Champions in passing on costs

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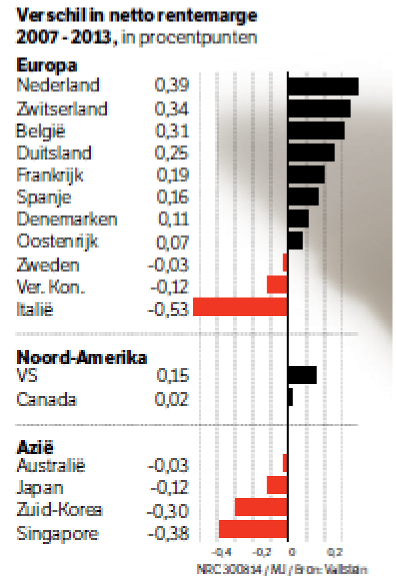
0.0039 euros. This is the extra amount of revenues Dutch banks earn on every euro they lend nowadays. No matter how many digits, for each banks this represents hundreds of millions if not billions of extra income. Before the crisis started the net interest margin – the difference between interest received on lending and paid on funding – was almost half as much.

We´ve got no choice, is what the banks say. Since the banking crisis society and politics demand more resilience. Raising our financial reserves has a cost.

According to critics the banks move beyond what is required. The Home Owners Association stated earlier this month that banks benefit much more from the historic low interest rate than clients, who are paying too much for their mortgage loan. Also the Authority for Consumers & Markets (ACM) concluded this spring that new regulation is costing clients money. This is caused by lack of competition between banks, was the conclusion of the ACM.

The situation in The Netherlands is unique, shows research by advisory firm Vallstein, which advises companies on their relationships with banks and vice versa. Nowhere else in the euro-zone or elsewhere in the developed world has the interest margin increased so much as in The Netherlands. And the trend is increasing.



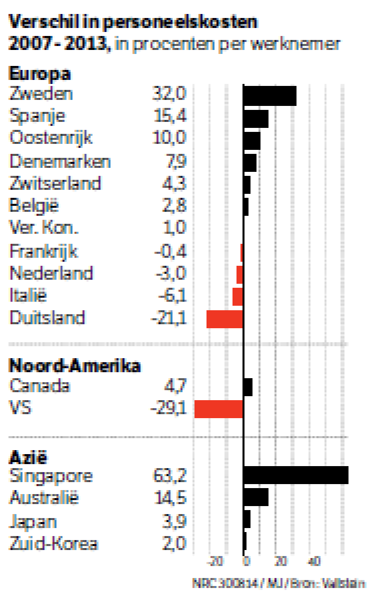
Vallstein reviewed the 108 most importants banks in Europe, North America and Asia to analise how they dealt with the new international regulatory capital requirements. In response to the crisis it was agreed that banks going forward should maintain a minimum of reserves (Basel 3). Vallstein wanted to know who paid for those buffers.

When the new rules were formulated in 2010, the Basel Committee stated that implementation would not need to hurt the economy provided costs would be distributed fairly: clients, banks and shareholders. Now that economic growth in the euro zone is stagnating, many parties point to the fact that bank lending is too expensive and restricted. Banks are supposed to be oiling the wheels of the economy, but are not performing sufficiently.

European banks are shown to have passed on the costs much more to their client base and their shareholders than American and Asian banks have done. These banks distributed the costs more evenly (for example also cutting deep into their own employee expenses). Dutch banks are champions in passing on the costs to their clients.

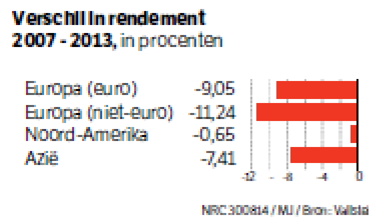
"Dutch banks have done less than average to bring their house in order", says Hugo van Wijk, director of Vallstein. "They sailed on the reduction in policy interest rates, and increased their own interest margin by not passing on the rate reduction to their clients." Van Wijk also notes a risk for the banks: if and when the ECB will raise rates, net interest margins will fall and profits will come down.

If they do not increase the interest rate to their clients, they will have to cut costs to maintain profit. Cutting costs was done insufficiently during the past 7 years according to the survey. Between 2007 and 2014 the Dutch banks reduced operating expenses with 3%. Also costs per employee came down 3% during this period. In America costs per bank employee decreased with nearly 30%, although the average level of costs per employee was before the crisis much higher.

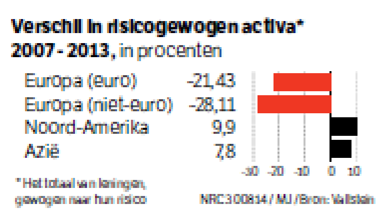


The three major banks, ING, Rabobank and ABN Amro were not available for comment or referred to their lobby group, the Netherlands Association of Banks. "In America it is much easier to reduce staff. In The Netherlands labor law is more strict as a result of which redundant staff is not immediately out", says Onno Steins of the NVB. "Also because of this, it is difficult to compare two countries". Van Wijk counters that the survey period covers 7 years, long enough to view effects of staff reduction.

American banks soon after the crisis broke out reinforced their buffers by issuing shares to investors. This solved with one stroke the problem their European counterparts are dealing with for years now. The profit they earn is available for dividend payments, contrary to European banks who need to retain profits to boost their reserves.



Banks in Europe also became more restrictive on lending. They reduced lending and replaced riskier loans for lower risk exposures. This in contrast to American and Asian banks who continued to expand their balance sheet. According to Van Wijk of Vallstein this points to a difference in culture. "In America it is easier to start with a clean sheet. Banks more than in Europe hold the view that a loan default also is their own judgment error and are more readily available for a new loan. The fact that this in Europe works differently has a high economic cost."



The NVB states that the difference between American and European banks above all are caused by differences in economy. In the US the economic recovery is faster, causing more demand for loans. Furthermore, bank balance sheets "are difficult to compare", says Steins. "In America most mortgage loans – where banks incur relatively little risk – are not on the bank´s balance sheet but with semi-government institutions like Fannie Mae and Freddie Mac."

Harald Benink, professor at Tilburg University, doubts that higher willingness by American banks to assume risk automatically is good for the economy. "If a bank has a lot of risky loans and decides to shrink that portolio that does not necessarily need to hurt to economy."

In its report Vallstein includes a number of unorthodox recommendations. The firm is for example of the opinion that the Basel Committee not only should define a minimum but also a target maximum level for regulatory capital. The major Dutch banks already comply with these requirements.

"One can compare the principle to blood pressure", says Van Wijk. "You then create awareness levels can also be too high, because that is bad for the economy. When banks achieve buffers above the maximum target, they become too expensive for their clients and their shareholders." They either charged more interest than was necessary or retained too much earnings.

Inasfar as the Dutch Central Bank (DNB) is concerned, however, buffers in principle cannot be high enough. A spokesperson declined to comment on the question whether an upper range should be defined, but does refer to a study from DNB itself earlier this year. This concluded that sufficient room exists with Dutch banks to maintain lending levels, even if and when requirements become firmer in the years ahead. DNB however also states that the development in the availability of credit and the level of buffers is monitored closely since it is an "important issue".

Also NVB does not support the idea of an upper range, but because of other reasons. "We believe diversity in the sector is important, and this is not compatible with a regulatory capital requirement ratio bandwith", says Onno Steins. "We firmly support a bottom level, because this ensures banks are stable. But above that level banks themselves should have freedom to set the level with which they are comfortable."

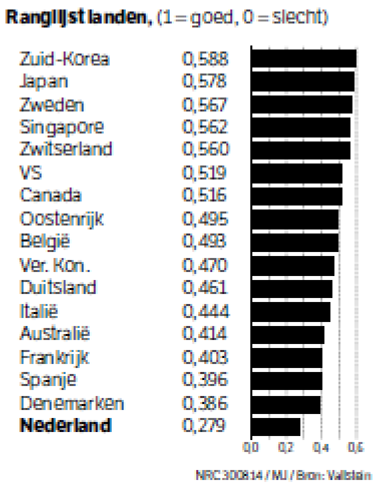
The call for an upper range is associated with the view there is too much capital tied up in the banking systems that is not put to use, says Professor Benink. According to him that is not the case. "The current buffers are still at historic lows," he says. "I think you should have a higher minimum. Ben Bernanke, the previous Federal Reserve Chairman, recently said that during the crisis 13 out of 14 of America´s most important banks were about to go under. We had therefore historically low levels."

The level of the required capital buffer depends on the degree of risk banks run on their lending. A complicating factor is that banks can assess those risk themselves, and they do this differently. The Basel Committee concluded that banks assess the risk on a loan sometimes with a difference as a large as a factor of 10 times.

Vallstein therefore suggests that banks instead apply a standardized approach that was used before. The approach must be improved and fine-tuned with more granularity, to accommodate differences in views and methods between banks.

NVB is opposed because in their view even with fine-tuning unsufficient recognition can be paid to the fact that markets in which banks operate are different. A mortgage is Amsterdam is different from a mortgage in London, says NVB. They do believe however internal models of banks must be improved further.

In the survey Vallstein included a ranking of how all countries dealt with Basel 3. Countries that distributed the "pain" more evenly across all stakeholders (clients, bank, shareholders) are ranked higher than countries where above all clients and shareholders carried the burden.



It is not a ranking of absolute values but it does provide some remarkable insights. For each of the 108 banks covered in the survey Vallstein determined the ranking on four factors (with equal weight), including development in the net interest margin (lower increase resulted in higher ranking). The results were grouped per country.

What stands out is that the four Dutch banks included in the population (ABN Amro, ING, Rabobank and SNS Reaal) end up in the bottom zone at a distance from the rest. South Korean banks come in at the first position with a score twice as high. Those banks generically cut cost significantly.

Van Wijk says that the poor performance of the Dutch banks above all results from increased interest margins and the fact they were more restrictive on lending. He acknowledges that reducing risks on the bank's balance sheet as such is not bad, but under the current circumstances the economy is not moving forward.

Just as the ACM Van Wijk is of the opinion that because of lack of competition in the Dutch banking landscape banks success in passing on the costs of new regulation to their clients. He summarizes: "there are enough banks in Europe, but not enough in every country."

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