

Arnold Schilder: The boundaries of the Civil Society? The example offered by financial supervision

Speech given by Professor A Schilder, Executive Director of the Nederlandsche Bank, in the context of the Second European Social Week held in Bad Honnef, Germany, on 7 April 2000.

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Introduction

The main theme of this Second European Social Week is the establishment of a Civil Society in Europe. This Week is intended to generate initiatives which could contribute towards this goal. At the same time, we need to ask ourselves where the boundaries of a Civil Society lie. Put differently, does the model for the Civil Society meet the requirements of the European Society that we envisage? I am sure that you have no need of an explanation of the concept of a Civil Society. Put briefly, a Civil Society is a society built on a large measure of self-control. If you favour a Civil Society you expect individuals to engage in responsible behaviour. In our societies, freedom is a great good. But freedom goes hand in hand with responsibility. One man's freedom may be another's lack of it. That is why freedom is curtailed by standards and values. At the end of the day, it is these standards and values that protect our freedom. These days we are increasingly asking ourselves to what extent individuals are capable of taking responsibility for their actions. This question arises from our growing interest in moral values. There is an increasing call for control and supervision of compliance with standards. Why? Well, we are living in highly democratized times, where the need for transparency and openness is growing daily. This is not least because of the development of a wide variety of new media, such as the Internet. Whether this call for more supervision and control spells the end of the Civil Society is something I will be going into later. Let me first say something about the boundaries of the Civil Society. Why do we need to see to it that individuals shoulder their responsibilities? I shall illustrate my point by taking a look at supervision as it is exercised on the financial sector.

Financial supervision in summary

Before discussing the boundaries of the Civil Society, I would like to provide you with a brief overview of financial supervision. The emphasis will be on how that supervision is organised in the Netherlands. However, keep in mind that the issues confronting the Dutch financial system are no different from those in other European countries or other parts of the world. In this context, the fact that supervision is organised differently from one country to the next is irrelevant. Supervision on the Dutch financial sector is segmented. The supervision on banks (credit institutions), investment institutions and exchange offices has been delegated to the Nederlandsche Bank. The Bank is also responsible for the stability of the financial system as a whole. Insurance companies are supervised by the Dutch Insurance Supervision Board, while the Dutch Securities Board supervises the stock exchange, securities firms and securities business in general. Regulatory issues which involve all three supervisory authorities are dealt with by the Council of Financial Regulators, without detracting from their individual responsibilities. This model is receiving increasing attention internationally. It forms a good alternative to the supervisory model whereby all regulators are united in a single agency. The supervision of the Dutch financial sector is laid down in a number of statutory instruments. The statutory objectives of banking supervision in particular may be summarised as follows: safeguarding a stable financial system, protecting creditors and, within the near future, maintaining the integrity of the financial sector, objectives which I will be looking at extensively later on. Let us now return to the Civil Society: what are key issues here? There are three, which I will be discussing in detail. First, externalities, i.e. the benefit for and cost to society of individual action. Second, reprehensible behaviour on the part of individuals. Third, the need to protect the interests of weaker groups in society. In each case, I will be drawing parallels with supervision of the financial sector and pointing out what lessons could be drawn from this for the Civil Society.

Key issues of Civil Society: externalities

A Civil Society is no free-for-all; it is a society of individuals engaging in responsible behaviour. As the Chairman of the Van Ede Foundation, Mr Leeuwens, put it very aptly not long ago: acting responsibly is acting appropriately on the common ground between self-interest and the greater good. This is not a novel idea, and has always held its place in economic science, as Mr Leeuwens so rightly pointed out. Adam Smith was a fervent advocate of free enterprise. He argued that when individuals are free to choose how to use scarce goods and capital, the resources available to an economy are put to their best use. Adam Smith was not thinking in terms of mere self-interest. He spoke of an invisible hand, providing guidance to the market mechanism. He too assumed that, individuals are guided by the common good consciously or unconsciously. The question arises whether this invisible hand always works properly. Most individuals base their behaviour on a cost/benefit analysis of their own. Even an individual who tries to take the general interest into account has no inkling of the true costs and benefits of his decisions for society as a whole. In addition, individuals often base their decisions on less rational considerations as well. Take, for instance, investor behaviour, such as the herd instinct on the stock exchanges. This can be explained by the theory of cognitive dissonance: investors filter information to justify earlier investment decisions. Economic textbooks often cite environmental pollution as an example of an area where the invisible hand does not work as it should. Industrialists undoubtedly take the consequences of their production process for the environment into account. Nevertheless, they are incapable of making an optimum assessment of the costs of pollution for society. In cases such as this, we need to seek ways of internalising the externalities into the market mechanism. One way of dealing with this problem is to impose statutory requirements on the release of pollutants and to set up an agency which checks compliance with these requirements. A Civil Society will also have externalities to deal with. Even if the participants in a Civil Society behave responsibly, the outcome of their actions may not be optimal to society. To what extent do externalities figure in the functioning of the financial sector? A good example is the Nederlandsche Bank's responsibility for the stability of the financial system. Through their behaviour, financial institutions may jeopardize their own continuity. Take, for instance, a bank which exposes itself to considerable risk by granting vast, high-risk loans. If the borrower defaults on these loans, the bank could founder. That in itself would be a disaster, but the ultimate outcome could be worse still. If the bank in question has borrowed heavily from another bank, the latter may also find itself in trouble. This is known as the domino effect. In order to prevent such situations from arising, the legislator has set up a banking supervisory authority. The first task entrusted to this supervisor was to watch over the continuity of banks. This is where prudential supervision came in. It made it possible for regulators to issue rules and guidelines for the way banks manage their balance sheets. The best known - internationally-agreed - rule is the Basel Capital Accord. It compels banks to maintain a buffer of own funds, of at least 8% of all loans outstanding. Should a bank fail, something that cannot be wholly precluded by supervision, the supervisory authorities can resort to other ways and means to keep it going. In the early-1990s, the Swedish government made vast amounts of funds available to the Swedish banking system when a major financial crisis threatened to paralyse the entire financial sector there. If and when a central bank will actually act as lender of last resort is known only to that central bank. This is to prevent banks from engaging in "moral hazard" behaviour. If banks knew under what conditions liquidity support is given to the banking system, they might anticipate such action, rather than shoulder their own responsibility for the continuity of their business. This brings us back to the Civil Society. Even though there may be an authority which supervises the functioning of the financial sector, at the end of the day it is up to banks themselves to bear responsibility at the very least for their own continuity. Supervisors do not act for bankers. In other words, rules and standards - and the establishment of an agency which ensures compliance - may help to internalise externalities in the Civil Society; ultimately, the participants of the Civil Society must shoulder their own responsibilities.

Key elements of the Civil Society: reprehensible behaviour

The second constraint on the Civil Society is reprehensible behaviour on the part of individual participants in respect of certain standards and values. Those who advocate a Civil Society assume that everyone is more or less concerned with the common good. Everyone operates on the common ground

between self-interest and the greater good. There are, however, always people who have only their own best interests at heart, and who have no qualms about sacrificing others in the process. This is considered reprehensible behaviour. In this sphere, too, there is a need for an agency to demarcate the boundaries between acceptable and unacceptable behaviour, as well as to ensure that these boundaries are not transgressed. Reprehensible behaviour is completely out of the question in the financial sector. Individuals entrust their money to financial institutions. Abuse of that trust will damage the reputation of the bank in question, and with it possibly its continuity. That is why financial supervisors are paying increasing attention to the integrity of financial institutions. This brings us to an area of great activity. In the past, supervisors focussed notably on the prudential aspects of banks' operations. Over the years, however, their attention has shifted to the integrity aspects of banking. First of all, it turned out that reprehensible behaviour can also threaten the continued existence of a financial institution. Secondly, the requirements to be met by the integrity of the financial sector have been sharpened over the years. Insider trading, never questioned several decades ago, is now considered totally unacceptable in most countries. The Nederlandsche Bank has also come to pay increasing attention to financial integrity. In July 1997, the Bank decided to set up an integrity unit. The unit offers specialised support in the sphere of regular integrity supervision. It also takes part in policymaking in this field. Financial integrity has since come to figure prominently on the Dutch political agenda. As things now stand, integrity supervision is becoming a separate, statutory aim of Dutch banking supervision. In anticipation of this development, an integrity audit has been drawn up under the auspices of the integrity unit. This is in fact a computerised methodology that allows supervisors to assess banks systematically in terms of integrity. Back to the Civil Society again. Tackling reprehensible behaviour does not mean distrusting every participant in the Civil Society in advance. That is in any case not how financial supervisors see their task. Financial institutions, and certainly the overwhelming majority of banks, are not out to engage in reprehensible behaviour. After all, if they did, they could be jeopardising their continuity. However, there is always the chance that an individual employed at an institution cannot resist the temptation to put his own interests above those of others. Supervisors must therefore be on the lookout at all times. However, if distrust were to get the upper hand, the open relationship between the supervisor and the bank would be undermined. The Civil Society, too, cannot function on the basis of distrust. The measure of trust among people determines the measure of cohesion within society.

Key elements of the Civil Society: protecting the weak

Let us take a look at the third element of the Civil Society. The participants of the Civil Society are basically assumed to be equal. They allegedly have the same information at their disposal and are considered capable of looking after their own interests. In practice, however, that is not always the case. Society also encompasses weaker groups, which are insufficiently able to defend their interests in a Civil Society. There are several solutions to this problem. Notably in a well-functioning Civil Society, the obvious thing would be for vulnerable groups of individuals to organise themselves. If this option proves ineffective, they should be able to resort to an agency which looks after their interests for them. From the point of view of the financial system, the weaker party is clearly discernible, viz. consumers, the individual customers of a financial institution. Their interests are protected by supervision in several ways, in the Netherlands, too. To begin with, the Dutch Act on the Supervision of the Credit System explicitly seeks to protect banks' creditors. Not only do the supervisory authorities watch over the continuity of financial institutions with a view to overall financial stability, they also seek to protect those who have entrusted their money to banks. In the event of a bank failure, its creditors can resort to a deposit guarantee scheme, which ensures that their deposits are guaranteed - subject to certain conditions - to an amount of EUR 20,000. Supervisors furthermore seek to ensure that financial institutions provide their customers with proper information. The supervisory authorities do not intermediate between banks and their customers, on the contrary. They - increasingly - require banks to provide consumers with adequate information. Consumers must have sufficient information at their disposal to make a well-founded choice. In the Netherlands, a package of minimum information requirements is currently being drawn up. Last year, the Nederlandsche Bank set up a consumer affairs unit. The unit's staff contribute to the rules being drawn

up with regard to the information being supplied to consumers. They also answer questions put by consumers about financial services, and inform consumers on what to do when they have concrete complaints about a financial institution. In this respect, the Netherlands is in the vanguard in Continental Europe. In the United States and the United Kingdom, consumer interests figure even more prominently in supervision. The conclusion is therefore that even in a Civil Society, it may be necessary to protect the interests of vulnerable groups by formulating standards and values.

Is the Civil Society infeasible?

So much for key elements of the Civil Society. Does this mean that the Civil Society is infeasible? Far from it. As I noted earlier, the proponents of the Civil Society are well aware of the bounds of societal responsibility. The Civil Society has nothing to do with unbridled liberalism. On the contrary, the protagonists of the Civil Society are continuously seeking to improve and supplement its model. This serves to internalise the constraints which I outlined earlier. In the Netherlands, supervision is, on the one hand, enforced by a statutory framework, providing for rules and obligations for financial institutions and sanctions for non-compliance. On the other, it was set up in a “partnership” with the financial sector. The financial system helped to shape supervision as we know it. In other words, the currently much-acclaimed Dutch polder model concerns not just the cooperation between government and social partners, but in a sense also the supervision exercised on the financial sector, with all parties involved acknowledging that proper supervision serves a common purpose. Obviously institutions have commercial goals, but they are also aware that the public’s confidence in the financial system is conditional upon sound supervision. An open relationship has consequently grown up between the Bank and the institutions subject to its supervision. Yet the Bank maintains a sufficient distance vis-à-vis the institutions, to safeguard objectivity and the authority to act when and where necessary. It is this mix of cooperation, efficacy and forceful action which makes the supervision exercised by the Bank so potent. I would like to point out that a partnership does not equal self-regulation where the supervision of the financial sector is concerned. The experience gained by the financial sector with self-regulation has not always been positive. Though widely sustained by the sector, financial supervision also clearly stands above it. As the Civil Society will not be able to function properly without impartial supervisory bodies, it will need to delegate part of its competencies and responsibilities to them.

Conclusion

I am nearing the end of my address. I am all for striving for a Civil Society in Europe. It means, however, that we need to analyse the obstacles that we find on our way to that goal. The model of the Civil Society is up against several constraints. First, the externalities of the behaviour evinced by those taking part in the Civil Society. Second, possible reprehensible behaviour by individuals - to the detriment of others. Third, the tendency to lose sight of the interests of weaker groups in society. I have attempted to show that the limitations that the Civil Society is up against also constrain the financial sector; there the remedy has been found in the establishment of a supervisory authority which sets standards and ensures compliance. Ideally, financial supervision is a partnership between the supervisory authority and the financial sector. At the same time, the supervisor should stand above the sector, and be capable of intervening forcefully and effectively. What does all this mean for the Civil Society? Though the constraints on the Civil Society can be remedied in part by society itself, some form of supervision is ultimately indispensable. The best illustration I can think of is street violence. Violence cannot be curbed by simply putting more police on the street. Maintaining standards within society calls for the active participation of all. A good example is the neighbourhood watch. On the other hand, it would be unacceptable if people were to take the law into their own hands, or if safety on the street were to become only their own responsibility. An impartial supervisory authority - in this case the police and other instruments of the constitutional state - may not be the ultimate remedy. It certainly is an indispensable tool in ensuring a well-functioning society. Finally, how does the Civil society achieve a state of supervision which is effective? This should develop through public debate as well as initiatives from participants. Recently in the Netherlands we noted some cases of so-called

meaningless violence: youngsters killed by mindless people for no reason. This raised storms of protest, demonstrations, silent procession. Now we see this developing into a mix of officially backed arrangements and joint private efforts to fight violence and the lack of solidarity. That is the right balance between organized supervision and self-regulation. So, there is no excuse for awaiting others' actions. That is why this conference may prove meaningful.