Nout Wellink: Working on the future of the financial sector

Speech by Mr Nout Wellink, President of the Netherlands Bank and Chairman of the Basel Committee on Banking Supervision, at the Dutch Embassy, London, 19 February 2010.

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I will first briefly share with you my view of the recent developments in the financial sector and on the crisis. Second, I will discuss what the future role of supervision will be in order to minimize future crises. I will speak about some of the initiatives of the Basel Committee, and why these alone will not be enough. And finally, I will speak about the role of the financial sector itself.

Let me first of all start by saying that although the financial sector has been hit severely, and probably none of us has ever experienced something like this before, it is not a unique situation from a historical perspective. In The Netherlands and the United Kingdom there have been a significant number of large financial and economic crises throughout history. One famous example of this is the Dutch tulip mania in the early 17th century, when the prices of tulips fell dramatically after an excessive speculative bubble period. Or, the collapse of Overend & Gurney bank in 1866 London, which triggered a series of bankruptcies of several smaller, but otherwise solvent British banks. We struggled, but came out stronger after each.

Just as what must have been said after each of those events, let me assure you that this crisis will also not be the last. All of our measures and good intentions aside, we are of course always perfectly prepared for the most recent crisis. The next crisis is a different story. What we can do is learn from each crisis and try to prevent and mitigate a similar crisis, and to do our best to diminish the likelihood and impact of any future crisis.

Our recent crisis is, in my opinion, the result of many problems. Let me mention some. One is undoubtedly the search for yield that has often led to excessive risk taking. Or the compensation schemes and bonuses in the financial sector that by leading to a strong public outcry, have laid the foundations for a lack of trust in the financial sector.

Supervision and the regulatory system must take responsibility for the crisis too. Despite the continuous improvement of regulatory practices throughout the years, certain risks were built up due to regulatory arbitrage opportunities.

But this crisis also showed a fundamental lack of transparency. Customers (private and institutional alike) did not know anymore just what exactly they were buying; supervisors found it increasingly difficult to assess which risks financial institutions where subject to, and institutions had more difficulty with valuing their products. Transparency was gone, which not only contributed to the lack of trust between financial institutions, but also between client and institution.

You will therefore understand that we, as supervisors, had to act quickly and act decisively. As chairman of the Basel Committee, let me mention some of the measures that the committee proposes. And I would also like to use this opportunity to convince you that these measures are really necessary. Despite being a significant improvement over the previous accord, Basel II has shown to still contain some significant weaknesses and shortcomings. Of many of these we were aware, but we were not able to adequately address them. However, now, under the pressure from the crisis, many of these issues are open for debate again.

Let me talk about some of these measures in more detail. First, we are going to improve the level and quality of capital. We have seen during the crisis that the current levels are not adequate and that in the end it is only the capital of the highest quality that counts in adverse conditions. An extension of this measure is that we will make capital requirements less cyclical, by means of additional capital buffers that are built up during economic upswings. This might imply that less profit can be used to pay out dividends or bonuses, as it is instead used for increasing the firm's capital buffers. Second, we want to make sure that we really cover all risks and allocate adequate capital to each. A key aspect of this is to prevent regulatory arbitrage opportunities, particularly with securitizations and between banking activities and trading activities. Third, we will work on an international accord on liquidity buffers and supervision, instead of the current fragmented, national rules.

Furthermore, the Basel Committee proposes to supplement these risk-based measures with a non risk-based measure that acts as a backstop in order to prevent an excessive build-up of leverage during favourable economic periods. The design of the leverage ratio as a simple, transparent, and supplementary measure of capital that is based on gross exposures, will therefore serve as a safeguard against attempts to game the risk-based requirements and address model risk and measurement error. By the end of 2010 we hope to have fully calibrated these measures such that they can be phased in as economic conditions improve, with the aim of implementing them by end-2012.

I would like to stress that these measures are really necessary. Not only to prevent further harm, but also to restore trust in the financial sector. Trust is an extremely important aspect of any services sector, and the financial sector is a services sector pur sang. If a feeling of uneasiness remains among clients and investors, or financial institutions cannot trust each other as they should, then financial (and consequently economic) development grinds to a halt. So restoring trust in the financial sector is an absolute priority and we have to go great lengths to achieve this.

At the same time it seems as if the sense of urgency for change among bankers and politicians has somewhat diminished lately, now that we see the first signs of recovery. Opposition against the proposals from the Basel Committee is growing, through lobbies from the financial sector. For this reason, we, as supervisors, have to do our utmost best to uphold these proposals, because otherwise countries may be forced to implement measures on their own. The result of this will be a distortion of the international level playing field, which in the end will not benefit the financial sector.

It is for this reason that we will organise a comprehensive quantitative impact study in the first half of this year. With this impact study we can see what the impact of all individual proposals will be, as well as the aggregate impact of all proposed measures combined, so that we can implement measures with care, in a responsible and well-considered manner. And all of these measures will be considered in the light of the economic recovery, making sure that they will not harm the recovery process. I am aware of the current debates about reducing the size of the sector, adding taxes, cutting bonuses, and the like. It is true that there are indeed excesses which are not acceptable anymore, and these have to be dealt with. At the same time, we should refrain from overreacting and take care to not implement measures which we have not fully thought through.

Beside all these new regulatory measures we have realised that there is also an urgent need for closer international supervisory cooperation. The rapid development in cross border banking has shown us supervisors that our current organisational structure is no longer adequate and limits our ability to rapidly respond to developing situations. A shift towards a more unified regulatory framework has therefore slowly been set into motion, for instance in Europe with the new structures for CEBS or CEIOPS, or through the intensified use of supervisory colleges. Crucial, though, in this process, is full and mutual openness and willingness to share information.

But there are limits to what supervision can do. We cannot supervise everything, even if we want to. Do we have to double our number of supervisors, or triple them? Will that be enough? And we have to realise that more supervision and rules also creates a moral hazard problem, because we take away the incentive for institutions and clients to take their own responsibility and use common sense when engaging in financial products. A good example of this is the deposit guarantee scheme. If one would keep on increasing the guarantee level, clients eventually become less alert and institutions might lower liquidity buffers. Both dangerous developments.

It is therefore that I would like to stress today the fact that market participants have to recognize their own responsibilities too, and act more according to them. This applies to institutional managers, traders, fund managers, accountants, and even customers. More than ever before should all market participants consider the consequences of their actions and continuously ask oneself questions about everything one does. In answering such questions I think that a prudent attitude must be taken and greater awareness of one's social responsibility, and ask one every time whether the right thing has been done and whether the actions are not harmful to vulnerable parties.

I think that an important step in the awareness of one's own responsibility is aiming for greater openness. Transparency is really something that should be improved. Because only when customers really understand financial products; or when the public understands compensation decisions, or bank managers and supervisors really know which risks an institution is subject to, will trust in the sector be restored. In the end, we may not forget that the financial sector is above all a services sector and this requires a great deal of responsibility and care from the side of all. I would therefore very much invite you to help in bringing greater openness and social responsibility to the financial sector.

I hope that I have been able to convince you that there is truly a need for change in the financial sector. Not only in terms of regulatory practices but also in terms of attitude and culture. I therefore welcome every initiative from the sector in order to achieve this and I look very much forward to a fruitful debate.