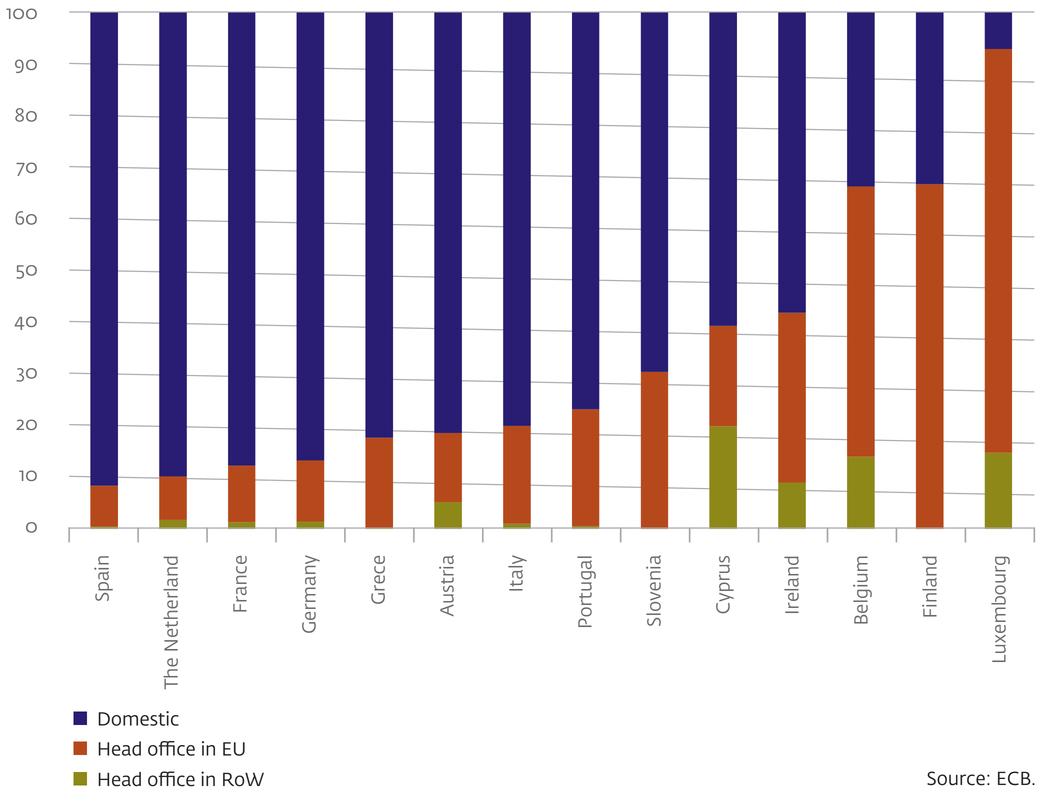
Foreign banks play a limited role in the Dutch banking sector. The Netherlands is almost top of the league in Europe when it comes to the dominance of its domestic players (see Chart 6). Recently, the share of foreign players has increased somewhat due, for example, to the break-up of ABN Amro (RBS, Deutsche Bank). Nevertheless, foreign players are scarce in the Dutch market, at a level more or less similar to that in Spain, Germany and France. Approximately 10% of Dutch banking assets are held by foreign players, of which approximately 85% originate from the EU and 15% from outside the EU. The largest foreign banks are RBS, Lloyds Bank, Deutsche Bank and Credit Europe Bank. RBS has meanwhile announced its intention to discontinue most of its activities in the Netherlands.

There are indications that the limited role of foreign participants in the Dutch market is caused by a combination of the high concentration rate and the perception that the Netherlands is a difficult market. For foreign entrants, it is difficult to secure a position in a concentrated market. The risks they need to take to get a foot in the door (i.e. providing relatively risky mortgages funded at short maturities) have during the crisis led to the end of their business model. In addition, the Netherlands may be a difficult market for foreign players for other reasons too. The provision of mortgages is characterised by high loan-to-value-ratios at a time – until recently – of falling house prices, a combination that may be looked at with suspicion by foreign players, whereas, for example, Dutch insurance companies decided to venture into this market. In addition, SMEs face problems of ageing population and solvency, which puts creditworthiness under pressure. Furthermore, some foreign players decided to withdraw due to

9 See also Arnoud Boot - *Banken echt niet gezond na deze stress test* (This stress test shows banks to be anything but healthy, Dutch only) in: NRC Handelsblad, 28 October 2014: 'The Netherlands offers a perfect example of how not to do it. Before the crisis, the large financial institutions were becoming to look like each other and were taking comparable risks, and when the crisis hit they were damaged in the same way. (...) Greater diversity is desirable to prevent one bank from exacerbating the problems of another. In the United States local, more grass-roots banks, create such diversity.'

Chart 6 The role of foreign banks in European national markets

Combined share of foreign banks; percentage of the domestic market in 2012.



Source: ECB.

developments in their domestic markets. Lastly, a further consideration for foreign entrants is that the lower profitability and limited prospects for growth of the European banking market make it less attractive than, for example, emerging economies or the United States.

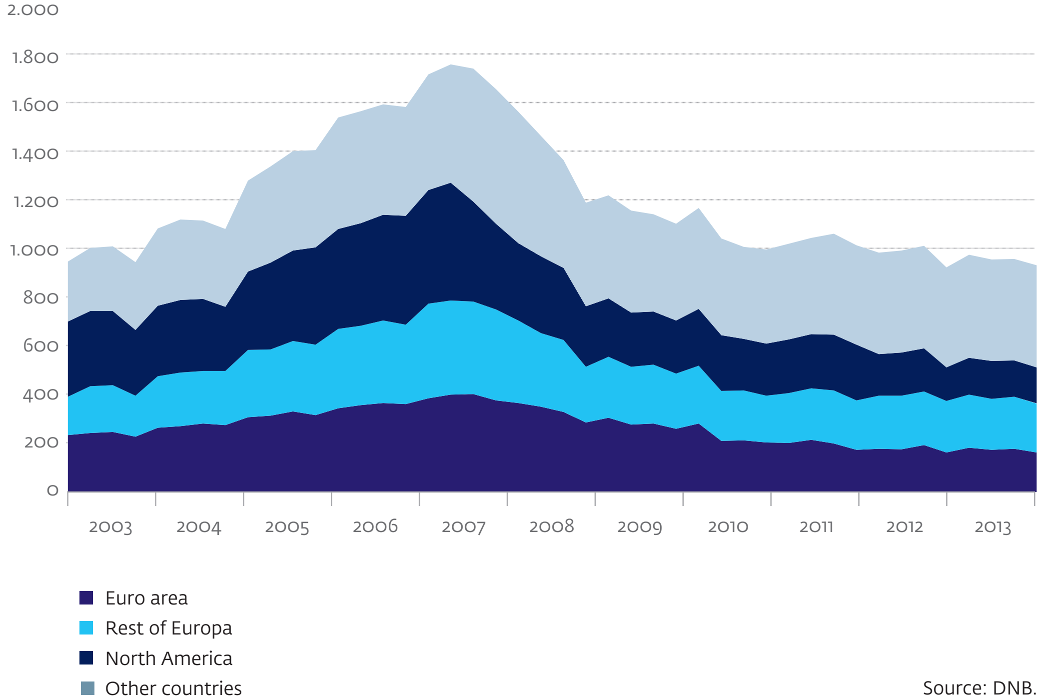
1.5 Dutch banks abroad

The activities of Dutch banks abroad have been significantly curtailed since the start of the crisis. Since the peak in 2007, such activities have been approximately halved. This is partly the result of the sale of ABN Amro's foreign business units, and partly due to a general retrenchment in the Dutch market, whether or not dictated by the measures imposed by the European Commission. Currently, these activities account for approximately 40% of the consolidated balance sheet total (see Chart 7).

Half of foreign lending comes from foreign business units, the other half from the Netherlands. Both cross-border and local debt claims rose strongly in the run-up to the crisis, dropping rapidly in the years thereafter. The direct, cross-border debt claims of Dutch banks (approximately 20% of the consolidated balance sheet total) form a fairly heterogeneous group, consisting of, for example, loans from ING Nederland to companies in Germany and Portuguese government bonds. The category of local debt claims (approximately 20% of the consolidated balance sheet total) forms a reasonable approximation of the foreign activities through local subsidiaries and branches (see Box 3 for a short description that applies to the three big banks). The trend in cross-border debt claims is more volatile than that in local ones. While the

Chart 7 Debt claims of Dutch banks against non-residents

Quarterly figures; amounts in billions of euros.



Source: DNB.

rise and fall of the local foreign branch was mostly a phenomenon in the United States (ING Direct, La Salle), it were mostly the European dynamics that dominated cross-border debt claims. The largest percentage falls of these relate to investments in Iceland and the GIIPS countries (Greece, Italy, Ireland, Portugal and Spain). The biggest absolute fall concerns the United Kingdom.

Box 3 What are the local activities of Dutch banks abroad?

ABN Amro is relatively firmly focused on the Dutch market. Although it has a presence in 22 countries, only 18% of its operating income is earned abroad. In terms of the balance sheet total, the proportion that is from abroad is less than 10%. Its foreign activities consist of private banking in a select group of European and Asian countries, specialised lending such as in Energy, Commodities & Transportation, Commercial Finance & Lease, and international clearing activities. ABN Amro has modest ambitions for foreign growth (20% to 25% of operating income), to be achieved mainly through organic growth of its current activities in the existing network.

ING is the most internationally oriented Dutch bank: two-thirds of its assets are related to foreign activities. Of those foreign activities, 80% are within Europe, especially Belgium and Germany, but to a smaller degree the UK, Poland, and Spain are also significant. ING offers a global network of commercial banking services. Within Europe, ING offers traditional, full-scope banks (Netherlands, Belgium, Poland and Turkey), as well as direct retail banks (Germany, Spain, Italy, and France). Diversification and providing support to Dutch companies operating abroad are important strategic considerations.

A little under 25% of Rabobank's activities are undertaken abroad. A large part of its foreign business is conducted in the United States and Australia and focuses on consumers and the agricultural sector, alongside the international leasing activities of the Rabobank subsidiary De Lage Landen. In addition, Rabobank has an international branch network that lends to businesses and the agricultural sector and provides support to Dutch enterprises operating abroad. Its activities in Poland have been sold, while part of those in Ireland are being discontinued.

2 Assessment of sector structure developments

The desirability of a development depends on whether it increases the stability of the provision of banking services. The term 'stability' here refers to the capacity of the sector to adequately maintain the level of service to its customers even in times of crisis, without requiring government support to do so. Also during an economic downturn, creditworthy consumers and businesses should be able to obtain loans, and deposit holders should not have to worry about the safety of their savings. If lending is excessively reduced, or if the safety of the savings of many consumers becomes uncertain, this exacerbates the economic downturn. To maintain the stability of banking services during crises, lending practices during economic upswings have to be sustainable as well. Guaranteeing the stability of banking services therefore is a core task of prudential supervision.

Furthermore, a development is more desirable if it increases the efficiency of banking services. An efficient banking sector offers products such as loans and deposits at reasonable, cost-effective charges, and through continuous innovation aims to keep these costs as low as possible. In this way, the needs of consumers and businesses for loans and deposits are supported in the best way possible, so that the banking sector optimally contributes to economic growth and social welfare. Ideally, any change in the structure of the sector increases both stability and efficiency of banking services. Box 4 explains the interrelationship between these two goals.

Developments in the structure of the Dutch banking sector must be assessed in the context of the introduction of the European banking union. Box 5 explores the introduction of this union in more detail, which increases both the stability and the efficiency of banking services. The union thereby represents an important step in the right direction, even though it is no panacea for fundamental defects in the structure of the sector.[10] Any developments in this structure that threaten the stability or efficiency of banking services therefore remain undesirable.

10 Cavelaars, De Haan, Hilbers, and Stellinga (2013), Key challenges for financial supervision after the crisis, *Webpublicatie* 71, Wetenschappelijke Raad voor het Regeringsbeleid, also conclude that supervision is no guarantee against instability, so that supervisory authorities must also think pro-actively about the future structure of the sector.

Box 4 Stability and efficiency of banking services: trade-off or add-on?

The objective of simultaneously enhancing stability and efficiency of banking services presupposes that both goals are in fact compatible. This issue has been extensively analysed in economic literature.[11] However, this research offers no definitive answer to the question whether stability and efficiency tend to reinforce or undermine each other. Aside from the complexity of the subject, the absence of a clearly observable relationship between both may be explained by the role of banking regulation and supervision: a highly competitive yet properly regulated sector may be more stable than a weakly competitive sector in which regulation and supervision are more lax. This conclusion is shared by the Committee on the Structure of Dutch banking (*Commissie Structuur Nederlandse Banken*): with adequate regulation and effective supervision, stability and efficiency can be compatible.

11 One of the first contributions to this debate is the work of Marcus (1984), Deregulation and bank financial policy, *Journal of Banking & Finance* 8, pp. 557-65, which argues that efficient banks make less excess profits and therefore have less reason to secure the continuation of their business. By contrast, the more recent work of Boyd and De Nicolo (2005), The theory of bank risk taking and competition revisited, *Journal of Finance* 60, pp. 1329-43, argues that efficient banks charge lower rates of interest on their loans, so that their borrowers are better able to meet their repayment obligations.

Box 5 The influence of the European banking union on stability and efficiency

The stricter European requirements for buffers and bank resolvability (CRD IV and BRRD), together with the harmonised European supervision of compliance therewith (SSM and SRM), aim to increase the stability of banking services. Banks with higher capital and liquidity buffers are better protected against economic decline and have a greater interest in the proper management of their risk profile (more skin in the game). Should a bank nevertheless become unstable, its improved resolvability means that its liquidation will have a less disruptive influence on the rest of the economy.

Higher buffers, improved resolvability and European supervision will significantly reduce the risk that banks must ever be given state support. As a result, distortionary funding advantages of big banks will be reduced, inefficient banks will face a greater likelihood of being driven from the market by competitive pressures, and the prospects for small banks and new entrants will be improved. Together with the European harmonisation of bank supervision, which lowers the thresholds for cross-border banking, these effects increase competition between banks, so that their service provision becomes more efficient.

Despite its positive influence, the introduction of the banking union is no panacea for unstable or inefficient banking services. The direct and indirect costs of supervision will increase, which will possibly raise the entry barrier for smaller players. Furthermore, the resolution instruments are new and have not yet been tested in practice, and therefore, under extreme circumstances, rescue operations and the nationalisation of systemically important banks by individual Member States cannot be ruled out entirely. It is therefore necessary to guarantee the stability and efficiency of banking services also without the need for government intervention. Hence, after the introduction of the European banking union, it will remain important to assess whether developments in the structure of the sector contribute to this objective, or indeed hinder it.

2.1 Size of the banking sector

A large, or fast-growing, sector may indicate that the stability of banking services is under pressure. The reason for this is that an increase in banks' risk-appetite often leads to growth in bank lending. If this growth is enabled by increasing leverage, falling risk premiums, and abundant availability of liquidity, the large size of the sector soon becomes an indicator of an increased risk of instability.[12] During the crisis, Iceland and Ireland proved to be the clearest examples of this, but since the 1990s in the Netherlands, too, banks have been relaxing their mortgage lending standards by extending larger loans in proportion to the value of the home and the income of the lender, and by requiring smaller interim repayments. This development spurred growth of the banking sector as a whole. If extending such higher mortgage loans is partly facilitated by higher leverage and by reliance on the continuous availability of short-term market funding, the growth of the mortgage loan portfolio goes hand in hand with increasing solvency and liquidity risks. The relatively high loan-to-deposit ratios of Dutch banks illustrates this effect.

The banking sector can become inefficiently large in size due to tax-related and other market distortions. A causal relationship between the size of the banking sector and the efficiency of banking services is difficult to establish. Nevertheless, the factors underlying growth in the size of the sector can also give rise to social welfare costs. In this respect, tax incentives play an important role. For example, the deductibility of interest payments increases the demand from companies for business loans and from consumers for large mortgages, thereby stimulating bank lending. Likewise, the deductibility of interest payments reduces the cost to banks of providing these loans, because banks' interest expenses for funding their lending operations can be deducted as well. Alongside tax incentives, other market distortions, such as implicit or explicit government guarantees and limited risk awareness among consumers, increase the probability that the banking sector grows inefficiently large (see also Box 6).

12 European Systemic Risk Board (2014), Is Europe overbanked?, *Advisory Scientific Committee Report*, February 2014, also establishes a connection between an increase in size of the banking sector and a reduction in stability. See also the conclusions of Schularick and Taylor (2012), Credit booms gone bust: monetary policy, leverage cycles and financial crises, 1870-2008, *American Economic Review* 102, pp. 1029-61.

Box 6 Do more banking services lead to more economic growth?

A long-standing consensus was that a larger financial sector contributes more to economic growth. Thus, for example, a well-developed financial system improves the corporate sector's access to finance, so that it can produce its goods and services at lower costs.

Recent studies of the BIS and the IMF suggest, however, that once it gets to a certain size, the financial sector becomes an impediment to economic growth.[13] For instance, in a large banking sector, more products could be supplied that contribute little to the real economy: an example of this is the American subprime mortgage. And if these products are highly profitable, they enable banks to pay higher salaries and thereby drain personnel from the rest of the economy.[14] Once it gets beyond a certain size, a financial sector continues to contribute to economic growth, but to a lesser extent than when it was still smaller. Although this argument sounds plausible, it appears that the initial empirical results are sensitive to changes in the sample and in the method of analysis.

A useful starting point in this debate is the economic consensus that activities need only be subsidised if they would otherwise be less available than is socially desirable. If not, then subsidies stimulate oversupply and lead to lower welfare. Dutch banks profit from an abundance of such subsidies, arising largely from tax regulations (see also Figure 1). Examples include i) increased demand for credit from businesses due to the deductibility of interest payments on debt funding; ii) increased demand for credit from consumers due to mortgage interest relief (which is currently being reduced), the national mortgage guarantee and

13 See Cecchetti and Kharroubi (2012), Reassessing the impact of finance on growth, *BIS Working Paper* 381, and Arcand, Berkes and Panizza (2012), Too much finance?, *IMF Working Paper* 12/161. Both studies are frequently cited in economic literature and policy discussions on the future of the financial sector.

14 See Kneer (2013), The absorption of talent into finance: evidence from U.S. banking deregulation, *DNB Working Paper* 391, and Kneer (2013), Finance as a magnet for the best and brightest: implications for the real economy, *DNB Working Paper* 392.

first-time buyer schemes; and iii) increases in the overall demand for banking services due to the VAT exemption.[15]

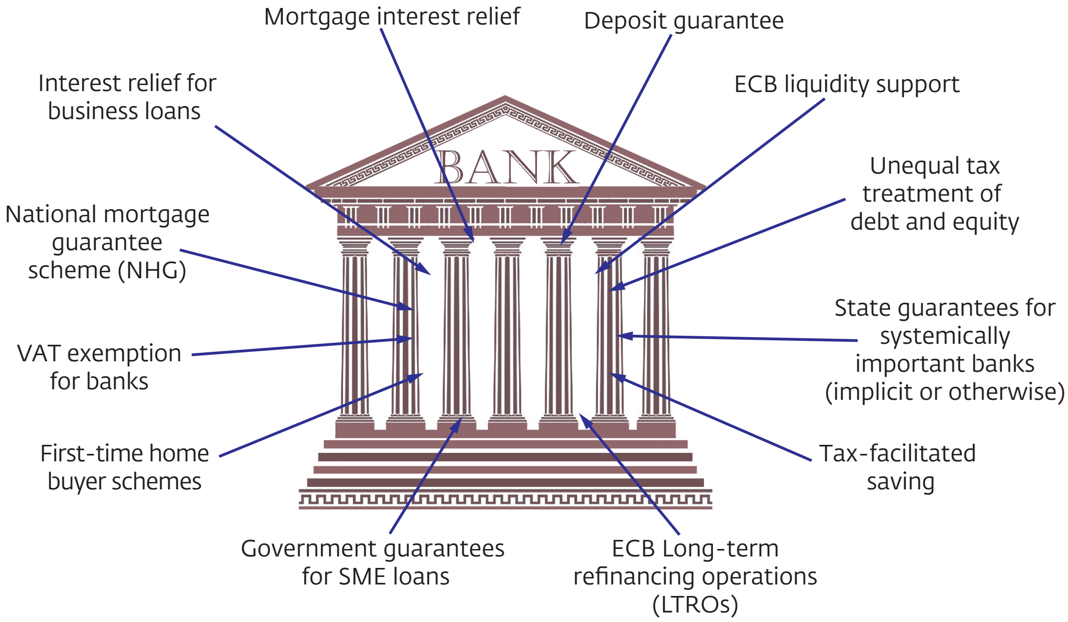
Alongside these types of subsidies, a limited risk awareness and information problems arising from the complexity of products also stimulate the demand of, for example, consumers for mortgage loans and unit-linked insurance policies, or the demand of housing corporations for interest-rate derivatives. The supply of banking services is further stimulated by the fact that big banks are able to offer services at lower costs due to the funding advantages they derive from the prospect of capital and liquidity support in the event of instability. Also, the deposit guarantee scheme enabled small banks to attract savings during the crisis against relatively low interest rates. The large size of the banking sector relative to the economy is partly the result of these sorts of inefficiencies (with the bank tax as a limited compensating factor). The solution to this lies, however, not in restricting the size of the sector *per se*, but in removing the subsidies and information problems that are the cause of it. In this regard, the progressive reduction in mortgage interest relief and the reduction of the loan-to-value ratio on new mortgages are steps in the right direction.

The European banking union can lead to further growth of the Dutch banking sector. If the banking union leads to banks competing more at an international level, due to the removal of geographical barriers, the price of their services will fall and demand for them will increase. In addition, the integration of the European banking market can trigger a wave of mergers and acquisitions. This would not increase the banking sector at a European level, but if Dutch banks are the ones making the acquisitions due, for example, to their relatively large size, then the national sector will grow. On the other hand, the banking union will mostly lay the costs of a bank liquidation at the door of the bank's financiers, meaning that state guarantees are reduced, so that banking services will become more expensive. Therefore, the banking union may also dampen the growth of the sector.

15 See Bettendorf and Cnossen (2014), Bouwstenen voor een moderne btw, *CPB Policy Brief* 2 (Dutch only).

A large sector increases the interests of society in stable and efficient banking services. For example, Dutch consumers mostly put their savings in bank accounts rather than in credit unions or money market funds, so that any instability in the banking sector will have direct consequences for the access of households to their savings (Box 7 considers whether a greater role for non-banks would be desirable). Furthermore, SMEs are heavily dependent on bank lending. Given that Dutch households largely finance the purchase of their homes by means of bank mortgages, measures that restrict bank competition, such as the European prohibition on price leadership of banks that were given state support, result in relatively high costs for the purchase of a home. Due to its large dependence on banking services, Dutch society can afford less instability and fewer inefficiencies in this service.

Figure 1 Taxation and other government policies contributing to an enlarged banking sector



Note: The bank tax is an example of a tax measure that does lead to a reduction in the size of the sector.

Advice: Work towards removal of tax incentives and other market distortions that lead to an artificially large sector.
Box 6 sets out various tax incentives and other market distortions that contribute to a relatively large Dutch banking sector (see also Figure 1).[16] Removing these kinds of distortions as much as possible keeps the banking sector from becoming bigger than is necessary for supporting the real economy. As long as the sector still remains large, it is of great importance to assure the stability and efficiency of banking services. The banking union is an important step in the right direction, although the state support necessary during the crisis to stabilise banking services illustrates the fact that there is still a long way to go.

Box 7 Should alternative banking service providers be given a larger role?

Were consumers to lose their confidence in the banking sector, demand for services from banks would drop, while alternative providers would benefit. Business owners faced with a reduced supply of credit could, for example, choose to form a credit union. And large enterprises could, in the face of an irregular availability of bank finance, resort to market funding by means of issuing bonds.[17]

16 The removal of implicit subsidies need not lead to lower profit margins per product, since banks can pass on some or all of their higher funding costs to their customers. However, total profits will fall due to a drop in demand for banking services, to the level that would prevail in the absence of the distortionary subsidies.

17 Issuing bonds involves fixed costs, such as for underwriting and for drawing up and reviewing the mandatory prospectus. This can create a hurdle especially for smaller businesses seeking market funding. See http://www.fd.nl/ beurs/896016/kosten-beursgang-stijgen (Dutch only).

The supply of bank services can also decrease due, for example, to stricter standards for resolvability and buffer adequacy. In particular for big banks, such standards restrict funding advantages from state guarantees, which can induce these institutions to raise their lending rates. Furthermore, the increased complexity of the supervisory framework involves implementation costs that banks pass on to their customers. If banks as a result offer lower interest rates on savings, this can encourage consumers to invest these savings in, for example, money market funds. And if mortgage rates increase as a result of banks being less able to finance themselves at short maturities, it will become more attractive to take out a mortgage with an insurance company instead.

If competition from non-banks increases, the service to consumers and businesses will be more efficient, while these new market entrants may also be more innovative than established players. An increasing role for alternative, non-bank providers is therefore desirable, as long as they can fail without the need for government support. The risk of these parties becoming systemically important – individually or as a group – must therefore be avoided. An example of how this could otherwise go wrong are shadow banks, such as the special purpose vehicles which banks had set up to evade supervisory standards, or the American money market funds that during the crisis were granted access to Federal Reserve liquidity support.[18] If such players are given government support just like banks, they must also be subject to regulation outside times of crisis.

18 See Brunnermeier, Crockett, Goodhart, Persaud, and Shin (2009), The fundamental principles of financial regulation, *Geneva Reports on the World Economy* 11. For a recent discussion of the implications of increasing integration of banks and financial markets, e.g. through shadow banking, see Boot and Thakor (2014), Commercial banking and shadow banking: the accelerating integration of banks and markets and its implications for regulation, in: *Oxford Handbook of Banking*, 2nd edition, p.47-76.

2.2 Market shares of individual banks

If individual banks enjoy a large market share, this reduces the stability of banking services. Although banks need to be of a certain minimum size in order to be profitable and stable, the failure of a bank with a large market share can threaten the stability of banking services. For example, if one of the three large Dutch banks were to cease to provide mortgage loans, this would have a greater impact on the ability of households to finance a home purchase than the failure of a small bank. Furthermore, a situation whereby all savers with a large bank were to lose access to their savings accounts would result in a bigger decline in the number of domestic payment transactions than the failure of a smaller bank. And the market for interbank loans would come under greater pressure in the event of doubts as to the creditworthiness of a larger market player. These higher risks are not compensated by greater stability of larger banks. It is precisely the large banks throughout the world that have lower risk-weighted capital buffers and higher leverage (see Chart 8).[19] Despite their greater diversification (see also section 2.3), three of the four large Dutch banks needed state support during the crisis to remain on their feet, a proportion that was much lower for small banks. Since banking services in the Netherlands are dominated by a small number of banks with large market shares, the likelihood of these services becoming instable is therefore relatively high.[20]

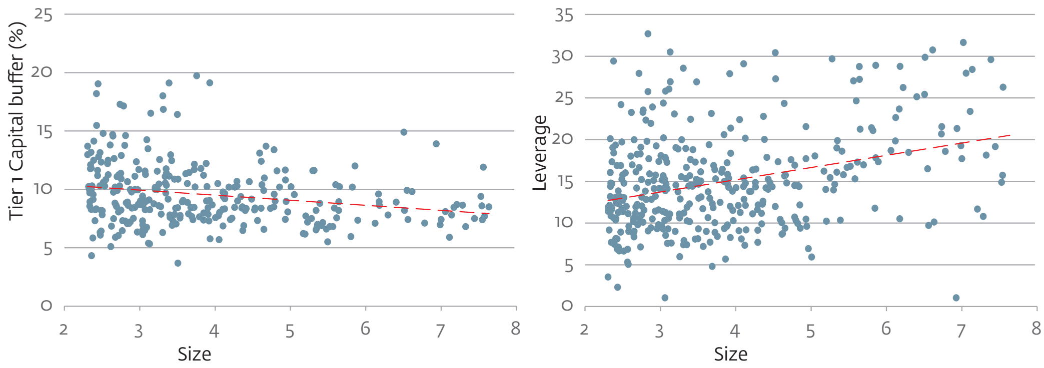
19 The new capital requirements for systemically important banks aim to increase their stability in relation to small banks, although the latter may feel forced to compete by increasing their own buffers in response.

20 This picture is confirmed by a recent study into the stability of banks in various US states during the recent crisis: banks in concentrated markets take on greater risks, are more likely to face regulatory intervention, and more frequently go into liquidation. See Tee Yong Jeffrey, Atkins, Li, and Rusticus (2015), Bank competition and stability: evidence from the financial crisis, *Journal of Financial & Quantitative Analysis*, forthcoming.

Due to scale economies, the growth in market share of smaller banks contributes to more efficient banking services. Such economies of scale are achieved, for example, because banks with a balance sheet total in excess of ten billion euros have less difficulty in meeting the fixed costs of a branch network or an ICT system. Additionally, larger banks can extend bigger loans to individual companies, whereas doing so would quickly lead small banks to face difficult to manage counterparty risks.

Furthermore, larger banks have a broader investor base, so that they can pay lower liquidity premiums to their shareholders or bond holders. Lastly, they can invest more in the development of internal models, the use of which often leads to lower capital requirement than the standardised approach. By growing in size, small banks can thus achieve scale economies, whereas they could be faced with viability problems in the absence of such growth.

Chart 8 Large banks have lower capital buffers and higher leverage



Source: Laeven, Ratnovski, and Tong (2014), Bank size and systemic risk, *IMF staff discussion note* 4.

Note: Bank size is measured as the logarithm of banks' balance sheet total. Banks' capital buffers are measured as the Tier 1 capital divided by risk-weighted assets. Leverage is measured as the balance sheet total divided by equity capital. The sample includes listed banks from 52 countries having a minimum balance sheet total of USD 10 billion. The charts show that size and lower buffers often go hand in hand in practice, irrespective of whether there is any actual causal relationship between the two. Grateful thanks to Lev Ratnovski for providing access to the database.

Growth in market share of bigger banks can lead to less efficient banking services. A market dominated by big banks could still be competitive if, for example, new challengers are able to enter the market without difficulty (see also Box 8). However, in such a market, a decrease in concentration will encourage competition as well. Established players then experience more pressure to innovate and to offer their services at as low a price as possible.[21] Furthermore, specifically in the case of the banking sector, banks with a large market share were almost always saved by governments if they got into difficulties. Rating agencies and financiers factor this in when they assess the creditworthiness of these big banks, resulting in these banks being able to obtain cheaper funding. This kind of drawback to efficiency is not compensated for by scale economies. There is little evidence that these are important for big banks, possibly because such banks are more complex to manage or are more likely to be faced with counterparty limits in attracting funding.[22] Furthermore, given their market power, bigger banks face less pressure from competitors to pass on scale economies to their customers.[23]

21 A recent literature review by the CPB finds that a higher market concentration rate leads to higher lending rates, see Bijlsma and Dubovik (2014), Banks, financial markets, and growth in developed countries: a survey of the empirical literature, *CPB Discussion Paper* 266. A review of older literature reveals no empirical evidence for a negative correlation between concentration and competition, see Berger, Demirgüc-Kunt, Levine and Haubrich (2004), Bank concentration and competition: an evolution in the making, *Journal of Money, Credit & Banking* 36, p. 433-51. A possible reason for this is that alongside concentration there are many other factors that influence competition in a market, which are not always easy to account for in empirical analyses. Furthermore, in the banking sector the measurement of competition is complicated because the products sold are complex and because their production cost depends in part on the risk profile of the customer and of the bank itself.

22 Recent evidence from Hughes and Mester (2013), Who said large banks don't experience scale economies? Evidence from a risk-return-driven cost function, *Journal of Financial Intermediation* 22, pp. 559-85 concludes that even after a correction for implicit state guarantees, scale economies for big banks can be substantial. This conclusion is challenged, however, by Davies and Tracey (2014), Too Big to Be Efficient? The Impact of Implicit Subsidies on Estimates of Scale Economies for Banks, *Journal of Money, Credit & Banking* 46, pp. 219-53. The debate continues.

23 For a seminal analysis of the trade-off between competition and scale economies, see Williamson (1968), Economies as an antitrust defense: the welfare tradeoffs, *American Economic Review* 58, pp. 18-36.

Low entry barriers can compensate for the drawbacks of high market concentration, but precisely in the banking sector, entry barriers are high. If a concentrated market is contestable, the threat of new entrants will ensure that established providers price their products competitively. In practice we see, however, that there are few new entrants onto the Dutch market, nor many foreign players. One reason may be that profit margins are already low (due, for example, to markets already being competitive or to prices being artificially low due to cross subsidies from other business units), because some markets are regarded as difficult, especially by foreign players (such as the mortgage market, due to the combination of high loan-to-value-ratios with – until recently – falling house prices), or due to entry barriers. Such entry barriers play a particularly significant role in the banking sector, a necessary one being financial regulation and supervision. The costs involved in the licensing process and subsequent need to comply with a large amount of complex regulations can frighten off potential entrants. Another entry barrier arises when small new challengers, especially those that lack a profitable home market, lack sufficient scale economies to compete with established players. And, finally, the importance of soft information about local market conditions or about the creditworthiness of customers can play a role, giving established market players a competitive advantage over new entrants. Of course, the importance of these effects may differ across markets.

Box 8 What do we know about competition within the Dutch banking sector?

As the degree of competition, i.e., the battle for market share, is difficult to measure directly, it is usually indirectly deduced by looking at the degree to which market conditions are in accordance with what would be expected in a competitive environment. In such an environment, banks not just aim to defend their market shares, but also continuously seek ways in which to increase it. To this end, rather than realising excessive profit margins on individual products, they charge prices that are not much higher than their marginal production costs. In itself, this cost level is less informative about competition, since banks with low costs can still charge high prices.

In addition, costs can be low due to scale economies associated with monopolisation, or due to the funding advantages associated with state guarantees – the very things that restrict, rather than promote, competition. In itself, therefore, a lower cost level does not prove that competition between banks is higher.

Especially in banking, the measurement of margins on individual products is not straightforward, because production costs are not directly observed while the same is sometimes true for product prices. For example, the average interest rate paid by a bank to fund its balance sheet can easily be measured, but the margins calculated on this basis are not comparable across banks due to the differences between banks' balance sheet structures and risk profiles. Product margins calculated according to product-specific funding costs would be comparable across banks, but the calculation of such funds transfer prices is not straightforward and, within the banking sector, it is subject to much (organisational politics) debate. A study by the Financial Stability Institute, a collaborative institution of the BIS and the BCBS, reveals that many banks still apply scarcely adequate methods in this area.[24] This complicates the measuring of their efficiency and the competition between them, while a further complication is that the resulting funds transfer prices are generally not disclosed.

Anecdotal evidence regarding competition within the Dutch market is not universally positive. For example, in the mortgage market, margins have increased over recent years, possibly through capacity constraints among banks wishing to shorten their balance sheets, combined with the limited options for new players to enter the market and fill this gap.[25] Additionally, the European ban on price leadership for banks that received state support during the crisis may have reduced competition. However, in recent times, we have been witnessing new providers enter the market, especially Dutch insurance companies.

24 See Grant (2011), Liquidity transfer pricing: a guide to better practice, *Financial Stability Institute Occasional Paper* 10. The study concludes that 'many LTP [liquidity transfer pricing] practices were largely deficient. Many banks lacked LTP policies, employed inconsistent LTP regimes, relied on off-line processes to manually update changes in funding costs, and had poor oversight of the LTP process.'

25 See Jansen, Bijlsma, Kruidhof, and Pattipeilohy (2013), Financieringsproblemen in de hypotheekmarkt, *DNB Occasional Studies* 1, and Authority for Consumers & Markets (2013), Concurrentie op de hypotheekmarkt, *Monitor Financiële Sector*, April (both in Dutch only).

In the deposit market, small banks need to offer relatively high interest rates to attract retail savings, due in part to practical reasons, such as the non-transferability of bank account numbers, and the perception that savings deposited with big banks are safer due to those banks' too-big-to-fail status. However, the differences in interest rates have become smaller since 2012, possibly because the overall stability of the sector has improved so that small banks are perceived as safer (and thus are offered more deposit savings), while bigger banks attempt to reduce their dependence on market funding (so that their demand for deposit savings increases).

Despite the complexities inherent in the accurate measurement of competition, it is generally accepted that a high market concentration, entry barriers, and products that are difficult to compare with each other, hinder competition between businesses. Precisely these are the characteristics of the Dutch market for banking services, in which, under a strict regime of authorisation requirements, a limited number of providers sell financial products and services, which are sometimes difficult to understand. Taking this and the aforesaid anecdotal evidence into account, it seems safe to conclude that the current level of competition offers room for improvement.[26]

The introduction of the banking union may lead to a consolidation wave in the European banking sector that could undermine stability of banking services. The banking union makes it more likely that the failure of banks with large market shares can be averted, or at least carried out in a more orderly manner. However, there is a risk that the integration of the European banking market may lead to a new consolidation wave as a result of which the systemic importance of European banks will increase further. It is uncertain whether the resolution framework and the additional buffer requirements for systemically important banks by themselves offer sufficient security against ever-increasing systemic importance. This argues in favour of looking carefully at financial stability risks and resolvability considerations when assessing mergers and acquisitions of European banks. As argued

26 The Authority for Consumers and Markets recently concluded that even before the crisis competition in the Dutch retail banking market was not optimal, and that since the crisis it has only worsened. It recommends that the contestability of the market be increased by lowering entry barriers. See Authority for Consumers and Markets (2014), Barrières voor toetreding tot de Nederlandse bancaire retailsector, *Monitor Financiële Sector*, June (Dutch only).

in DNB's 2014 Annual Report, it is important that the European Commission and the ECB examine this issue in the near future (see also Box 9). Amendment of the relevant European directive is probably desirable, and this is something that DNB and the Ministry of Finance jointly advocate in Europe.

Box 9 Is the banking union prepared for a European consolidation wave?

The run-up to the financial crisis was characterised by increasing consolidation within the European banking sector. Whereas the total value of mergers and acquisitions was still less than EUR 20 billion in 2003, it had risen to over EUR 140 billion by 2007. The outbreak of the crisis abruptly reversed this trend, with a fall in consolidations to less than EUR 30 billion in 2012.[27] Besides the fact that liquidity and solvency problems restricted the room for banks to finance large acquisitions, this kind of transaction was complicated by uncertainty as to the risk profiles of potential takeover targets.

The introduction of the banking union and the publication of the results of the Comprehensive Assessment may bring changes to both situations. The increased transparency about banks' risk profiles and their strengthened capital positions facilitate attracting funding for acquisitions and valuing potential acquisition targets. Combined with the gradual recovery of the European economy and the continued integration of the European banking market, this could generate a new wave of consolidations.

It is tempting to believe that with the introduction of the banking union and the accompanying resolution framework, an increase in size of even the biggest European banks need no longer be a problem. However, a comparison with the United States raises

27 See PwC (2013), European Financial Services M&A News and Views, *Sharing Deal Insight*, March 2013.

the question whether this is actually the case. For example, the balance sheet total of BNP Paribas, the largest bank in the banking union, represents around 15% of GDP in the euro area, and more than thirty times the size of the European bank resolution fund. This is not much less than the comparable percentage of JP Morgan Chase, the (IFRS) balance sheet total of which was approximately 20% of the US economy. Banks of this size cannot easily be resolved, as evidenced by the fact that the Federal Deposit Insurance Committee (FDIC) recently assessed the resolution plans of the eleven biggest US banks as lacking credibility. The FDIC concluded that the resolution plans were unrealistic, contained insufficiently supported assumptions, and failed to provide for the identification of, let alone remove, bottlenecks in the organisational structure that may hinder an orderly resolution. Further to this, the Board of Governors of the Federal Reserve System has indicated that banks must improve their resolution plans before mid-2015 or they will be rejected.[28]

The above illustrates the need to deal explicitly with the question whether all or some European banks should be allowed to increase in size any further. The answer depends not just on their market shares, but also on the size at which a bank becomes too big to resolve in an orderly way during a crisis. In other words, how big is the largest European bank that can be orderly resolved under the European resolution framework without the need for government support? The experience in the United States suggests a limit below 20% of euro area GDP, but perhaps a bank with a balance sheet total of 10% of GDP is already on the large side. In any event, banks must be able to submit a credible resolution plan as part of a request for approval of a merger or acquisition. Since 1 January 2015, in the United States bank mergers and acquisitions have been prohibited if the resultant new institution would hold more than 10% of the consolidated obligations (with the exception of the capital levels required by law) of the sector as a whole. As the ECB is ultimately responsible for approving bank mergers and acquisitions, it should consider the above issues in the near future. In this respect, an amendment to the relevant European directive would probably be desirable, something that DNB and the Ministry of Finance jointly advocate in Europe.

28 See FRB and FDIC (2014), Agencies provide feedback on sound resolution plans of 'first-wave' filers, *Joint press release*, 5 August 2014.

Advice: Strive towards lower market concentration for the benefit of larger market shares for smaller banks and new entrants. This does not imply that the supply of services by the big banks should actively be reduced, but it could, for example, be achieved by encouraging competition in facilitating the entry of new market players, introducing standard products, reducing funding advantages for big banks through effective supervision and resolution, and, where possible, simplifying regulations. If systemically important banks have smaller market shares, their systemic importance declines, which benefits the stability of banking services (Box 10 examines from various perspectives until which point a market share can still be considered reasonable). Furthermore, this increases the viability of small and medium-sized banks and alternative providers, causing the supply of banking services to become more efficient. Although a potential decline in scale economies of systemically important banks could cancel out part of this effect, there is little evidence that such scale economies for big banks are substantial to begin with. Furthermore, such a decline could be offset if systemically important banks outsource activities with high fixed costs to third parties. Examples include having payment transactions settled by a specialist institution, extending larger business loans through a syndicate and providing mortgages through an agent's branch network.

Box 10 What would still be a reasonable market share for an individual bank?

In considering the question as to the maximum market share that could still be considered reasonable for an individual bank, a number of rules of thumb provide guidance. Focusing on stability one can look, for example, at the market share in the mortgage market or business loans market beyond which a bank would be characterised as systemically important. Ideally, the market share of individual banks should not exceed this percentage. Focusing on efficiency, one can look, for example, at the Herfindahl-Hirschman Index (the sum of the squared market shares of the various providers). In US competition law, a value higher than 0.15 is interpreted as a sign of market concentration.[29] In that case, a sector of at least six

29 See US Department of Justice and the Federal Trade Commission (2009), Horizontal Merger Guidelines, August 2010.

banks, each with a maximum share of 15%, is just below the point at which it would qualify as concentrated, with the remaining 10% being held by the smaller banks. In such a sector, the C5 ratio – the sum of the five biggest market shares – is slightly below the current Dutch value of 80%, which in international terms remains high (see Chart 3). The C3 ratio would decrease, and at a value of 45% would be less than the 60% to 80% that is currently observed in the larger euro area Member States.[30] Chart 4 shows that the current market shares of several banks considerably exceed 15%.

2.3 Diversity and diversification

Viewed from the perspective of an individual bank, diversification is an effective means of managing risks, although its benefits are often offset by higher leverage. Spreading income sources across countries and sectors (such as consumer mortgages, business loans, and trade finance) dampens fluctuations in the bank's profitability, and thus limits the risk of sudden losses that could threaten its financial position.[31] Banks can use this benefit to increase their overall stability, but can also offset it by taking more risk elsewhere on their balance sheet. Just as airbags and anti-lock braking systems can encourage reckless driving, this undesirable conduct frequently occurs in practice.[32] In this way, on average, banks combine diversification of income sources with lower risk-weighted capital buffers and higher leverage (see Chart 9), although the scope for the latter is restricted by the recently introduced leverage ratio requirement. In such cases a bank's decision to diversify seems to suggest a preference for a long balance sheet (lower asset risks with higher leverage) rather than for a below-average risk profile, which explains in part why in practice diversified banks do not appear to be more stable.[33]

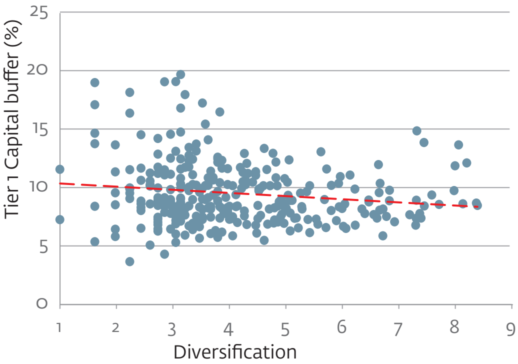
30 See European Systemic Risk Board (2014), Is Europe overbanked?, *Advisory Scientific Committee Report*, February.

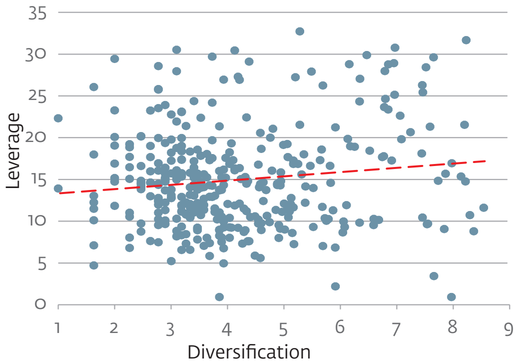
31 In this study, 'diversification' refers to the spread of activities across different countries and sectors, rather than the spread of loans across different counterparties with a view to the granularity of the portfolio.

32 See Winston, Maheshri and Mannering (2006), An exploration of the offset hypothesis with disaggregate data: the case of airbags and antilock brakes, *Journal of Risk and Uncertainty* 32, pp. 83-99.

33 For a recent overview of the economic literature on bank diversification, see Stiroh (2010), Diversification in banking, in Berger, Molyneux, and Wilson (eds), *The Oxford Handbook of Banking*, Oxford University Press, pp. 146-70.

Chart 9 Diversified banks have lower capital buffers and higher leverage





Source: Laeven, Ratnovski and Tong (2014), Bank size and systemic risk, *IMF staff discussion note* 4.

Note: As the degree of diversification is difficult to measure, the chart uses as an indicator (the logarithm of one plus) the number of a bank's subsidiaries, which reflects the fact that banks with more subsidiaries u e countries and markets. Banks' capital buffers are measured as the Tier 1 capital divided by risk-weighted assets, and leverage is measured as the balance sheet total divided by equity capital. The sample includes listed banks from 52 countries having a minimum balance sheet total of USD 10 billion.
The charts show that diversification and lower buffers often go hand in hand in practice, irrespective of whether there is any actual causal relationship between the two. Grateful thanks to Lev Ratnovski for providing access to the database.

In addition, diversification benefits are not always easy to achieve. For example, the correlation between different income sources can prove greater than expected precisely during times of crisis, losses on relatively small balance sheet items can still cause big problems, and the search for diversification opportunities can cause unforeseen risks to be put on the balance sheet.[34] In terms of resolution, diversification has the added disadvantage that banks that undertake activities in different countries and market segments are usually more complex, and thus more difficult to resolve.

From the perspective of the sector as a whole, and compared to other risk management approaches, a disadvantage of diversification is that sector diversity is reduced, so that systemic risk increases. The reason for this is that differences between the risks of activities in different sectors or countries form a source of diversity between banks. The more banks diversify, the more their risk of losses is reduced due to the reduction in their exposure to – idiosyncratic – sector-specific and country-specific risks. What remains, however, is their exposure to the – systematic – risk that different sectors and countries have in common, so that the correlation between their credit losses increases. Through diversification, the risk of an individual bank suffering large losses thereby decreases, which leads to a more stable individual bank as long as it does not increase its leverage, but if such losses occur, the risk of other banks suffering losses at the same time is much greater than before.[35] Compared to other forms of risk

34 See, for example the work of Stiroh and Rumble (2006), The dark side of diversification: the case of US holding companies, *Journal of Banking & Finance* 30, pp. 2131-61, in which it is demonstrated how diversification benefits for individual American banks are cancelled out by an increased exposure to volatile sources of income. A Dutch example of this is SNS, which in 2006 decided to spread its income sources by acquiring Bouwfonds Property Finance, see Annual Report SNS Reaal 2006, p. 11 (Dutch only), but went under in 2013 as a result of real estate losses. And in 2009, ING was given state support for its US Alt-A mortgages, an investment that bore very little relationship with its core business.

35 A stylised example of this mechanism is the diversification between regions. If Bank A provides mortgages to consumers in the city of Amsterdam and Bank B provides mortgages to consumers in the city of Groningen, there is a relatively small risk that the two banks will face credit losses at the same time. Although both banks are exposed to the same (systematic) Netherlands-risk, Bank A is also exposed to the (idiosyncratic) risk of the Amsterdam housing market, whereas Bank B is also exposed to the (idiosyncratic) risk of the Groningen housing market. If Bank A now were to diversify by providing mortgages to half of the Dutch population, while Bank B were to provide mortgages to the other half, this kind of regional variation would average out and, ultimately, both banks would be largely exposed to the Netherlands-risk. As the differences between them have hereby decreased, sector diversity has declined and there is a greater risk that both banks face credit losses simultaneously.

management, diversification therefore involves a trade-off between the stability of individual banks and the stability of the sector as a whole.[36]

Box 11 Diversification and diversity in the insurance sector

While diversification by banks is commonplace in practice, the most extreme example being the universal bank, the insurance sector is characterised by more specialisation, the most extreme form being the monoline business model focusing on a single activity or sector. For each activity (sector), insurance companies must hold a separate authorisation. In a single application for authorisation, there are boxes to tick for each activity that the insurer wishes to undertake within the relevant type of insurance (non-life, life, health insurance). Statutory frameworks set out which of these types may or may not be combined.
The banking sector, by contrast, operates under universal authorisations. Furthermore, banks may also undertake activities for which no authorisation is required at all, whereas

36 This is analysed in Beale, Rand, Battey, Croxson, May and Nowak (2011), Individual versus systemic risk and the regulator's dilemma, *Proceedings of the National Academy of Sciences* 108, pp. 12647-52, and also follows from the analysis of Wagner (2010), Diversification and systemic crisis, *Journal of Financial Intermediation* 19, pp. 373-86. As a consequence of this, risk management approaches that reduce the risk of instability of individual banks do not necessarily contribute to a reduction in the risk of instability of several banks at the same time, as is also demonstrated by Van Oordt and Zhou (2014), Systemic risk and bank business models, *DNB Working Paper* 443. The relationship between systemic risk and similarities between the portfolios of different banks is explored in more detail in Zhou (2013), The impact of imposing capital requirements on systemic risk, *Journal of Financial Stability* 9, pp. 320-29. Empirical findings that demonstrate the drawbacks of diversification are put forward by, inter alia, De Jonghe (2010), Back to the basics in banking? A micro-analysis of banking system stability, *Journal of Financial Intermediation* 19, pp. 387-417, or by Nijskens and Wagner (2011), Credit risk transfer activities and systemic risk: how banks became less risky individually but posed greater risks to the financial system at the same time, *Journal of Banking & Finance* 35, pp. 1391-98. The risk that a lack of diversity poses for the stability of the financial sector is also demonstrated by Mink (2012), Financial system instability: contagion or common shocks? *SOM Dissertation Series*, University of Groningen.

any secondary activities undertaken by insurance companies are prohibited. In addition, insurance companies are prohibited from providing life assurance and non-life insurance from the same business unit. Lastly, in practice, health insurance is provided from separate business units, and legal expenses insurance is provided by specialist players. The relatively strong focus on supervision of individual business units, compared to consolidated bank supervision, further discourages diversification.[37]

The above restrictions on diversification by insurance companies aim to promote the stability of their service provision. After all, counteracting diversification prevents the instability of one activity from threatening the stability of another. An example from everyday practice are the claims for damages by customers who invested in profiteering policies *(woekerpolissen)*. These claims pose a risk to the stability of the life insurance companies that sold these policies, but they do not pose a risk to the stability of the non-life business. The reverse was true in the banking sector at the time of the collapse of the US housing market in 2007 – this collapse caused problems for many banks throughout the world, and much more so than if US mortgages had been provided only by local players with specialist market knowledge. At times of great shocks in particular, the spreading of risks through diversification therefore reduces stability in the sector. And although diversification can be an effective means to absorb smaller shocks, it is precisely this kind of risk that can also be managed in other ways.[38]

37 The insurance sector also illustrates that a monoline player is not the same thing as a monopolist: the fact that institutions focus on one or more core activities does not necessarily reduce the number of providers or competition among them. In fact, the opposite can be the case in practice: if institutions diversify their activities mostly by taking over their competitors in other markets, increasing diversification is coupled with an increasing concentration rate of the sector as a whole.

38 An example of successful risk management using diversification is the one of the Dutch housing market crisis in the 1980s. This crisis led to the demise of the independent Dutch mortgage banks, but did not spread to general banks that also focused on providing business loans or attracting consumer savings. For a detailed account, see Koelewijn (1987), De achtergronden van het verdwijnen van de zelfstandige hypotheekbanken in de jaren tachtig, *Research memorandum* 14, VU University Amsterdam (Dutch only).

Diversification into other European countries may increase the diversity of the sector domestically while reducing diversity within the banking union as a whole. Within the insurance sector, diversity is promoted by means of the regulatory framework: authorisations are granted for specific insurance activities (sectors), non-life and life insurance activities must be carried out by separate business units (see Box 11). Conversely, in the banking sector, it is the universal bank that has become commonplace. If banks had given greater consideration to the drawbacks of diversification to the stability of the banking system when choosing to diversify, several banks would probably be less diversified today.

Excessive diversification can reduce synergy and efficiency. If performing a range of activities allows banks to save costs, their services will become more efficient. For example, a diversified bank can use its branch network not only for providing mortgages, but also to offer personal loans, savings accounts, and even insurance products. Performing a range of different activities can, however, also lead to reduced efficiency. For example, institutions that perform more activities are more difficult to manage. And complex institutions can more easily use their profit sources to cross-subsidise loss-making business units.[39] Furthermore, an expansion of activities can also be prompted by 'empire building' ambitions, or by regulatory arbitrage (such as double leverage in bank insurers that use borrowed funds to supply other business units with capital). In such cases, diversification is driven by considerations other than efficiency. The significance of these kinds of effects in practice is demonstrated by the fact that the market value of a conglomerate is often below the sum of its parts.[40] And for small banks, specialisation even seems to be a precondition for being able to compete.

The introduction of the banking union may reduce diversity within the European banking sector. The banking union provides supervisors with more instruments to either prevent banks from failing or resolve such failures in a more orderly fashion. At the same time this means that these instruments are made uniform between all supervisory authorities. The European harmonisation of supervision and regulation thereby creates harmonisation of the risk management practices of individual banks, which reduces diversity in the sector. If banks also use the integration of the European banking market as a means to diversify more into foreign markets, this may reduce their exposure to country-specific risks and thereby increase the risk of instability coinciding between banks.

39 See, for example, the work of Jensen (1986), Agency costs of free cash flow, corporate finance and takeovers, *American Economic Review* 76, pp. 323-29.

40 The diversification discount in financial conglomerates is analysed by, for example, Laeven and Levine (2007), Is there a diversification discount in financial conglomerates? *Journal of Financial Economics* 85, pp. 331-67, and by Van Lelyveld and Knot (2009), Do financial conglomerates create or destroy value? Evidence for the EU, *Journal of Banking & Finance* 12, pp. 2312-21.

Advice: Increase diversity in the banking sector by encouraging banks to take into account the drawbacks of diversification (into other countries and sectors) for the stability of the system as a whole, by, for example, focusing more on risk management with prudent lending standards, with adequate buffers and with proactive loan monitoring instead.

In the particular case of diversification into activities that have little synergy between them, alternative forms of risk management should be encouraged. For example, by promoting competition, banks will naturally focus more on those activities that they are good at. In addition, the insurance sector illustrates how diversity can be enhanced by prohibiting some forms of diversification (see Box 11). Furthermore, the removal of opportunities for regulatory arbitrage within conglomerates, such as the prohibition of double leverage, and an alertness to diversification-based motivations for mergers and acquisitions, can help increase sector diversity.

2.4 Foreign banks in the Netherlands

Foreign banks may be more inclined than domestic banks to suddenly wind down their activities, but this risk is much smaller for banks that invest in local customer relations or that during a domestic crisis can rely on their foreign parent companies. During a crisis, foreign banks may choose to terminate their Dutch activities, for example because they have more limited knowledge of, or connection with, the Dutch market. They could also withdraw due to political pressure to maintain sufficient lending levels in their home countries. Economic literature shows that foreign banks are quicker to restrict their lending than domestic banks, unless these domestic banks themselves depend heavily on foreign funding.[41]
In addition, the risk that foreign banks wind down their activities is smaller if these banks operate through a subsidiary, have been operating longer in the domestic market, have a larger market share, or attract deposit funding.[42] For foreign banks that in

41 See, for example the work of Ongena, Peydro, and Van Horen (2013), Shocks Abroad, Pain at Home? Bank-Firm Level Evidence on the International Transmission of Financial Shocks, *DNB Working Paper* 385. Based on a detailed empirical study, the authors demonstrate how both foreign banks and domestic banks with foreign funding reduce their credit supply in a crisis, especially if their customers are small businesses that purchase services from a single bank.

42 The differences in the degree to which foreign banks withdraw to their home market in the event of a crisis is analysed by Claessens and Van Horen (2013), Impact of foreign banks, *Journal of Financial Perspectives* 1, pp. 1-18; Claessens and Van Horen (2014), Foreign banks: Trends and impact, *Journal of Money, Credit and Banking* 46, pp. 295-326; De Haas and Van Horen (2013), Running for the Exit? International Bank Lending during a Financial Crisis, *Review of Financial Studies* 26, pp. 244-85; and De Haas and Van Lelyveld (2014), Multinational banks and the global financial crisis: Weathering the perfect storm?, *Journal of Money, Credit and Banking* 46, pp. 333-64. See also IMF (2015), International banking after the crisis: increasingly local and safer?, *Global Financial Stability Report*, April, pp. 55-91.

this way invest in local customer relations, it can be attractive during a crisis to continue to provide their services.[43] Furthermore, in the case of a crisis that is of domestic origin, the service by foreign banks can prove to be more stable if, for example, they can rely on capital or liquidity support from their parent companies.[44]

The entry of foreign banks benefits the efficiency of domestic banking services. In the concentrated Dutch market it is difficult for new entrants to compete with established players. This is due, for example, to competitive advantages and scale economies that established players derive from their larger market shares, but also due to the ability of these players to combat new entrants by temporarily offering their services below cost price. Accordingly, competition for these established parties will have to come primarily from innovative internet banks with low cost levels or larger foreign banks that have sufficient scale or alternative profit sources to grow in the Dutch market.[45] Alternatively, they might choose to acquire a Dutch market player to gain expertise about local market conditions and build up a market share in a short period of time (see also Box 12).

43 The work of Bolton, Freixas, Gambacorta, and Mistrulli (2013), Relationship and Transaction Lending in a Crisis, *BIS Working Paper* 417, shows that banks that in good times build up customer relations charge higher interest rates, but in bad times are more inclined to continue lending and are faced with fewer loan defaults. In addition, Beck, Degryse, De Haas, and Van Horen (2014), When arm's length is too far. Relationship banking over the business cycle, *DNB Working Paper* 431, show that in times when credit is widely available, it does not matter whether businesses lend from banks that invest in customer relations, but that lending by this type of bank is more stable during a crisis.

44 See the work of De Haas and Van Lelyveld (2010), Internal Capital Markets and Lending by Multinational Bank Subsidiaries, *Journal of Financial Intermediation* 19, pp. 1-25.

45 The presence of foreign banks has also wider benefits for the domestic economy, since it can encourage other foreign businesses to invest in the Netherlands as well. For an analysis of this effect, see the study by Poelhekke (2011), Home bank intermediation and foreign direct investment, *DNB Working Paper* 299.

Box 12 Dutch banks in foreign hands: worrisome or welcome?

A plea for smaller market shares for the big Dutch banks may raise the question whether these systemically important banks could then become takeover targets of large foreign players and, if so, whether that is a matter for concern.

Less dominant market positions of the systemically important banks in the Netherlands may be associated with a reduction in their absolute size, but such a connection does not necessarily exist (targeted foreign expansion could compensate for this, see section 2.5). And even if the systemically important Dutch banks became smaller in absolute terms, this does not mean that they would automatically become takeover targets. A larger size offers only limited protection against acquisition, as the experience with ABN Amro has illustrated. Instead, inefficiency appears to be a much more significant indicator of the risk of being taken over. Banks that generate added value in a competitive sector usually have high market valuations and are less likely to become prey to acquisition as a result.

The Dutch banking sector is relatively heavily dominated by domestic players (see Chart 6). Wider entry by foreign players can help improve the competitive dynamics of the Dutch market. The acquisition of a Dutch bank by a foreign player can be a means to achieve this, even if such a party comes from outside the banking union. A bank from inside the European banking union is to be particularly welcomed, especially if it intends to build a sustainable position in the Dutch market by means of an independently capitalised subsidiary. After all, European banks will be less quick to withdraw to their home market after the introduction of the European banking market, for example because they define this home market less along national lines and because national supervisory authorities cooperate more closely. The counterargument that DNB as the host country supervising authority has a lesser hold over foreign players is becoming less and less true with the arrival of the banking union: as a part of the SSM and SRM, DNB is able to influence important decisions concerning foreign parent companies. In addition, and conversely, DNB will be less able to exercise influence over domestic banks than previously.

In time, the banking union will stimulate both the entry of European banks into the Dutch market and the stability of the services they provide. Harmonisation of regulations and supervision at European level will make it easier for banks to perform cross-border activities. Although there will continue to be differences between national markets, for example in the fields of tax law, contract law and consumer protection, the banking union will make it easier for foreign banks to enter the Dutch market. The integration of the European banking market also means that foreign banks will be less inclined to withdraw to their home markets in the event of a crisis, for example because they define their home markets less along national lines and because national supervisory authorities collaborate better.

Advice: encourage the market entry of foreign banks, especially those banks that are willing to invest in local customer relations and that are able to fall back on financially healthy parent companies.
Foreign players entering the Dutch market, or the threat thereof, increase competition, while the negative consequences for the stability of banking services are manageable. Furthermore, in a crisis that originates domestically the services provided by foreign banks can be more stable, for example if such banks can rely on capital or liquidity support from their parent companies.

2.5 Dutch banks abroad

Safeguarding the stability of banking services requires an alertness to the risks arising from Dutch banks' foreign activities. Their foreign activities may enable banks to spread their income sources but, as noted above, this type of diversification can lead to less diversity and less stable services in the sector as a whole. In addition, individual banks do not necessarily become more stable by undertaking foreign activities. Such activities may involve an above-average degree of risk if Dutch banks need to provide relatively risky loans to get a foot in the door in foreign markets or if they are less familiar with local market conditions. The risk of the latter, however, can be reduced if banks focus on supporting Dutch companies operating abroad rather than on conquering foreign markets. Since risky foreign activities are not intrinsically different from risky domestic activities, the risks on both types of activity can be managed in a similar way. An exception is attracting foreign retail deposits during the crisis, which could threaten the stability of domestic banking services because the associated risks for the deposit guarantee system are borne by the banking sector as a whole. The new resolution regime reduces this risk by providing savers with a preferential claim on their banks' assets, but this remains a point for consideration in the absence of a European deposit guarantee system.

Foreign activities probably have little influence on the efficiency of domestic banking services. If the combination of domestic and foreign activities creates synergy benefits, and if there is sufficient competition, these benefits are passed on to both foreign and domestic customers in the form of more favourable lending and savings rates. In practice, however, any such effect appears to be limited: in respect of branch networks, staff deployment and IT systems, for example, the foreign departments of banks are often independent units. If a foreign entity operates as a subsidiary, it must also be liquid and solvent on an independent basis, which means that there is less room for funding foreign loans with domestic savings, for example. It is also expected that within the banking union standards governing the local availability of capital and liquidity buffers will remain in force for the time being, partly for the purposes of resolvability. This will restrict a successful European growth strategy.

Foreign activities are especially useful if they contribute to the creation of a European market for banking services. The foreign activities of Dutch banks do not always contribute much to the domestic economy. For example, while mortgage lending abroad could be profitable for a Dutch bank, such profits mostly benefit shareholders (who are based across the globe). Furthermore, these profits are usually taxed abroad, so that the benefits for the Dutch economy consist predominantly of domestic jobs created to perform the foreign activities.
The same applies if Dutch banks provide services to Dutch companies abroad, since these companies do not always create more domestic production and jobs as a result.[46] And those companies that operate internationally and do create domestic jobs, for example by establishing their head offices in the Netherlands or manufacturing export products in the Netherlands, appear to benefit from adequate domestic, rather than foreign, banking services.
For example, the Dutch export sector benefits from good access to trade finance, which is a form of domestic credit. The main advantage of banking activities abroad therefore is that they may enhance competition within the European banking market.

46 According to economic literature, the foreign activities of a business can either increase or decrease the number of domestic jobs. If, for example, a bank relocates its IT support to a low-wage country, this will reduce domestic employment, but if it creates a branch network in a foreign market this may also create jobs in the domestic market through the growth of its business. A recent empirical study finds that foreign activities have no, or a slightly negative, effect on domestic employment, see Debaere, Lee, and Lee (2010). It matters where you go: outward foreign direct investment and multinational employment growth at home, *Journal of Development Economics* 91: p. 301-9.

In time, the banking union may prompt Dutch banks to operate elsewhere in Europe, and lead to better management of the risks arising from such activities. Just as the banking union can prompt European banks to venture onto the Dutch market, it may lead Dutch banks to start operations in the European market. In the shorter term, this process will be subdued due to supervision and resolution requirements with respect to the local availability of capital and liquidity. However, the consistent application of risk management measures to domestic and foreign activities will be easier since both will be supervised at European level. The collaboration between national supervisory authorities will also contribute to detecting elevated risks arising from foreign activities and to taking measures where necessary.

Advice: do not impose any advance restrictions on the foreign activities of Dutch banks.
If it is assured that the higher risks of foreign activities are adequately managed, these activities will have little influence on the stability of domestic banking services. Given the fact that diversification has drawbacks for the stability of the system as a whole (see section 2.3), it should be a requirement that these activities generate sufficient economies of scale and scope with existing services. This can be facilitated by integrating these activities within the business as a whole. If such economies of scale and scope are realised to a greater extent than is currently the case, this may increase the efficiency of domestic services. For the time being, however, the benefits of foreign activities to the Dutch economy primarily consist of their contribution to the development of a truly European market for banking services.

3 Policy options

Although there is limited room for manoeuvre, policy options to guide the structure of the sector in the desired direction can be formulated based on five principles. Post-war legislation offered instruments for implementing policies specifically targeted at the sector structure, in line with prevailing ideas on the guiding role of government in the financial sector and in the economy as a whole. An example of this is the former ban on mergers between banks and insurance companies. During the 1990s, these regulations were gradually relaxed. In addition, nowadays, most financial regulation is adopted at the European level. Nevertheless, it is possible to formulate policy based on five principles in order to guide the structure of the banking sector in a more desirable direction:

1. **Remove market distortions and tax incentives that encourage excessive growth of banks and of the sector as a whole,** for example by removing implicit too-big-to-fail subsidies by means of supervision and resolution, further restricting mortgage interest relief and further reducing the maximum loan-to-value ratio on new mortgages once the housing market has sufficiently recovered.

2. **Increase diversity in the banking sector by encouraging banks to take into account the drawbacks of diversification across countries and sectors for the stability of the system as a whole,** for example by focusing more on risk management with prudent lending standards, adequate buffers and a proactive credit control.

3. **Reduce the high market concentration within the sector,** for example by stimulating competition from innovative new market entrants, introducing standard products and, where possible, simplifying regulation.

4. **Encourage market entry of foreign banks,** especially those that are willing to invest in local customer relations and are able to fall back on financially healthy parent companies.

5. **Anticipate developments that could have an impact on the sector structure,** such as the ongoing integration of the European banking market and the increasing role of technological innovation in the financial sector.

A policy measure can influence various dimensions of the sector structure. Discouraging diversification, for instance, may lead banks to cut back on certain activities, so that fewer providers remain and market concentration increases. At the same time, cutting back on activities can also create space for new market entrants, or can be done by spinning off certain activities. The concentration within the sector could then possibly be decreased. And if discouraging diversification reduces banks' optimism about potential economies of scale associated with mergers and acquisitions, this can also have a beneficial impact on sector concentration: past consolidation waves have significantly reduced sector diversity and increased sector concentration. By giving proper consideration to the consequences of future policy decisions for different aspects of the sector structure, a structure can emerge that contributes as much as possible to the Dutch economy and social welfare.

Policy measures based on these principles have positive effects on society as a whole, but can be costly for individual banks. An example of this is the increase of competition by reducing entry barriers: this will lead to banks earning smaller margins on their products, leading to a possible drop in their profits and thus in shareholders' returns. A consequence of this is that a bank's market value (or, if it is exchange-listed, its share price) will drop until the lower profits expressed as a percentage of the new market value have become equal to shareholders' required return on investment (at the same time, shareholders may eventually benefit as competition spurs banks towards innovation, higher cost efficiencies and a better service, so that the demand for financial services increases). However, this transitional issue does not provide an argument for entry barriers to be left in place, since, at the level of society as a whole, the costs of such barriers exceed their benefits. It does, however, argue in favour of implementing policy changes in a gradual and well-considered way, so that any shock effects are avoided.

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