Nout Wellink: A changing financial landscape – two of the key challenges facing supervisors in Europe

Speech by Dr Nout Wellink, President of the Netherlands Bank and Chairman of the Basel Committee on Banking Supervision, at the Annual General Meeting of the Foreign Bankers Association, Amsterdam, 15 May 2007.

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It is a great pleasure to speak here, at the Annual General Meeting of the Foreign Bankers Association (FBA). The FBA's mission statement is "to protect and promote the interests of foreign banks operating in the Netherlands". Looking at recent developments, I think it is fair to say that your mission will become a whole lot bigger, and, for that matter, so will DNB's interest in the soundness of foreign banks operating in this country. As both DNB and the FBA strive for a robust and efficient financial system, the rapidly changing financial landscape offers us opportunities as well as challenges and uncertainties. Addressing these in a market-friendly way is essential, yet certainly not easy, and from time to time even mind-bending. Fortunately, we – supervisors and market participants – are in this together.

I would like to address two of the key challenges we presently face. One of these challenges is to ensure an effective and efficient framework for the supervision of cross-border financial institutions. Given that financial integration in Europe and beyond will continue, it is essential that supervisory structures, which traditionally have been organized along national lines, remain viable in the longer run. Another challenge relates to the growing role of unregulated players such as hedge funds and private equity in the financial sector. Hedge funds and private equity have enriched the financial system. At the same time, these unregulated players are rapidly growing and, with that their activities are getting more relevant from a systemic point of view. Before going into these important challenges and their implications for supervision, let me first sketch the major developments in the financial system in the recent past.

Changing financial landscape

The European financial landscape has changed to a great extent over the past years. Indeed, numerous measures have been taken to deregulate and liberalize the financial sector, although much remains to be done. The need for these changes is evident: a market-oriented and liberal financial sector fosters an efficient allocation of scarce resources and thereby promotes economic prosperity. In addition, the financial sector has witnessed rapid technological innovations, facilitating an increase in new services and products and a growing sophistication in the way financial institutions manage risks. Deregulation, liberalization and technological innovation have greatly changed the financial system. Four key interrelated trends can be distinguished.

- First, the traditional demarcation between banks and other financial institutions has blurred. Large and complex financial institutions are the most evident example of the increasing interwovenness within the financial system.
- Second, financial institutions themselves have become increasingly market-dependent. Financial innovations, such as credit risk transfer and derivatives, enable financial institutions to manage and spread their risks more effectively. Although risk-sharing has come at the expense of transparency, risks today are now more widely spread to those willing and hopefully able to bear them.
- Third, financial institutions are moving more easily across national boundaries. They have increasingly embarked on international operations and cross-border mergers and acquisitions, so becoming more integrated in other countries. In light of recent events surrounding ABN AMRO, this process seems set to accelerate. This is not only reflected in the growing share of banks' foreign operations, but also in the expansion of institutional investors' holdings of foreign paper. Interbank markets, derivatives markets and payment systems are becoming more internationally integrated too.
- Finally, the financial system has become more complex, partly because of the rapidly increasing role of unregulated financial entities. Regulated institutions are now more

exposed to hedge funds and private equity, while these new players also foster the transfer of risks inside and outside the financial sector. Problems in these unregulated industries can have a larger potential impact on the regulated financial system than before.

Prompted by the first two trends – the blurring of financial products and markets and the increasing market-orientation of financial institutions – the set up of financial supervision has already been reorganized in many countries. Nowadays, the majority of Europe's supervisors operates on a cross-sectoral basis, and in an increasingly risk-oriented manner. In this respect, supervisors have taken a big step towards delivering more effective and more risk-based supervision. However, what constitutes an adequate regulatory response to the last two trends – the cross-border consolidation of financial intermediaries and the expansion of unregulated parts of the financial sector – is still an open question. Let me elaborate on these two challenges, starting with how to ensure effective and efficient supervision of cross-border financial institutions in Europe.

Ensuring effective and efficient supervision in Europe

The internationalization of financial services in Europe is steadily progressing, even though some degree of national segmentation remains. Having said this, it is a fact that both the number and the value of cross-border mergers and acquisitions is rising and, as mentioned, will continue further; at least there is absolutely no reason to assume that the rise in cross-border mergers and acquisitions will abate any time soon. A direct result of these cross-border deals is that the share of foreign banks in domestic European markets has increased substantially, from 20% of total assets in 1999 to 26% in 2005. There are several catalysts for the internationalization of European financials, most notably their growth opportunities. Indeed, international expansion is one of the most attractive growth opportunities for the profitable, capital rich European banks.

With the ongoing integration of European financial institutions and markets, the conduct of financial supervision in Europe has moved beyond its primarily national orientation. Supervisory rules and regulations are progressively internationally harmonized – Basel II is in this respect a leading example. Of course, the implementation of these rules is predominantly performed at the level of national supervisors. The practical consequences of this discrepancy are interesting. Let us look at, say, an internationally active bank with subsidiaries in ten other EU countries. Such a bank has to deal with at least one home supervisor and ten foreign supervisors. Although all these supervisors apply the same general, internationally agreed standards, they may impose their own specific requirements, for example with regard to a firm’s internal control system. The process of financial integration across Europe thus suggests we should keep thinking about whether the model underlying financial supervision in Europe remains adequate.

Given that financial integration and consolidation in Europe is desirable and will continue, it is essential that supervisory structures remain viable. I therefore believe that further steps are needed to achieve more convergence of supervisory practices in Europe. National supervisors are already moving, albeit slowly, towards more convergence of their supervisory practices. This is supported by the Approval Procedures for Basel II-Model Validation under the Capital Requirements Directive, Art. 129. However, a single European supervisor should not be considered a panacea for the cross-border challenges being faced by Europe’s supervisors. I do not need to remind you that many European banks with large cross-border activities have their largest exposures outside the EU – predominantly in North and South America – rather than within the EU. Besides, large institutional differences exist between European countries. Legal frameworks, deposit guarantee schemes and even aspects of fiscal regimes must be harmonized before substantial integration of supervision can be realized. One can imagine the technical and political complexity of such a process.

A major step forward in the convergence of supervision in Europe can be achieved through the Lead Supervisor model. As you will know, the Lead Supervisor model was launched by the European Financial Services Roundtable in 2003/2004. Under this model, the home supervisor is made responsible for supervision of an entire financial firm, including its foreign subsidiaries, while recognizing the need for an important role for the host supervisor. Indeed, in my view the Lead Supervisor model requires a close working relationship between the host and the home supervisors so as to achieve effective supervision. The home supervisor, referred to as the lead supervisor, is given final authority to set the reporting requirements for the entire group, to coordinate the validation of its internal models at the group and local levels, as well as the planning of on-site bank inspection regimes, and to co-ordinate the authorisation process. The concept of Lead Supervision promotes greater efficiency. Moreover, the Lead Supervisor model also fits in with the continuous integration –

or perhaps I should say globalization – of the financial sector. After all, Europe is part of the global financial market, and many large financial players, notably also in the Netherlands, have expanded far beyond the European frontiers. DNB believes the Lead Supervisor model can properly support the interests of market participants, which should be carefully weighed when deciding upon the future architecture of financial supervision in Europe.

An illustration of how the Lead Supervisor model can work is the preliminary high level agreement between DNB and the United Kingdom Financial Services Authority (FSA) regarding the supervisory consequences of a possible merger between ABN AMRO and Barclays. In this specific case, we have been able to come to good, pragmatic and transparent agreements. It has been agreed that decisions will be taken on a consensus basis where material issues affecting the combined group are concerned. In the unlikely event that the supervisors do not agree, the lead supervisor, the FSA, will have the final power of decision making.

Addressing the rise of hedge funds

A second challenge facing supervisors today is to deal with concerns that unregulated parties such as hedge funds and private equity constitute a potential source of systemic risk. Before I discuss these concerns, let me stress that both hedge funds and private equity have enriched the financial system in many ways. Hedge funds provide liquidity and price discovery in many markets and have fostered financial innovation, so facilitating the distribution of risk within the financial system. Private equity mobilizes risk-bearing capital for investments in companies and generally helps to sharpen a company's strategic goals. As such, it is beyond dispute that hedge funds and private equity contribute to the functioning of the economy. In what follows, I am restricting myself to hedge funds.

For three reasons there are concerns that hedge funds may exert a destabilizing influence:

- The first concern is the potential impact on regulated firms of a sudden collapse of highly leveraged hedge funds. Banks and other regulated financial institutions are heavily involved in investing and extending credit to hedge funds. This exposure implies that large losses at one such institution could have knock-on effects for institutions closer to the heart of the financial system. In times of market stress, such effects may even threaten the stability of the financial system, as illustrated by the LTCM case in 1998. There is no certainty that such an event will not happen again.
- The second concern relates to market dynamics associated with the potential for large and concentrated positions or "crowded trades" that can seriously amplify market pressures. Crowded trades can arise when hedge fund managers take similar investment positions on a large scale. Especially in combination with high leverage, this concentration could contribute to price instability if market conditions force hedge funds to unwind their positions simultaneously.
- A third concern relates to the intense form of shareholder activism associated with some hedge funds. The prominent role of shareholders today is a direct result of two developments; the first is the deregulating measures that have been taken in recent years by regulators. The second development concerns the changing corporate governance structure at private firms, including the relaxation of protection constructions. Amid the ensuing public debate, regulators and supervisors are being called upon to assess the risks associated with shareholder activism, such as the potential violation of market integrity and uncompromising behaviour with the sole aim of maximizing shareholder value. Particularly the latter may have broader financial stability implications in so far as a single-minded pursuit of shareholder maximization may in some cases undermine the stability of, and public confidence in, a financial institution, such as a bank. Such institutions do after all also provide a public good, which should be taken into account when deciding upon the future strategy, and which explains why they are subject to supervision.

These examples illustrate that hedge funds are generally beneficial but may under certain circumstances have a destabilizing influence. Therefore, the call is on those responsible for safeguarding financial stability to ensure that checks and balances are in place to limit the risks these entities pose, while avoiding restrictive measures that may prevent them from playing their beneficial role in today's markets. So far, the common view amongst supervisors is that the first concern posed by hedge funds is best addressed through indirect supervision, via their regulated counterparties. For that reason, many of the regulatory initiatives since the near-collapse of LTCM were, and still are, aimed at improving the counterparty risk management practices at regulated institutions. Effective risk management depends, however, on reliable and timely information. Supervisors have therefore also made recommendations to bolster market discipline and improve information flow between market participants. In fact, much has been achieved to date in containing hedge fund related macro prudential risks. Yet, in a continuously changing financial environment there is no room for complacency. New categories of financial products have rendered the credit relationship between regulated institutions and hedge funds more challenging. In addition, the recent protracted period of abundant liquidity and low volatility has increased the exposure of hedge funds to riskier assets. Finally, the attractiveness of doing business with hedge funds is a constant temptation for counterparties to relax their conditions, such as the haircuts applied to collateral. Hence, there is a continuous need to assess ongoing market developments and address any weaknesses in counterparty risk management and market discipline.

Indirect supervision, although essential, will not mitigate all the risks associated with hedge funds. For instance, given the importance of hedge funds in some markets, any abrupt liquidation of their positions could have implications for market stability. In addition, indirect supervision may not be in a position to address the concerns related to shareholder activism I mentioned earlier. In order to address these concerns, additional measures may have to be considered. I hasten to add, however, that tight regulation of hedge funds – such as we know for banks – is undesirable. In order to preserve the beneficial role that hedge funds play in today's market, I would prefer a lighter approach. Greater, market-driven transparency could provide markets and firms with a better sense of the build-up of large, concentrated positions or crowded trades. Of course, I also recognize that there are limits to providing data, if only given the speed at which hedge funds' positions change. Secondly, there should be better access to information on shareholder positions and strategies, including those of hedge funds. Such an approach could limit risks of market integrity and behaviour that does not consider the stability of financial firms and the financial system as a whole as a precondition. Improved disclosure along these lines could be linked to the supervisory reporting requirement on shareholding in financial firms, for which the threshold could be lowered. Finally, an additional option is to register the operating managers of hedge funds. It should be kept in mind, however, that these managers are often already registered elsewhere and operate internationally, making such registration on a national level less useful. In a nutshell, hedge funds have enriched our financial system, but they also pose some systemic concerns. The job of the supervisors is to ensure that appropriate checks and balances are in place. Further transparency and disclosure could be helpful in facilitating this process, as it would enhance market surveillance.

Conclusion

I spoke to you about recent trends in the financial industry and the challenges these pose to supervisors. I believe that a further convergence of financial supervision in Europe is desirable and indeed already progressing. In this respect, as DNB believes that the interests of market participants should be carefully weighted when deciding upon the architecture of European supervision, the Lead Supervisor model is a possibility. Regarding hedge funds, I stress that indirect supervision is a necessary but not sufficient condition for mitigating the risks they could pose to financial stability. For that reason, further transparency and disclosure by hedge funds is essential in limiting risks of market integrity and uncompromising behaviour that potentially could damage the stability of financial firms. In addressing these important challenges, co-operation amongst market participants and supervisors is key. Thank you for your attention.