Banking sector diversity is key to financial stability

In January 2019, the Netherlands Scientific Council for Government Policy published the report *Money and Debt* ('Geld en Schuld'). This report explains how money creation works, describes the main problems of the current monetary and financial system and discusses several reform options. In this article we present the report's main analysis and conclusions. We focus in particular on our recommendation to facilitate a bank that deals exclusively with payment and savings services.

IN BRIEF

- The Dutch financial system is characterized by exceptionally high private debt levels and an imbalance between public and private interests.
- To address these problems, our financial system needs to change significantly. In particular, greater diversity in the banking sector is essential.
- A payment bank can contribute to diversity and, as such, be part of the solution.

BART STELLINGA
Researcher at the Scientific Council for Government Policy (WRR)

JOSTA DE HOOG
Researcher at the WRR

ARTHUR VAN RIEL
Researcher at the WRR and lecturer at Utrecht University

JANNE VERSTAPPEN
Researcher at the WRR

CASPER DE VRIES
Council member at the WRR and Professor at Erasmus University Rotterdam

More than ten years after the start of the financial crisis, the financial system is still characterized by fundamental shortcomings. In the Netherlands especially, private debt levels remain high and there is an imbalance between public and private interests in the banking sector.

Balanced growth of money and debt

Balanced growth of money and debt is essential for financial stability and economic growth. Insufficient lending and excessive lending both have adverse consequences for society. In this regard, the history of monetary systems shows a permanent need to balance stringency and flexibility. In recent decades, however, the balance has shifted excessively towards flexibility. Since the 1980s, the post-war policies of controlling credit growth and restricting international capital flows have been gradually dismantled. At the same time, other factors, such as tax incentives and housing market policies, have strongly boosted lending.

The strong concentration of the Dutch banking sector and the sharply reduced role of cash in favour of bank money have also contributed to excessive credit creation. How can this be understood? Concentration in the banking sector and excessive credit creation are often seen as two separate problems. The novelty of our report lies in recognizing the connection between these issues. One way in which these two problems are linked relates to the process of money creation. When a bank grants a loan, it simultaneously creates a new deposit in the borrower's bank account. Since the borrower can transfer this money to other banks, the bank needs to attract new (potentially more expensive) funding. This possibility acts as a constraint on lending. Due to the increased concentration of the Dutch banking sector and the decreased importance of cash, newly created money effectively circulates only between a small number of large banks. This means that in our current system this particular constraint on money creation is weakened.

In addition, the growing uniformity in the banking sector creates an environment that incentivizes excessive lending. During a period of optimism about a particular market segment, banks pursue similar strategies and activities, thereby contributing to the boom. In a recession with falling asset prices or low profits, this herd behaviour works in the opposite direction.

These developments have led to a level of Dutch private debt that is unprecedented, in both historical and comparative terms. It is often assumed that high debts do not pose a problem as long as they are matched by sufficient assets and debtors have a track record of low default. Even then, high levels of debt can create macroeconomic problems. Not only are many financial crises preceded by strong credit growth, but post-crisis recovery also takes longer when debt levels are high (Schularick and Taylor, 2012; IMF, 2016).

Furthermore, it is now clear that the positive relation between credit growth and economic development only exists up to a certain threshold. Above that level, the effect of further credit growth on economic development is absent or indeed negative. The OECD shows that further credit growth in most OECD countries would actually constrain economic growth (OECD, 2015). In addition, a highly volatile credit supply creates unbalanced economic growth (WRR, 2016).

The balance between public and private interests

In principle, the financial sector provides key public services, in particular maintaining a well-functioning payment infrastructure and providing a stable credit supply. Historically, both public and private institutions have played a major role in safeguarding these public interests. Over the past decades, however, there has been a fundamental shift in the relationship between public and private actors. Bank deposits have become much more important than cash, and in the Netherlands the public payment and

savings banks have been privatized. In addition, the uniformity and concentration in the Dutch banking sector have increased substantially (DNB, 2015).

As a result, a limited number of private actors, in particular the three systemically important banks, have become indispensable for providing key public services. The functioning of these banks directly affects society as a whole – witness the numerous and substantial bank bailouts during the last crisis. It is striking that in a period of persistent liberalization (such as the removal of credit restrictions and capital controls) large banks have increasingly come to see themselves as purely commercial institutions, whereas in fact they have assumed an ever greater public role.

Further action is required

We currently face two major challenges: achieving more sustainable debt levels and restoring the balance between public and private interests in the banking sector. Of course, the financial sector and financial regulation and oversight have already changed significantly since the crisis. However, there are still significant reasons for concern: strong incentives for excessive debt growth remain, and the concentration in the Dutch banking sector has increased rather than decreased. In our report *Money and Debt* (WRR, 2019) we formulate four main recommendations to address these challenges. We briefly address each of these below.

Promote diversity in the financial sector

A uniform and highly concentrated banking system leads to herd behaviour, thereby amplifying the credit cycle. It also leads to dependence on a small number of systemically important banks for crucial public services. One way to achieve greater diversity is to introduce an alternative payment and savings option, alongside the existing banks. The WRR also recommends taking more ambitious action so as to reduce the dominance of systemic banks, for example by taxing banks' contribution to systemic risks more heavily. Policymakers could also actively encourage newcomers, for instance by having different regulatory regimes for different types of banks, as was in fact the case up until the 1980s (see also Box 1).

Curb excessive growth of debt

Striving for greater diversity in the banking sector can help curb excessive credit growth, but more needs to be done. Even though some changes have been made, the tax system continues to treat debt financing more favourably than equity financing. This creates incentives for households, businesses and financial institutions to take on excessively high debts. An important step would be to align the tax treatment of debt and equity. This can be achieved by further limiting the tax deductibility of interest payments, but also by granting a tax deduction for return on equity. Curbing excessive debt growth also requires the use of more ambitious macroprudential instruments, such as a countercyclical leverage ratio.

Be better prepared for the next crisis

The financial system is inherently unstable. The period of post-war stability was probably exceptional and is unlikely to return in the near future. Since the 1980s we have seen an increase in both the frequency and severity of financial instability. If problematic financial positions are not tackled in a timely manner, the aftermath of a crisis can be long drawn out. In the Netherlands, almost all of the credit risk is borne by the debtor. It is advisable to consider a more balanced allocation of default risks. A mandatory general recapitalization of banks after a crisis can also contribute to a more rapid post-crisis recovery. The different paths of post-crisis recovery in the United States and Europe demonstrate that a swift bank recapitalization is essential.

Safeguard the public responsibilities of banks

Given banks' current semi-public character, it is important that they strike an appropriate balance between the interests of customers, employees, creditors, shareholders and wider society. This requires, among other things, changes in the corporate governance of banks. For example, banks could be required to set up an advisory council, comparable to the client boards that are common in Dutch healthcare institutions. Encouraging other business models – such as the cooperative banking model – could also help strengthen banks' focus on their public roles.

A payment bank as part of the solution

After the publication of the WRR report, media coverage focused specifically on the proposal to facilitate or set up a 'payment bank'. This can be either a public or private institution that deals exclusively with payment services. By only holding central bank reserves and not granting loans, this institution can be thought of as a 'full reserve bank' (see Box 2). A more ambitious reform is the introduction of central bank digital currency (CBDC), the electronic equivalent of cash. This would involve enabling citizens to open a payment account at the central bank.

The proposal for such a payment bank is part of a broader range of measures to ensure a stable financial sector that is aware of its public role. A payment bank can contribute to this goal in three ways: firstly, by taming the credit cycle; secondly, by increasing financial sector resilience; and thirdly, by reducing society's dependence on major banks.

Diversity in the banking sector

BOX 1

The importance of increasing diversity in the banking sector extends beyond counteracting market power and ensuring fair consumer prices. In fact, diversity is essential for financial stability and a prerequisite for the sustainable growth of money and credit. Apart from introducing a payment bank, other steps are conceivable to increase financial sector diversity. For example, policymakers could consider more ambitious reforms to limit the many explicit and implicit advantages that systemic banks derive from their dominant position. Dutch politicians also have to take an important decision regarding the future of the Volksbank, which is currently in public hands after its predecessor (SNS Bank) was nationalized in 2013. Parliament has to decide what future role, business model and ownership structure would best contribute to a more varied banking landscape. The Volksbank's value is broader than just its potential value when sold to the market. To value it properly, one has to take into account the positive and negative externalities for society. Does its envisaged future role contribute to diversity, or will it simply add to a further concentration and standardization of the banking landscape? Finally, at the European level the pursuit of diversity should play an important role when considering the further development of the Banking Union.

The business model of a payment bank

BOX 2

From a microeconomic perspective, one of the practical questions to be addressed concerns the payment bank's business model. Its revenues consist of the fees that customers have to pay for an account and/or for transactions. The most important costs are operational costs and (given current negative rates) interest payments on central bank reserves. As we can assume that the current situation with negative interest rates on central bank reserves is an exceptional situation that will not endure, this leaves operational costs.
For most commercial banks, providing payment and savings accounts and facilitating payment transactions is an inherent part of their lending activities. There is a kind of cross-subsidization (and product bundling) that can be problematic from a competition perspective. This allows banks to charge customers less for payment services.
It is not clear in advance how high the payment bank's operational costs might be. It could be that the costs of setting up and running a new payment bank are much lower than those for existing banks, because of legacy problems at the commercial banks. But even if the payment bank is at a disadvantage relative to the commercial banks, policymakers should also take the public benefits into account when considering the introduction of a payment bank.

Taming the credit cycle

The core idea behind the introduction of a payment bank is that it provides a genuine alternative to payment accounts at commercial banks. It would require important changes at commercial banks. Banks would be forced to rely more on long-term funding to ensure that they are able to accommodate the possibility of a significant outflow of deposits to the payment bank. This would thereby act as a constraint on excessive credit creation, dampening the financial cycle.

Increasing financial sector resilience

The introduction of a payment bank could contribute to the resilience of the financial sector in a number of ways. Because of the disciplining effect of a genuine alternative to commercial banks, these banks will have to do more to convince their financiers that they are funded prudently. This requires a greater reliance on equity (capital) funding and long-term debt funding (Yoke, 2018). This ensures that the system is better able to cope with shocks. Over time, large banks will have to reduce their balance sheets, because they can no longer rely unconditionally on a broad basis of payment and savings deposits for funding. A payment bank of significant size can therefore help limit the too-big-to-fail problem and contribute to a resilient financial sector.

The disciplining effect that a payment bank has on the commercial banks also offers an answer to critics who argue that introducing a safe haven has a destabilizing effect. The argument that it would facilitate a large-scale bank run during a crisis ignores the fact that the mere existence of a payment bank forces banks to ensure more solid funding. Commercial banks will have to finance themselves more conservatively – with more long-term financing and more equity. As such, a payment bank can contribute to the solidity of commercial banks.

It is nevertheless important that banks are given enough time to adjust to the presence of a payment bank. Its introduction therefore requires a careful approach. Policymakers could, for instance, consider introducing daily limits on transactions from the commercial banks to the payment bank (daily limits on banking transactions are also currently used by many commercial banks). One could also consider capping the amount of money that a client can hold at the payment bank. In any case, the concern that a payment bank would destabilize our financial system is indicative of our current system's shortcomings. It is not a conclusive argument against the existence of a safe haven per se.

Reducing dependence on the systemic banks

Finally, a payment bank could help reduce our dependence on the systemically important banks. Such a bank offers an effective alternative to the commercial banks, and over time could function as a parallel payment infrastructure. If commercial banks run into difficulty due to financial instability or technical problems, the existence of a parallel payment circuit could offer a temporary solution. By creating a genuine 'exit opportunity', a payment bank would also give citizens a stronger position vis-à-vis the commercial banks.

Conclusion

The WRR report *Money and Debt* shows that over the past few decades our financial system has gradually – and therefore largely imperceptibly – become unbalanced. The Dutch economy is faced with very high private debt levels and a volatile supply of credit. In addition, our society is highly dependent on a very limited number of systemically important banks for the provision of key public services. Tackling these problems will take time and requires caution, but more ambitious policy reforms are necessary: promoting financial sector diversity, curbing the excessive growth of debt, being better prepared for the next crisis and safeguarding the public responsibilities of the banking sector.

In this contribution, we have paid specific attention to the recommendation to facilitate the introduction of a payment bank. Such a bank could contribute to taming the credit cycle, increasing financial sector resilience and reducing our dependence on systemic banks. Introducing a payment bank is not a minor change: it would necessitate substantial changes in the financial sector. It should not come as a surprise, therefore, that this topic has led to fierce discussion. Such discussions are much needed: after all, innovation and change are inherent to the financial system, and doing nothing is not an option.

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