Nout Wellink: It's the incentive, stupid!

Speech by Dr Nout Wellink, President of the Netherlands Bank and Chairman of the Basel Committee on Banking Supervision, at the Conference "Integrating micro and macroeconomic perspectives on financial stability", University van Groningen, Groningen, 26 May 2008.

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Introduction

1. It is a great pleasure for me to deliver a speech at this conference on financial stability. Needless to say, this subject has hardly been more challenging than in recent times. But let me start on a positive note. Because of the market turbulence, many people seem to forget how the financial system has improved over the past decades. The system has developed and expanded, and its potential to facilitate efficient allocation in the economy has increased enormously. Financial services have become more accessible to broad categories of firms and households. And the possibilities to spread and manage risks have improved, which partly explains why the financial system has been able to absorb an accumulation of setbacks in recent years, including the burst of the dotcom bubble, the September 11 attacks and rising geopolitical tensions. If the financial system is the switchboard or operating system of the world economy, this switchboard has clearly become more powerful, allowing more transactions at a higher speed.

2. But higher speed and greater power also entail the possibility of more severe accidents, as illustrated in the past year. Looking at financial history, this is not surprising. Financial development over the past centuries has always been characterised by ups and downs. Typically, vulnerabilities like the ones we have seen recently can be traced to wrong incentives and a lack of checks and balances. In the rest of this speech, I will first discuss common patterns of past crisis episodes, emphasising the role of incentives. Against this background, I will then examine the current crisis. I will conclude by discussing policy implications and the recent recommendations of the Financial Stability Forum.

Role of incentives: lessons from history

3. Although every financial crisis has its unique features, there are several recurrent themes. As Charles Kindleberger argues in his famous book "Manias, Panics and Crashes", financial crises are typically the result of a prolonged accumulation of imbalances, preceded by some exogenous shock or structural change in the financial system. Examples are changes in the political environment, new regulation and financial innovation. These changes create new opportunities but also uncertainty and a lack of awareness about potential new risks – the so-called "unknown unknowns". In such an environment, traditional checks and balances may become inadequate and easily lead to excessive risk

4. We have seen numerous examples where periods of exuberance were accommodated by the financial system, reflected by increasing leverage and asset price inflation, followed by a correction. Without any doubt, the best example in Dutch financial history is the Tulip Mania, which took place around 1635. This episode is especially known for its incredible price increases. At the peak, 14 thousand guilders were paid for a single tulip bulb – more than a workman earned in his entire life those days. Less known is that the speculative bubble was largely driven by financial innovation. In the years before the Tulip Mania, new financial markets evolved in the Netherlands, including a stock exchange and futures markets. Sophisticated trading techniques were developed, allowing short selling and the use of put and call options. Derivative contracts allowed massive trading in tulips that were not even planted yet – a genuine financial innovation at the time. Many investors did not realise that these new instruments were inflating a speculative bubble on an unprecedented scale and

lost all their money when the market collapsed after two years. The Tulip Mania illustrates how imbalances can develop when previous constraints are lifted – in this case by new financial tools allowing investors to take large speculative positions. But it also illustrates the role of naive optimism and even greed.

5. Misguided incentives are often also at the root of growing imbalances, because of conflicting micro and macro perspectives. This is because at the micro level, market participants tend to take the environment in which they operate as given, for instance prices and the behaviour of other market participants. But factors that are considered exogenous at the micro level may become endogenous for the financial system as a whole. At the macro level, this easily leads to fallacies of composition. For example, for an individual investor, increasing leverage is a way to boost returns. But if everybody does this, without sufficient profitable investment opportunities, it can only be counterproductive by reducing long-term yields and raising risks.

Pro-cyclicality

6. A closely related issue is the financial system's inherent pro-cyclicality. We all know that with a favourable economic outlook and upbeat financial markets, balance sheets look strong for both financial firms and their counterparts in the real economy. In such an environment, it is understandable that banks' lending criteria become looser and, for instance, pension contributions are reduced. As the cycle turns, lending criteria are tightened and firms will find it more difficult to finance their investments, which exacerbates economic fluctuations.

7. So, financial institutions' pro-cyclical behaviour is to some extent inevitable. The same holds for the role of regulation, which may strengthen pro-cyclicality: regulatory rules are more likely to become binding during unfavourable times. Nonetheless, there are examples where we managed to soften this trade-off between sound risk management and pro-cyclicality. One example is the new Capital Accord, Basle II, which requires banks to perform stress tests and demonstrate that they hold sufficient capital buffers above the regulatory minimum level when economic conditions are favourable. Another example is the Dutch Financial Assessment Framework for pension funds, implemented last year. Pension funds now have the possibility to make part of their liabilities conditional, allowing them to spread out shocks over 15 years. In addition, pension funds are required to use this long horizon when setting their premiums. This way, our defined benefit pension system has become more sustainable and at the same time less pro-cyclical. It is important that this carefully designed system will also be better acknowledged in the new IFRS accounting rules. We must avoid an overly rigid application of these rules, which should reflect the real risks and risk mitigants, and should therefore take into account the conditionality of Dutch pension contracts.

Characteristics of the current crisis

8. It is too early to provide a thorough analysis of the causes and characteristics of the recent financial turbulence. Apart from the fact that markets are still fragile, it will probably take several years before we are in a position to put these developments fully into perspective. Nonetheless, even at this stage it is not hard to find similarities with earlier crisis episodes. In particular, there has been a structural change in the form of financial innovation. Deregulation and liberalisation have created scope for new financial instruments and enhanced the mobility of risks. This is most clearly illustrated by the so-called "originate-to-distribute" banking model, which has emerged over the past decade. By securitising loans, retail banks can focus on their role as originators, while other institutions such as investment banks specialise in bundling these loans into structured products that are then sold to investors. The benefits are clear: specialisation along the securitisation chain creates a more efficient financial intermediation process, in which risks can be priced and transferred.

9. However, the shortcomings of the originate-to-distribute model have also become painfully clear and have everything to do with incentives. Some examples:

- Obviously, a bank that sells its risks to other parties has less interest to vet the original borrower, nor to continue monitoring these risks as closely as before.
- Unbalanced remuneration incentives are another source of excessive risk taking. Employees who receive massive bonuses when earnings are high but are hardly hit when losses are made, are probably less prudent than would be in the interest of their employer. This not to say that bonus systems are by definition wrong, but they should be designed in such a way that curbs exist on inappropriate behaviour. Perhaps, one way to improve this is to ensure that an employee's time horizon is aligned with that of more general interest, for instance by making bonus payments dependent on broad performance indicators over a longer period.
- Incentives are also affected by insufficient risk awareness. For complex financial instruments such as structured products, it is difficult to assess their value and underlying risks. This, and a lack of experience how these instruments are performing under stress, has complicated the determination of adequate credit ratings for structured products. In addition, rating agencies are confronted with conflicts of interest between debt issuers, who pay for the ratings, and investors who rely on them.
- Wrong incentives are also due to slow implementation of new regulation which, I am afraid, is a fact of life. Already in the 1990s it had become clear that the old Basle Accord was becoming outdated and needed to be replaced with a new framework. Basle II is more risk-oriented and provides better checks and balances. It should have been implemented earlier; and, if it had, the recent developments would probably have been less turbulent. Indeed, under the old Accord, banks could circumvent regulatory requirements by transferring risks to special off-balance entities such as Structures Investment Vehicles (SIVs) and conduits.

10. Let me revisit the interaction between micro and macro perspectives, which has become increasingly relevant in today's market-oriented financial system. Wrong incentives at the micro level have resulted in excessive risk taking, such as the supply of subprime mortgages to households that cannot afford them. At the macro level, the size and distribution of risks is blurred by complex instruments and risk transfer mechanisms. It has also become more difficult to interpret macroeconomic data on money and credit growth, which makes it more challenging to formulate a balanced monetary policy. Furthermore, with the deterioration of market sentiment and evaporation of market liquidity, risks have rebounded to individual firms in the form of funding liquidity problems.

11. So, apart from the similarities with earlier crisis episodes, what makes this crisis special? Let me stress two striking features:

- First, many of the risks that crystallised in the past year were on our radar screen long before the crisis started. If you read the numerous Financial Stability Reports that were published in the past years, including our own Overview of Financial Stability, you will see several analyses about excessive risk tolerance, hazardous risk transfer mechanisms and possible shortcomings of the originate-to-distribute model. One of the key lessons is why we have not been able to translate our risk assessment into mitigating action.
- Second, this crisis stands out on account of its global nature. More than in the past, the turmoil affects all advanced economies, reflecting the integration of financial systems over the past decades.

Policy implications: FSF recommendations

12. This global scope underscores the importance of an international policy response. Fortunately, international cooperation between financial authorities has increased over time. Examples are standard setters such as the Basle Committee on Banking Supervision (BCBS) and the International Accounting Standards Board (IASB), and international organisations like the International Monetary Fund (IMF) and the Bank for International Settlements (BIS). All these organisations, as well as the major economies, are represented in the Financial Stability Forum (FSF) which meets biannually. When the market turbulence intensified last summer, the FSF was asked by the G7 to take the lead in organising a coordinated policy response. In my capacity as chairman of the Basle Committee, I am a member of the FSF working group that prepared a report that was published last month.

13. The FSF report includes 67 policy recommendations. It is impossible to discuss them all, but let me just mention some of the major themes:

- Many recommendations are aimed at strengthening firms' risk management. Perhaps the best contribution to this is a timely implementation of Basle II, some elements of which will be strengthened (e.g. capital treatment of structured credit and securitisation activities, risk management practices (pillar 2)). In addition, regulators should work with market participants to mitigate the risks arising from inappropriate remuneration structures.
- Many recommendations are aimed at improving transparency and valuation. When publishing their upcoming mid-year reports, financial institutions should disclose their risk exposures according to a template in the FSF report. This is important to enhance consistency across firms. Other proposals aim at improving accounting standards for off-balance sheet vehicles and strengthening guidance on the valuation of financial instruments. A specific set of recommendations focus on the role and uses of credit ratings. Rating agencies should improve the quality of the rating process and avoid conflicts of interest in rating structured products. Furthermore, these ratings should be differentiated from those of regular bonds, for instance by using a different rating scale. At the same time, investors should address their over-reliance on ratings.
- Several recommendations refer to the role of the official authorities. I already indicated that many of the risks that have manifested themselves were not a surprise; to some extent, we saw this crisis coming. Therefore, it is important to improve the translation of our risk assessments into action. This requires better information exchange between authorities and with the private sector. It involves improving cooperation between regulators and central banks but also cross-border (e.g. supervisory colleges). Finally, crisis management arrangements need to be strengthened. This includes central banks' liquidity operations which must be more flexible, avoid stigma-effects and allow cooperation with other central banks (e.g. by establishing swap lines and allowing cross-border use of collateral).

For most of these measures, it is not difficult to see how they influence incentives. Remuneration structures, possible conflicts of interest and stigma-problems clearly have a bearing on the behaviour of market participants.

14. The FSF recommendations have been welcomed by the international financial community. But the real challenge is to implement them in such a way that the checks and balances in the financial system are restored so it becomes less prone to instability. In other words: we must get the incentives right. The Netherlands is in a good position to implement the recommendations. Our institutional set-up is helpful: the cooperation between central bank and supervisors is already ensured because they are combined in one institution. But we must avoid complacency; the implementation of the FSF recommendations will be one of our top priorities in the next months. Furthermore, even though we are on the right track,

risks from the macro-financial environment have not disappeared. Banks are going through a fundamental adjustment process, which needs time. Financial markets, like the interbank money market, do not perform as they should and the US housing market is still weak. Therefore, the economic outlook remains uncertain.

Concluding remarks

15. The international response to the credit crisis, coordinated by the Financial Stability Forum, is a crucial first step towards restoring financial stability. But I am sure that, at some point, our incentives will be tested again. Therefore, we need creative minds that help us to identify new imbalances at an early stage. These are great times for financial economists. Traditional macroeconomic analysis and monetary economics have been extended by a variety of financial stability issues, with both micro and macro dimensions. I am confident that this conference will contribute to this interesting and rapidly developing field.