Klaas Knot: Simplicity in the financial sector

Speech by Mr Klaas Knot, President of the Netherlands Bank, at the 20th RiskMinds Global Risk Regulation Summit, Amsterdam, 2 December 2013.

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Ladies and gentlemen,

Thank you for inviting me to speak at the Risk Minds conference today, also as this enables me to congratulate you on its 20th edition.

Twenty years have passed since the first Risk Minds conference, and I'm glad to say that risk management has made substantial progress during this period. The past few years have certainly underlined the importance of proper risk management.

As I see it, risk management is a key building block for ensuring sufficient capital and liquidity buffers in the financial system. Strong and reliable financial institutions are one of the vital elements of financial stability.

And financial stability in turn is of prime importance to De Nederlandsche Bank as a central bank and prudential supervisor. And that is because central banks have a mandate to promote financial stability. And we've seen in recent years, that this is not an easy task. In hindsight, we can say that the financial sector had become too complex and non-transparent. Technological advances had created various new financial products and instruments whose risks were often unclear.

This particularly held for products and instruments involving the packaging and repackaging of exposures, the sale of CDOs (Collateralized Debt Obligations) and CDO2s, and the use of SIVs (Structured Investment Vehicles).

The financial sector's increasing globalization has also made it more difficult to assess risks properly. It was because of Lehman Brothers' global presence that its failure had such an impact on the world. In every country where Lehman Brothers had a branch, its bankruptcy had to be filed for and resolved.

The financial environment that we faced in the run-up to the crisis – and, by "we", I mean the public, investors, counterparties, supervisors and regulators – was non-transparent, and the risks were getting more and more complex. And then it all went wrong, and many financial institutions had to be bailed out by governments. It was no wonder that the public's confidence in the financial sector fell sharply. And it still hasn't recovered.

How can we regain the public's trust? For one, by making the financial sector less complex and more transparent. The crisis has highlighted various fundamental problems in the design of the financial system. The level of complexity, the mutual dependence – *where everyone is dependent on everyone else* – and the rapid speed of transactions – *where there is no time to resolve problems that may arise* – all these factors together make the system more prone to failure.

In existing and new regulations, including the forthcoming Basel III framework, regulators have focused on the problem of institutions being Too ***Big*** To Fail. This is because of the pressure that having to rescue financial institutions has put on public finances.

But, actually, we should be more worried about banks being Too ***Complex*** To Fail. If institutions are too complex, it's even more difficult and therefore perhaps more expensive to resolve them.

The need for change is obvious. And responsibility for this change lies in your hands, too! I see three areas where you can contribute to achieving this change.

First of all, banks' business models must not be unduly complex. In the past, we have seen financial institutions offering lending services, participating in trading activities, setting up joint ventures and combining their activities with insurance companies or businesses outside the financial sector.

The products they offered ranged from traditional loans and lend-to-invest structures to all kinds of complex off-balance sheet derivatives. Their activities were spread all over the world, while the risks and rules varied from one country to another. The big picture was therefore often lost.

At the same time, the benefits of diversifying their activities in these different ways and at these different locations have proved disappointing. Experience has shown that combining banking and insurance activities is not as effective in offsetting cash flows and exposures as was once thought. Risks run on one side of the world are difficult to monitor from the other side of the world.

And, this time around, the crisis has not been confined to one country or region, but has been felt all over the globe. A clear and simple business strategy and a streamlined business model will help reduce complexity. Banks need to focus once again on their traditional roles of maturity transformation and lending to the real economy. This ties in closely with the question of how best to structure the banking sector. This is a relevant issue when we're discussing the activities a bank should engage in.

Committees all around the world have examined this issue, as the Volcker Rule in the US, the Vickers Report in the UK and the European Commission's Liikanen report show. All of them have one thing in common. They argue for a simpler banking sector focusing on traditional banking activities. These reports have resulted in calls for traditional banking activities to be separated from trading operations by being held in different entities. This will make banks less complex and improve their stability.

However, complete separation may not be efficient if these trading operations also provide services to the bank's clients, like market-making services. That's why the Liikanen Report suggests that trading activities should be separated from the other parts of the bank ***only*** if these trading activities exceed certain limits.

Although this debate is far from over, the direction of the change needed is clear. In other words, we need to move towards a less complex sector, with more focused activities.

A second way to increase simplicity and transparency in the sector is to simplify the internal organization of financial institutions. The financial sector in general, and banks in particular, can be seen as one of the most complex areas in today's world. But we all know that complex organizations are hard to manage.

Having complex internal structures and many management layers can make it more difficult for organizations to respond to external developments. Complex organizations are like oil tankers: it takes a long time to turn them around. And that may mean they miss out on business opportunities.

A simpler organization, by contrast, can take decisions more quickly. This enables it to respond more flexibly to new business opportunities, and also to risks that arise. It can also help staff feel more involved in, and committed to, change.

Thirdly – and this may be the most difficult one – people working for financial institutions need a prudent mindset. It's ironic, isn't it, that, instead of using sophisticated financial risk models to identify risks, "smart" people in the financial sector used these models to circumvent financial regulation.

Remember the trend towards moving exposures off balance sheet? What about the way benchmark rates were manipulated, and separate legal entities were used in the shadow banking sector? This behavior was obviously encouraged by the fact that variable benefits were based on achieving short-term results. This is all changing. And I am happy to see this happening.

De Nederlandsche Bank, for instance, now explicitly includes “organizational culture” as a separate aspect in its risk assessment of institutions. In a clear, open environment, employees should have the interests of their clients at heart. And having a prudent mindset will also make it easier for them to be transparent. For simpler institutions, regulation and supervision can be simpler as well. The more complex an organization and its business model are, the more complex its risks will be. The rules that are meant to capture these risks will then be at least equally complex.

The reverse is also true. In other words, the regulatory rules for banks engaging only in traditional lending and funding needn’t be as complex as those for banks specializing in more sophisticated products. The volume of regulations applying to less complex institutions can also be more limited. Banks that don’t have investment operations, for example, can skip many of the trading book regulations.

Greater regulatory simplicity also has other advantages. Detailed rules may make it more difficult for supervisors and financial institutions to spot actual risks. The requirements applying to risk models, for example, are quite detailed. Institutions spend a lot of time and resources on them. You might think that if a model complies with all these requirements, the outcomes it produces will also be right. But it is still only a model, and you have to look at risks in more depth.

Overly detailed rules may also make decision-making less effective. For decisions may be based on compliance with rules instead of being true risk trade-offs.

Simple rules, by contrast, could help focus on the major risks. Take, for example, a simple rule that states that all exposures must be covered by some form of capital. Such a rule would automatically also apply to any new products or instruments.

And it would include exposures that now – *in my view, unjustifiably so*– have a 0% risk weighting, such as certain exposures to governments. A leverage ratio used as a backstop to these risk models would also achieve this, while still being easy to calculate and understand. And this is why supervisors are now taking leverage ratios into account when assessing institutional risk, in addition to the standard risk-weighted ratios. This allows for a multi-angled view of institutions’ risk profiles.

Other rules, such as limits on LTV ratios, may set clear limits on loan portfolios’ risk profiles. That way, a smart combination of simple rules can help to highlight risks in an institution’s balance sheet. To be sure, risks should obviously be regulated in similar ways, whatever the sector. Otherwise, risks will simply shift to less or non-regulated entities.

Simple rules can also offer guidance for the future. Problems we experience in the future are unlikely to be exactly the same as in the recent past. We also cannot foresee exactly where new risks will arise.

Simple rules can form a clear benchmark in uncertain situations, and there is a lot of academic theory to back this up. The economist Frank Knight introduced the concept of “Knightian uncertainty” by making a distinction between uncertainty and risk in the sense that uncertainty cannot be quantified.

Indeed, we don’t know where we are heading, or what we will encounter along the way. We simply have to learn to live with unknown unknowns.

Another economist, Hayek, also saw imperfect knowledge as a central issue. Simple, robust rules can make a difference in such an uncertain and imperfect world. In a complex environment, we cannot possibly consider or measure all the conceivable outcomes. As well as being too expensive from an information point of view, it is also too complex to weigh up all the different options.

Although we like to assume our economic models are rational and omniscient, this is certainly not the case in reality. It would be more accurate to describe our world as having bounded rationality and imperfect information.

Simple rules are a way of reducing a complex problem with many unknowns to simpler trade-offs, like yes or no, above or below, or left or right. It's as in traffic: in the vast majority of situations, driving on the correct side of the road is good advice. Or reducing your speed in misty weather.

If we can progress along the road of simplicity, I'm sure we can also stop the pace of regulatory expansion. As Leonardo da Vinci said, "*Simplicity is the ultimate sophistication".* Simplicity and transparency can help restore the public's trust in the financial sector. Financial institutions can achieve this by switching to clear business models, with streamlined structures and a prudent mindset.

If they do so, the amount of regulations to be complied with can be reduced and the remaining regulations can be simplified, if and where applicable.

In addition, simple rules can help us focus on key risks, as well as forming a guide for the future. Greater trust, increased transparency and less complex risks will ultimately make the overall financial system more robust.

And that in turn will make it easier for central banks to promote financial stability.

Thank you!