Nout Wellink: Financial sector integrity

Remarks by Dr Nout Wellink, President of the Netherlands Bank and Chairman of the Basel Committee on Banking Supervision, at the Symposium about Integrity, Amsterdam, 30 October 2008.

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Back in around 1630, average annual income in the Low Countries was 150 guilders, a barrel of butter cost about 100 guilders and eight fat pigs were worth close on 250 guilders. But a red and white flamed tulip, the Semper Augustus, cost 6000 guilders, almost as much as a house on a canal. That was at the peak of the tulip mania: the frenetic trade in tulips that quickly became speculation, an economic bubble. Three years after that climax, the mania and the trade came slowly but surely to a halt. The prices began to fall sharply, and many traders went bankrupt, at that time a criminal offence that could carry a long prison sentence. Fortunes dissolved into thin air and many of those involved lost their jobs. In April 1637, the government intervened by invalidating all speculative agreements and capping the price of tulip bulbs at 50 guilders.

But what really triggered the beginning of the end? A simple lack of confidence. In fact, all markets are built on confidence. From the Albert Cuyp street market to the stock exchange on Beursplein 5, from Amsterdam to Tokyo. Confidence in the quality of the products, in the reputation of the seller, in the timeliness of delivery. The financial market is especially dependent on confidence. Confidence in every layer and link in the system. Confidence in reliable figures and sound people and in well-enforced laws against fraud and corruption.

Integrity and confidence are not synonymous, but they are interdependent. Confidence is obviously closely related, and interlinked, to integrity: confidence is essential for economic transactions and that confidence is based on the integrity of market players. So it goes without saying that integrity is not just a matter for sociologists, but for economists too. And it’s also self-evident that integrity is a topical subject, which plays an important role in the causes of, and the solutions for, the current credit crisis. That in turn is why I find it so important to exchange views with you on integrity here today.

It is imperative that the sector, that you, show that you embrace integrity as your cornerstone. And that you realise that sound conduct goes beyond strict compliance with the letter of the law. Laws and regulations reflect the prevailing social norms and values. Since regulations codify norms and values, it is vital that the financial sector keeps in touch with the current and changing views in society on what integrity involves and what type of conduct is worthy of confidence. As Ien Dales said back in 1992: “It’s no good being just a little honest”.

Confidence is not just about integrity. The solvency and stability of the financial system are also crucial for confidence in the sector. But the sector still needs to observe business integrity, in a way that we as a society find admissible and acceptable.

Monitoring and safeguarding business integrity is a job for the supervisors. In the Netherlands we apply the Twin Peaks model, for which the US Minister of Finance Paulson recently expressed a preference. In this model, we separate market conduct supervision and prudential supervision. The Authority for the Financial Markets (AFM) exercises supervision on the conduct of financial institutions in the market and towards their customers, and DNB targets the solidity of financial enterprises. An important component in the supervision by DNB and AFM is the supervision of financial sector integrity.

How does DNB go about it? By exercising supervision on the various levels of integrity: supervision of personal integrity, relationship integrity, organisational integrity and market integrity. We target the main risks: money laundering, terrorist financing, fraud, harm to third parties and insider trading. These risks could affect the activities of financial institutions and harm their reputation. DNB expects that institutions will act responsibly in identifying and managing such risks.

For most enterprises, and particularly financial institutions, the tone at the top is more significant for business integrity than the conduct of individual employees. The integrity of directors and those who determine or co-determine policy at financial institutions has traditionally been verified by the integrity test. The trustworthiness of an enterprise's top management should be beyond doubt. In 2007, DNB conducted integrity tests on 1578 persons responsible for determining policy. Not one of them failed the test, although 58 candidates withdrew their application.

These tests sometimes hinge on delicate considerations. Is, say, Mr X, who threatened a traffic warden after receiving a traffic fine, still a fit and proper director? And how do you deal with the director who, whether or not intentionally, fails to report previous offences on his integrity form.

Openness plays an important role in such decisions. For DNB, failure to mention a mistake is sometimes worse than the mistake itself. I assure you that DNB treats such questions with the greatest possible care.

And of course we require the highest standards of integrity from our own employees and organisation. For DNB too, a sharp awareness of integrity at all layers of the organisation is crucial. We work hard on that. Not only through rules and regulations but also through training sessions on integrity in the workplace. Such sessions lend DNB employees greater insight into the integrity dilemmas that may arise in their work. But more importantly, DNB employees discuss integrity and what it means for us. In addition, our central compliance department continuously analyses the integrity risks that we run as a central bank and supervisor, especially in view of our public role. Unsound conduct by DNB or its employees could have an immediate impact on public confidence in our organisation.

The Prevention of Money Laundering and Terrorist Financing Act, which recently came into effect, gives substance to customer due diligence. Financial institutions must at all times apply the basic criteria: know your customer and know your business. In other words: even if an institution's employees are sound, they may unwittingly do business with dishonest customers. Banks could be drawn into money laundering constructions engineered by criminal organisations that use complex methods to finance real estate with criminal gains.

Besides "know your customer", there are specific sanctions regulations aimed in part at preventing terrorist financing. Institutions must also take measures to prevent their misuse for financing weapons of mass destruction in countries such as Iran. DNB is obviously not the only supervisor of these practices. Under UN resolutions and EU legislation, institutions are obliged to have a clear view of their trade financing activities.

We must always stay alert for new developments. In 2006, for example, an estimated USD 1 billion was spent on goods and services in digital virtual communities. The combination of anonymity and the possibility of channelling profits to the real economy make such websites a potential source of terrorist financing.

In tracking down risks, we sometimes look right through sectors to examine a specific issue. The real estate sector is a good example. The real estate market is often closed and intransparent, with a select group of players who can act in various capacities. That makes the sector vulnerable and exposed to dubious practices. Seeing this as a serious concern, DNB has asked the sector to establish a robust framework of control measures.

Besides monitoring the development of risk, DNB also seeks methods to make integrity supervision more efficient. This is aptly illustrated by the so-termed self-assessments, whereby institutions assess their business integrity with the help of questionnaires.

DNB subsequently examines these self-assessments. This is an efficient way to chart the risks within a sector without having to visit each institution individually. Self-assessments were introduced at small and medium-sized insurers this autumn; they were developed in consultation with the sector in order to accommodate insurer-specific features. We also learnt greatly from the AFM's experiences with its contribution model.

DNB's operational supervision is obviously closely connected to the integrity issues of concern to the intelligence and security service, the AFM, tax authorities, fiscal and economic intelligence service and the police. DNB neither prepares nor continues the work of the investigative and prosecution authorities, but we cooperate well with them and share information with other supervisors and investigative and prosecution agencies, naturally keeping within the statutory bounds of confidentiality. As the chair of the Financial Expertise Centrum, the FEC, DNB is committed to further intensifying cooperation between the services.

Besides the integrity supervision of persons, business relations and organisations, DNB also concerns itself with the integrity of the entire financial sector. Here too, integrity goes beyond compliance with statutory rules and provisions. Unsound conduct can damage the sector as a whole, even if, strictly speaking, no violations occur. The wrong sort of incentives could induce sound people, working in sound companies, to exhibit behaviour that impacts negatively on market integrity in general. Notably in this area, it is up to the sector to act responsibility. You are responsible for making the right choices. Where those choices are difficult, DNB would be glad to discuss them with you. But if you don't make any choices at all, you will find that DNB takes its role as supervisor very seriously when it comes to integrity.

In my view, this sector is itself responsible for all aspects and manifestations of sound conduct. Confidence must be earned! And what the sector, or certain players in the sector, do or do not earn, is now a target of much agitation and dissatisfaction and a subject of debate that focuses particularly on transaction-related bonuses. Without going so far as to say that the credit crisis is a direct result of such bonuses, we can say that the incentives attached to such bonuses could generate irresponsible and socially undesirable behaviour. Behaviour that in any case lowers confidence in the reliability of the financial sector.

Let me assure you that DNB will keep a strict watch on bonus structures at financial institutions that induce directors to take irresponsible risks. We do not need to completely prohibit bonuses, but it is essential to align the size and the time frame of bonuses more closely to the longer-term goals of the enterprise itself. As far as I am concerned, bonuses could be scrapped altogether. I would prefer to see executives drawing good, competitive salaries. That salary should be enough incentive for a good and sound performance that actually contributes to financial institutions' long-term objectives. I am convinced that the financial sector itself would benefit most from stable pay structures.

Of course this issue must be tackled internationally. Globalisation has removed the borders in the financial sector. Since financial risks have become marketable, and borders between countries have blurred, losses are spread more widely. We not only reap the rewards of globalisation, but the bitter fruits too, because everybody is affected when things go badly wrong. That's why we need international discussion and action on bonus structures, integrity and other such matters.

The Financial Stability Forum, in which I sit as the chairman of the Basel Committee, published a code of conduct for pay structures in July. It centres on the recommendation that pay incentives should be based on actual performance and should be in line with the long-term interests of shareholders and the profitability of the enterprise as a whole. In addition, DNB is supported at national level by the AFM's serious approach to its integrity task. AFM supervises the sound conduct of the sector towards its customers, the consumers. And only when the sector deals soundly with consumer interests, will consumers regain confidence in the financial sector.

The first steps have been taken: nationally and internationally, financial sector integrity is on the agenda. In the coming period we will join in European and global discussions on sound, confidence-inspiring international supervision. Supervisors, governments and enterprises together. Because if there's one thing we've learnt from the credit crisis, from the loss of confidence in the financial sector, it is – in my opinion – that we can only regain that confidence through national and international cooperation!