Nout Wellink: Supervisory arrangements – lessons from the crisis

Speech by Dr Nout Wellink, President of the Netherlands Bank and Chairman of the Basel Committee on Banking Supervision, at the 44th SEACEN Governors' Conference 2008 "Preserving monetary and financial stability in the new global environment", Kuala Lumpur, 6 February 2009.

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When former US President Bush welcomed G20 world leaders in Washington last November to discuss the financial crisis, neither French President Sarkozy nor German chancellor Merkel had the honour of sitting next to him at the formal dinner. In fact, none of the Western leaders had. As a clear display of the shifting balance of economic power, President Hu Jintao of China and President Lula da Silva of Brazil sat either side of Bush. Evidently the world economic order is changing. Emerging economies are catching up with the developed world at great speed. As a result, preserving monetary and financial stability – the theme of this conference – is an ever more global challenge that requires global cooperation.

The financial turmoil has underlined the importance of better coordination among public authorities at the international level. From the start of the crisis in August 2007, central banks across the world have engaged in large-scale coordinated actions to support liquidity conditions in the global money markets. More recently, national governments have acted to shore up the capital base of individual financial institutions. Regrettably, but understandably, they did so in a largely uncoordinated way. Given the many cross-border externalities that are involved, increased coordination of national measures is clearly desirable, be they capital injections or state guarantees. In spite of authorities' efforts, uncertainty in the financial markets remains unusually high, and stabilizing financial systems is still our top priority. Nonetheless, it is not too soon to think about how we can prevent and mitigate future financial crises.

Indeed, in light of weaknesses revealed by the financial crisis, the Basel Committee has developed a series of proposed enhancements to strengthen the Basel II framework. These enhancements will help ensure that banks' risks, whether on- or off-balance sheet, are better reflected in minimum capital requirements, risk management practices and disclosures to the public. Another issue the Committee is currently addressing is procyclicality, or the possibility that regulatory requirements amplify an economic cycle. This is a difficult issue as there are a variety of factors at play – such as loan loss provisioning – that influence procyclicality. And, we should not forget that banking tends to be a cyclical business irrespective of regulatory requirements. Nonetheless, the Basel Committee has begun a comprehensive review of the potential procyclicality of the Basel II framework. The objective is to promote adequate capital buffers over the credit cycle and to mitigate the risk that the minimum capital requirement magnifies the procyclicality of the financial system. Under discussion are ways to promote a high quality Tier 1 capital buffer that banks would increase in good times and be allowed to use in difficult times. Supervisors are also reviewing the need to supplement the current risk-based approaches with simple, transparent gross measures of risk. This would constrain the amount of leverage banks could have in good times and therefore also contain the degree of deleveraging in bad times.

Let me now turn to lessons that can be drawn from the financial crisis with regards to supervisory arrangements. Over the past one and a half years supervisory arrangements around the world have been put to the test. These real stress tests have provided us with important insights into the pros and cons of different supervisory arrangements. And, though there is no single optimal supervisory arrangement, three lessons can be drawn. First, as macroprudential supervision and microprudential supervision strongly overlap, central bankers and prudential supervisors should cooperate closely and continuously. Second, financial supervisors need to step up international cooperation, simply because the financial industry is particularly internationalized. Third, while prudential and conduct of business supervision are distinctly different, they are complementary and should both receive due attention. Separating prudential and conduct of business supervision institutionally helps to keep both supervisory goals in clear sight.

As financial sectors today are more concentrated, more integrated and more exposed to the financial markets than ever before, problems at individual institutions are increasingly likely to have systemic consequences. Indeed, during the financial crisis we saw several examples, most notably the collapse of Lehman Brothers in September 2008 which had a truly systemic impact. These events have demonstrated that the distinction between macro- and microprudential stability is hypothetical in practice. Therefore, there is an urgent need for close and continuous cooperation between macro- and microprudential supervisors, of course with due observance of the relevant legal provisions. Such cooperation can be achieved in different institutional settings. Also when the central bank plays no role in microprudential supervision, extensive micro-macro cooperation can be and in fact should be organized.

The need for effective interplay between central banks and supervisors is particularly pressing in times of crisis. In the Netherlands, increasing cooperation was relatively straightforward, because DNB has both central banking and supervisory functions under one roof. To the best of my knowledge, the same holds for most SEACEN central banks. In response to the crisis, several working groups have been established within DNB, bringing together supervisory and central banking expertise to work on multifaceted problems. One particular multidisciplinary challenge concerned the recent capital injections by the Dutch State. To determine the amount of capital that needed to be injected in well-known financial institutions like Aegon and ING, we were able to draw on the extensive expertise available in our organization. Another example of information-related synergies concerns liquidity. During the crisis, supervisory information on the liquidity arrangements, sources of funding and financial position of Dutch banks proved essential in obtaining a clear picture of their liquidity pressures. Note that the information synergies have also worked the other way round. Insight into financial market developments and information from payment systems and monetary policy operations have been extremely valuable for the performance of supervisory tasks. Contacts with major, market-leading intermediaries have also been useful for producing timely and meaningful information on major trends and sentiments in the financial system.

While cooperation between central bankers and prudential supervisors naturally intensifies in periods of financial stress, more cooperation is also desirable in boom times, when the seeds for later bursts are sown. When confidence levels are high and perceived risk levels are low, authorities should act to mitigate the build-up of systemic financial vulnerabilities. In the past we have been pretty good in analysing risks to financial stability. We have failed however in effectively translating our analyses into concrete risk-mitigating actions. Indeed, we have been aware of large global imbalances for some time. But little was done about it. While global macroeconomic conditions are not at the origin of the crisis, they have contributed to it.

Related to this, I believe that the macroprudential orientation of regulatory regimes, notably that of the Basel II framework, needs to be enhanced. Tight supervision of individual financial institutions will certainly remain crucial, but supervisors will also need to devote resources to understanding interactions among financial institutions and linkages within the financial system at large. This includes understanding how banks' major business lines are linked into the broader credit intermediation process and where pockets of risk concentrations may be emerging in the financial system. A more comprehensive approach to supervision and regulation will enable supervisors to focus their limited resources on those activities that contribute most towards counteracting the build up of risk in the banking system. In setting our goals however, we must be realistic. It is not realistic to believe that we can prevent financial crises completely, as crises are a fact of life. What we can do is create a more resilient financial system, thereby decreasing the frequency and severity of financial crises.

Since financial institutions and systems are part of an integrated global financial system, we need to go beyond more micro-macro cooperation at the national level. In this respect, it is encouraging that the FSF and IMF will intensify their cooperation at the global level, each complementing the other's role. The IMF will report on its monitoring of financial stability risks to FSF meetings, and in turn will seek to incorporate relevant FSF conclusions into its own bilateral and multilateral surveillance work. A similar initiative is envisaged at the European level, where the European System of Central Banks Banking Supervision Committee and the Committee of European Banking Supervisors (CEBS) will intensify cooperation.

Supervisors will also need to step up their cooperation. In line with the recommendations by the Financial Stability Forum, so-called colleges of supervisors have been established for several major cross-border financial groups. These colleges include all relevant supervisors and promote cooperation on ongoing supervisory issues. DNB is currently chairing global supervisory colleges for Aegon and ING. In fact, only two weeks ago, we hosted the ING college in Amsterdam. Colleges of supervisors are also promoted on the European level. In response to the growing integration of Europe's banking industry and to the specific nature of trans-national banking groups, ECOFIN Finance Ministers have called for the set-up of colleges of supervisors. Furthermore, the European Commission has set up a "high level" group headed by former Bank of France Governor Jacques de Larosière, to bring forward ideas on strengthening EU financial supervision. There are two possible outcomes. Either cooperation will intensify gradually – building forth on existing institutions such as CEBS –, or cooperation will intensify abruptly – creating a European Financial Supervisory Authority. More will be known shortly, as the De Larosière group is set to give its first advice next March.

Let me now turn to a third lesson from the crisis, which is related to the difference between prudential and conduct of business supervision. While prudential supervisors' main concern is the safety and soundness of financial institutions, conduct of business supervisors first and foremost strive for a fair and transparent market. Undeniably both types of supervision are important and in fact they are generally reinforcing. Let me give an example to illustrate this. In the United States, home loans were extended to very risky borrowers, with little or no income and few, if any, assets. From a conduct of business perspective, these US consumers were not treated fairly. Had this practice been stopped in time by the relevant conduct of business supervisor, we would have fewer problems now. Unfortunately practice did not stop, but rather worsened. And now these US mortgages are awfully problematic from a prudential point of view.

That being said, prudential and conduct of business supervision can also be conflicting. Prudential supervisors work most effectively behind the scenes. This contrasts with conduct of business supervision, which benefits from being in the public eye. Publicity helps to warn off consumers, investors and the industry from misconduct and wrongful practices. If both types of financial supervision are exercised by the same organization, there is the risk that an inappropriate balance is struck. Therefore, in integrated supervisory authorities, arrangements can and should be made to ensure the necessary amount of resources is allocated to both types of supervision. Establishing such arrangements, however, can be rather challenging in practice. Indeed, a key finding of the UK FSA's internal audit review in light of Northern Rock was that too many resources had been allocated to conduct of business supervision, and too few to prudential risks.

In the Netherlands, and also in Australia, the danger that either prudential or conduct of business supervision will be overlooked has been addressed institutionally. In our objective-based supervisory arrangement, prudential and conduct of business supervision are performed by two separate institutions. The former type of supervision is the responsibility of DNB; the latter is the remit of the Dutch conduct of business supervisor, the Authority for the Financial Markets. Consequently, our institutional set-up leads to a transparent consideration of prudential interests on the one hand and conduct of business interests on the other. Let me give a clear example to illustrate this point. Some years ago a Dutch subsidiary of a foreign bank had neglected its duty of care. From a conduct of business perspective, the bank had to be penalized for this. It was clear, however, that this would entail the end of the bank. Therefore, DNB had extensive talks with the Authority for the Financial Markets on this issue, as interests clearly conflicted. These talks ultimately led to the consideration that the bank had to be penalized for not being compliant with conduct of business regulations, as long as this would not endanger the stability of the financial system. An objective-based set-up thus promotes a transparent consideration of interests.

In addition, linking the regulatory objectives to the supervisory structure also improves supervisory efficiency. In particular, a major advantage of objectives-based supervision is that responsibilities are consolidated in areas where natural synergies take place. While prudential supervisors focus on risks and the management of risks, conduct of business supervisors concentrate their efforts on disclosure issues and sales and marketing practices. Confidence in objective-based supervision has been supported by the US Treasury Blueprint for a modernized financial regulatory structure, which states “an objective-based regulatory approach would represent the optimal regulatory structure for the future”.

Let me conclude. I began my speech with the changing world economic order. Indeed, the balance of power is shifting. Emerging economies will produce and consume an increasing share of world economic output. With more economic and political power comes more responsibility. In this respect, the increasingly active role of emerging countries in addressing global problems is encouraging. One important challenge we all face now concerns global financial stability. To promote financial stability now and in the future, cooperation between macroprudential supervisors and microprudential supervisors should be strengthened. Especially when the good times return – and they will – this will prove challenging. The international cooperation between financial supervisors should also intensify, as the current financial crisis has clearly shown. Regarding the different objectives of financial supervision, recent experiences have reinforced the arguments in favour of objective-based supervision.