

Nout Wellink: Responding to uncertainty

Remarks by Dr Nout Wellink, President of the Netherlands Bank and Chairman of the Basel Committee on Banking Supervision, at the International Conference of Banking Supervisors 2008, Brussels, 24 September 2008.

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Introduction

Good morning and welcome to Brussels for this fifteenth International Conference of Banking Supervisors. I would like to begin by thanking Governor Guy Quaden of the National Bank of Belgium and Chairman Jean-Paul Servais of Belgium's Banking, Finance and Insurance Commission for graciously hosting this conference. The organisation of this conference began shortly after the ICBS in Mexico ended. Despite the extensive preparation of our Belgian hosts, I do not think any kind of planning could have prepared us for what we are now experiencing in the financial markets.

The events we have witnessed in the past two weeks are nothing short of extraordinary. Some of the world's largest financial institutions have declared bankruptcy, have been purchased or have been thrown a government lifeline. Considerable uncertainty and market volatility persist and will likely continue for some time to come. The official sector, including the supervisory community, are working to promote a deleveraging process that limits as much as possible the spillover from the financial to the real economy.

As supervisors, central bankers and policy makers – what are we to make of all of this? Just as we caution bankers during the good times to prepare for the rough times that inevitably lie ahead, we too must use this opportunity to assess the lessons learned to better prepare for the future.

This morning I would like to share with you some of my views on the lessons the crisis has taught us and, more importantly, how we can use this experience to better prepare for the future. Clearly, we are still in the midst of this process and more lessons are likely to arise. As you know, both Belgium and my home country, the Netherlands, are on the shore of the North Sea, which can be extremely stormy at times. In the past, people were at the mercy of these storms. For instance, in 1570 more than 20,000 people died during one of the worst storms in history. So how did people react? They built dikes to protect against the floodwaters. Despite these buffers, a bit more than 50 years ago, the Netherlands as well as Belgium, the UK and Germany were caught again by an enormous flood, which flowed over the dikes – the buffers – that had been built up during the good years.

I believe this story is a good metaphor for what has recently happened to the global financial system. From time to time we witness financial storms. As supervisors we learn from these experiences and build dikes, or buffers, to protect against future floods. Nevertheless, the land beneath the dikes – our financial system and economies – can erode due to the passing of time or the battering from a tremendous storm. As the builders of the dikes, it is our role to continually monitor the strength and condition of the dikes; to assess the damage caused by each storm and try to anticipate the next storm. Bankers too have an important role in preserving the soundness of the dike – supervisors by themselves can not have sole responsibility.

Origins of the storm

As with almost any financial crisis, leverage and risk concentrations have played a central role in the current situation. I will be quick to add, however, that leverage in and of itself was not the problem. Indeed, risk taking and leverage are essential elements in banking. Instead, what I will focus on is the manner in which these elements are managed and controlled. As in

other financial storms, it is poor execution of the basics that are at the root of today's problems.

Complacency – on the part of bankers and supervisors – certainly played a role. The banking industry is exceedingly optimistic during times of benign economic conditions – when the seas are calm. It is difficult to keep a proper perspective and to exercise prudent judgment when all of your competitors are generating huge volumes of business. As one banker famously said last year “As long as the music is playing, you've got to get up and dance”. Well, if it is the role of the central banker to take away the punch bowl just as the party gets going, perhaps the role of the supervisor is to silence the band so the bankers stop dancing.

Supervisors – for our part – tend to focus on bank-specific issues. But, as we have learned, we must also pay attention to the broader aspects of financial stability. For example, excessive leverage, risk concentrations and maturity mismatches – whether on- or off-balance sheet – are examples of destructive forces that, especially in combination, can have severe consequences for entire sectors and economies. One of the main lessons from this turmoil is clear: bankers and supervisors need to remain focused on the big picture and the longer term horizon.

Risk management and oversight

Let me give you a few examples of some fundamental aspects of **risk management and oversight** that were violated by many. As supervisors, we have seen time and time again that financial crises are characterised by the failure to adhere to basic risk management principles, especially during times of financial innovation.

This crisis is no different. **Weakness in fundamental underwriting** principles, among other factors, was a key contributor to asset quality problems. So was poor risk management, which at some firms allowed the build-up of **massive risk concentrations** across the firm that further compounded already shaky asset quality. Some banks were caught completely unaware by concentrations to subprime loans that they had in their loan portfolios. Others did not fully understand their full exposure to subprime mortgages, particularly when they purchased an exposure that contained dozens of other exposures – I am of course referring here to CDOs of ABS. Poor asset quality and risk concentrations are at the heart of the turmoil involving subprime mortgages which has led to the exceptional uncertainty and volatility that we see today. These problems have been further compounded by uncertainties relating to valuation practices.

What should we take away from this? That banks – and supervisors – must redouble their efforts to ensure that sound underwriting standards are in place and that there are adequate, systematic procedures for identifying firm-wide risk concentrations.

Originate-to-distribute business model

What other factors – aside from complacency – have hindered adoption of such basic principles? Perhaps one of the stumbling blocks has been the expanded use of the **originate-to-distribute model**. Managing this model's associated risks poses significant challenges and, in some cases, has led to large risk exposures and concentrations that firms' senior management failed to detect.

The recent problem with the originate-to-distribute model has been one of **incentives**. Instead of the traditional focus on a borrower's ability to repay a loan, many banks focused instead on generating a high volume of loans, and booking as income the fees received to originate the mortgages. Many firms chose not to invest the necessary time and resources in thorough credit analysis and underwriting since someone else would be purchasing the mortgage.

Investors did not perform their own due diligence. Instead, they relied on the due diligence of originators and packagers, who lacked interest in exercising this due diligence. They also placed undue reliance on the judgments of the credit rating agencies, and the capacity of modern technology and diversification to manage financial risks.

What can we draw from this? The combination of excess lending with an obvious failure to adhere to fundamental and sound risk management standards not only produced significant losses in mortgage portfolios; it also tainted an asset type that was key in the broader securitisation and credit distribution process. The reckless use of the originate-to-distribute model increased uncertainty regarding credit quality, where risk resides and the impact of deterioration. This heightened uncertainty suggests that in maintaining their **capital buffers** – the dikes – banks need to do a better job capturing the risks related to this business model. We have to build higher dikes but must not forget the importance of building on a sound foundation, which is high quality capital. Basel II provides the necessary framework within which to achieve these enhancements. I will return to the capital issue in a moment.

Liquidity

Liquidity was another victim of the current storm and its demise holds valuable lessons for supervisors. Increasing banks' liquidity cushions and improving liquidity risk management and supervision has been an area of sharp focus for the Committee. We have seen massive illiquidity in certain market segments (especially complex structured products) for a much longer period than any market participant would have predicted. Complex and illiquid investor-specific instruments, such as resecuritisations, have experienced significant market-value losses, which has led to the loss of confidence in their financial worthiness and the drying up of liquidity in the short-term interbank market.

The recent turmoil has shown that banks must strengthen their liquidity buffers. One way to do this is to increase their holdings of high quality liquid securities – in particular, liquid central government securities. The Committee's guidance on sound liquidity risk management and supervision and vigorous supervisory follow-up will help raise the bar in this area. We will continue to examine the topic of liquidity with a focus on cross-border aspects of liquidity supervision.

While liquidity risk cannot be mitigated with capital, capital is itself a form of liquidity since, unlike other liabilities, it does not have to be repaid. Furthermore, a strong capital buffer enhances a bank's creditworthiness and, from the market's perspective, reduces its counterparty risk. This helps to ensure continued access to funding.

Capital adequacy

And this brings me to the issue of capital adequacy. After several years of high profits, often record profits, we know that the level of risk was grossly underestimated by many financial institutions.

This latest storm has therefore revealed cracks in the dikes and the supervisory community is in the process of patching up those cracks. High losses have put pressure on capital cushions and many banks have been forced to go to the market to replenish their capital base. This is critical if a contraction in lending and credit are to be avoided. Of greater importance, though, are the cracks in the dike that are not yet evident. While we do not know the nature and strength of the next storm, we can take measures today to strengthen the dike so it could withstand the battering. One of those measures is to significantly strengthen banks' capital buffers. In addition to moving ahead aggressively with Basel II, the Committee has issued a proposal to strengthen the capital treatment for risks not captured under Basel II's existing trading book regime.

In this context, the Committee is also carefully considering the topic of procyclicality, especially as it is influenced by bank capital issues. There are many dimensions here, such

as the level and quality of capital; provisioning, capital buffers and the ability of banks to dip into those buffers. We will continue to review these and other issues related to procyclicality and are in the process of developing a work programme to address both near term and longer-term issues.

The Committee is also developing enhanced guidance under Pillar 2, the supervisory review process. Here, our focus is on improving risk management practices, such as stress testing and the management of risks arising from complex instruments, among other things. We are also developing proposals to strengthen Pillar 3 disclosures, especially for securitisation activities.

Conclusion

We have learned much from the severe storm that is currently raging. I have outlined some of the measures that banks and supervisors must take to better prepare for the next storm. But what is becoming increasingly clear is that, over time, the banking system needs to strengthen capital and liquidity buffers to withstand prolonged periods of stress in the financial system and the broader economy. This will be done in a manner that does not aggravate the current stress in the system. Enhancements to risk management and market transparency will help, but we must enhance banks' buffers to reflect the increased degree of uncertainty in the system. The need for increased margins to protect against uncertainty will also become apparent as rapid financial innovation continues and uncertainty increases about how new products, valuations, markets and the real economy will interact in times of stress. This will better reflect the risks that already are inherent – but perhaps not easily recognised – in banks' portfolios, either in regulatory or internal metrics. Finally, enforcement by banks and supervisors of the basics of sound risk management and underwriting practices are key to promoting a return to financial stability.