Nout Wellink: Managing complexity

Speech by Dr Nout Wellink, President of the Netherlands Bank and Chairman of the Basel Committee on Banking Supervision, at the NautaDutilh seminar, Bussum, 10 November 2009.

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I have been informed that the topic for discussion will be the new balance between banks and supervisors in the financial system. This is an issue I'm happy to address. However, before doing so, let me first say a thing or two about complexity in the financial system.

How should we treat complexity?

Let me start by stating the obvious. A solid financial sector is crucial to the functioning of our economy. Its existence allows the efficient allocation of capital between different activities and across time, and promotes the efficient spreading of risk within society. Today, it is hard to think of any form of economic activity that is not in some way dependent on its existence.

Therefore, the stakes are high in the current debate on financial sector regulation. After the events of the last two years, everyone agrees that change is needed. However, opinions differ about the kind of change we need. First, there are those that see the complexity of the financial system as the root of the problem, and therefore propose to constrain finance much in the way it was until the 1980's. Some suggestions along this line are narrow limits on the activities of banks, splitting supposedly "safe" banks from banks engaging in capital market activities, or constraining specifications of financial products to those pre-approved by authorities. Second, there are those who think that complexity itself is not the root of the problems, but rather circumstances allowed the complexity of the financial system to contribute to the crisis. They believe that the goal of regulatory changes should not be to decrease complexity per se. Rather, they think complexity should be made more manageable.

In this debate, I find myself squarely backing the second view. The reason for this is that I do not believe complexity in itself to be a bad thing. Complex systems are designed, in many cases, to be more useful and efficient than simple ones. Radios from the 1950s – of the kind I used when I was an amateur broadcaster – are much simpler than the ones we have today. Yet today, thanks to innovation and rising complexity, radios have become cheaper and more reliable. And, on top it all, they offer a much wider range of functionality and are easier to use. Cars are another example where complexity and technology has been used to make them safer, rather than more hazardous. Wonderfully named features as ABS and ESC are only possible because of innovation driving growing complexity in car-making. This is the kind of complexity that keeps drivers safe every day.

The finance industry also offers us some wonderfully names symbols of complexity, such as RMBS and CDS. Unfortunately, unlike their counterparts in the car industry, these are not currently associated with safety and reliability. So it is clear that innovation and complexity may have improved the system's ability to allocate capital efficiently in many cases, but certainly not in all. This implies we should go back to the drawing board to improve the resilience of the financial system. But it does not mean we should go back to the past. Innovation cannot be undone and the idea that tomorrow's problems can be solved by yesterday's regulation strikes me as overly simple and even dangerous, as it could constrain the possibilities for financial system to allocate capital around the world and transfer risk efficiently.

While we are at the drawing board, we also need to address the issue of containing systemic risk. The new financial system as a whole, as well as its individual institutions, will need to be

more resilient to shocks. The present-day financial system is a complex system, characterized by a high level of interconnectedness. Therefore, monitoring the financial system as a whole, and the linkages between its elements, has become all the more important. Such "macro-prudential" supervision mechanisms help to spot sources of financial instability at an early stage. A positive development in this regard is the establishment of the European Systemic Risk Board next year. But changes are also at hand to strengthen each financial institution individually. And some of these changes will have a profound effect on the balance between banks and supervisors.

Managing complexity

This brings me back to our topic of discussion. The balance between banks and supervisors. What changes are necessary for individual banks and supervisors, in order to strengthen the resilience of the financial system and manage its complexity?

Let's start by looking at changes for individual banks. Some policy proposals have received ample attention in the debate. In order to make the financial system more resilient to shocks, each individual bank will need to hold a bigger capital buffer than before. This can be achieved through higher overall buffers, increases in capital charges for specific activities, or a combination of the two. Furthermore, the quality of capital buffers needs consideration to ensure that they can absorb shocks while the bank is still functioning. Banks' leverage will have to be limited in some shape or form.

Banks also have a responsibility to actively manage their own complexity. In this regard, I think a proposal that is rightly being considered is that of "living wills". Living wills are plans drawn up by banks for an orderly wind-down of operations, in case they are not able to continue operating on a going-concern basis. This would be very beneficial to financial stability in case of a large-scale default. Lehman Brothers, for instance, was composed of over 3000 legal entities at the time of its demise. Better guidance on how the organization could be properly wound down would have made life considerably less stressful for its supervisors, counterparties and administrators, as well as the financial system as a whole.

As an aside, the legal profession has a role to play here as well. The number of entities may be one useful proxy for the level of complexity in an organization, but the combined length of all the contracts determining the mutual obligations between these entities surely is another. At the end of the day, one of the key qualities of the legal profession is to make complexity more manageable by providing market participants with clear, unambiguous and concise contracts rather than the opaque, heavily cross referenced and nearly inaccessible piles of paper that one too often encounters in practice. Here, as always, more is less, less is more. True craftsmanship produces documentation that even a layman can appreciate and more importantly, understand.

By comparison, I think the changes needed in the supervisor's toolbox have not always received the same amount of attention. These changes are crucial, though, to ensure that supervisors are well-equipped to ensure the resilience of the financial system in a complex world. Recent events have again confirmed that in some cases, our options for intervention are limited and can only be exercised at a late stage. For the supervisor to be effective in an increasingly complex and interconnected world, it will need more power to intervene at an earlier point in time. Internationally, promising policy has already been implemented in this regard, such as the Special Resolution Regime in the United Kingdom.

Making it work

As I see it, banks should welcome all these measures. Bigger capital buffers and the existence of living wills enhance the stability of the financial system. So does the existence of a more powerful supervisor with an enhanced toolkit. Financial instability in the end threatens

the survival of all banks, not just the ones that spark a crisis. Therefore, a more effective design and supervision of the financial system is in the interest of every individual bank.

Finally, banks should also be keenly aware that the option to manage complexity will not be on the table forever. Society's patience with the financial sector has already been put to the test, and is not unlimited. It can perhaps accept that a complex system fails once; it would be unlikely to accept the risk of another failure. If banks do not take their responsibility to show that lessons have been learned from the crisis, a serious threat exists that legislators may opt for overly simple solutions that try to reduce complexity at any price and, from a societal perspective, are suboptimal. Therefore, all parties in the financial system should work together to show that complexity can be properly managed for the benefit of society.