DeNederlandscheBank

EUROSYSTEEM

"Changing gears: about cycling and the future of banking"

Speech by Frank Elderson at DNB's banking seminar
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At DNB's Banking Seminar, Frank Elderson delivered a keynote speech, adressing three challenges for the Dutch banking sector. Within each challenge, Frank Elderson indicates what steps have been taken already, and where attention is still needed.

When I took up this job as chief supervisor for the Dutch banking sector, summer last year, I realized again how much better shape the Dutch banks are in, than the last time I was actively involved in prudential banking supervision.

You see, I was leading the DNB team responsible for supervising ABN Amro back in 2006.
I remember going to the Zuidas by bike, parking it right in front of that huge entrance of the ABN Amro building - which wasn't allowed by the way. That solitary black bicycle, against the sheer backdrop of one of the tallest sky-scrapers of Amsterdam at that time, in a way that bicycle formed an early example of transparent supervision: since everybody knew it was my bike, every time they saw it they knew the supervisor was in the building.

Of course, it's a story with a tragic undertone. The years 2006 and 2007 have a fateful ring to them. We were witnessing the tearing apart of the largest bank in the Netherlands. Less than a year after the consortium took over ABN Amro, on a sunny day people were leaving the Lehman head offices carrying cardboard boxes. The rest is history.

How totally different to the picture we observe today! Today I see a banking sector that has weathered the storm, and has emerged stronger. Smaller perhaps, but more resilient, more focused and better capitalized.

A banking sector with one of the lowest NPL ratios on average in the euro area. And that leaves the Dutch banking sector in a very good position to seize new opportunities. Opportunities abound, I don't have to tell you that. FinTech, together with new regulation like PSD2, will drive competition and innovation, and it may trigger the biggest change in how customers interact with their banks since the introduction of the automated teller machine. Andrea Enria just gave some very interesting and lucid thoughts and observations on how this digital future might (or might not!) look like.

The green transformation of the economy may be an even bigger revolution. 180 billion euros: that is the estimated additional annual investment needed in the European Union to meet its climate targets for the year 2030. For this to succeed, we need funding, we need fundable projects and we need them to connect. Once the conditions are in place, and we are slowly but surely getting there, it will create tremendous opportunities for banks with the alertness and the capacity for change.

But just so I'm not in any danger of sounding like a consultant rather than a watchful supervisor, it's high time to introduce the word "risk". For we are not of course entering the garden of Eden. There are plenty of dangerous-looking creatures lurking in the undergrowth, that always threaten to spoil the party.

One of them, called Brexit, is just a few weeks. Over the past year you have been active in mapping out and managing Brexit-related risks. Ensuring that in the event of a hard Brexit, the continuity of your services will not be jeopardized, and you will not be exposed to material risks. Still, we need to be vigilant for this impact in the coming weeks. And then we have the 'animals' that are all too familiar to us, like the risk of an economic downturn and a change in risk perceptions in financial markets. You know them, we know them, and I will not discuss them in detail now.

But apart from these more mainstream risks, as I perhaps somewhat disrespectfully refer to them, today I would like to focus on some specific challenges. Three serious challenges that need to be met, in order to be ready for the new banking future.

1st challenge: AML/CFT
First of all, after all that happened last year, I cannot speak about banking supervision in general without mentioning AML/CFT. Last year, a significant number of banks came under public and political scrutiny, because they failed to fulfill their role as gate-keepers in the fight against financial crime. By doing so, banks are risking large fines for breaking the law, they run the risk of facilitating all kinds of crime that undermine the fabric of society, including terrorism and they are also undermining trust in the integrity of the financial sector.

This has to change. And I have spoken at length with many of you about this. Of course, this problem is not unique to the banking sector, but you have a special responsibility. Because you are the electricity, the heating and the running water of the economy, and the bulk of the money flows through your balance sheets.

Luckily, there are signs that executive boards of banks are starting to take their responsibility in this area more seriously. As DNB, we will continue our supervisory investigation into whether banks manage AML/CFT-related risks sufficiently and comply with the relevant legislation. Wherever they do not, we will enforce compliance.

In the meantime, we will continue to facilitate your efforts where possible, to make processes for customer due diligence and transaction monitoring more efficient. For example through cooperation within the sector. Also, we are brainstorming with some of you and with public partners, like the Public Prosecutor, on how to deal with this problem at the core. For example by finding ways to reduce the estimated tens of billions euro of illicit funds in the Netherlands.

I can almost hear you think: we liked the consultant part better. But this issue is not all doom and gloom. I see an opportunity for you as well.

As you may all know, the European Commission has put forward proposals to strengthen European cooperation in fighting financial crime in Europe and to enhance the powers of the European Banking Authority in that area. As DNB, we very much welcome enhanced European cooperation, because money laundering and terrorist financing are problems of an international nature and therefore require an internationally coordinated approach.

In fact, we see the EC proposals as an intermediate step towards a fully-fledged European AML/CFT supervisor. It might take many years, or it may all go much quicker than we all in this room can now foresee. But the trend is clearly towards more European harmonization of AML/CFT supervision. And now comes my point: if you succeed in tackling this problem convincingly today, you might turn out to be a shining example of best practices in Europe tomorrow. Whereas your European peers might still be struggling with sorting out their AML/CFT legacy under the new European regime, you would have your hands free to focus on strategic issues. All in all, getting your AML/CFT compliance in order is not only a must today, it may also pay off nicely in the future.

2nd challenge: restoring trust

A second serious challenge, in fact one that is connected with all the other challenges you are facing, is restoring public trust in the banking sector. Trust is a tricky thing. The supervisor, the politicians and the banks are talking a lot about restoring trust, but it is ultimately not something you can gain yourself, it is given to you.

However, there is a lot you can do to create the right conditions. Like preventing negative publicity, where possible. Like learning to read the public sentiment, which is not easy I admit. By making a contribution to addressing social challenges. For example by supporting the green transition. The way the financial sector supported the negotiations and pledged funding, did a lot to hammer out the national Climate Accord. As chief supervisor for the Dutch banking sector I am very grateful for that. These are all steps that may contribute to restoring trust.

Why do I think strengthening trust in the banking sector is important? Isn’t it all going well? Customers are entrusting their savings to you, they continue to take out insurance policies. The banking sector in general is scoring fairly decently in reputation monitors. So what’s the problem?

Earlier in my speech I mentioned PSD2, and how it is probably going to change the way customers interact with financial services providers. But these kind of innovations can only succeed if customers trust the new services. A recent survey we did suggests there’s some public skepticism about PSD2. That’s understandable.

One of the goals of PSD2 is for customers to benefit from a myriad of new and useful services. But if they have concerns about fraud, or their data being used without permission, they might see it as a risk that’s just not worth taking. As a result of PSD2, banks will lose their privileged access to customer data. New FinTechs are entering the market, that are often ideally positioned to make full use of this data.

One of few competitive advantages that banks have, is they enjoy a stronger position of public trust than FinTechs do. Our survey revealed that if customers had the choice between an app offered by their bank, or a similar service from an unknown FinTech startup, they'd stay loyal to the bank they're familiar with. But no one knows where the tipping point lies. Once it is crossed, PSD2 could drive banks into the background. With customers obtaining services directly from third party providers.

That makes public trust an asset of great value for the banking sector at this juncture.

3rd challenge: forward looking risk management
The third challenge I would like to mention, and which I think applies equally to you as banks as to us supervisors, is to cultivate our capability to look ahead. To sharpen our receptiveness to developments around us. What do I mean by that? Let me explain. Today, the risk of climate change and the transition to a sustainable economy is on the way to become a permanent element in risk management. Who thought that possible only ten years ago? The same goes for cybercrime. This subject was barely mentioned in risk management twenty years ago, but now it is one of the main risks and banks are investing large sums of money to protect themselves against these risks.

Of course, banks and supervisors are continuously assessing the top risks for the financial sector. Banks have made large investments in top notch quantitative models that try to gauge the magnitude of risks. Although this does sharpen our focus, and is undoubtedly important, we must not allow it to cloud our intuition, the propensity we have for being alert to 'unknown unknowns', the dark matter of the financial universe. It was ten years ago that several dangerous developments collided in an explosive cocktail that saw the financial system on the brink of collapse. What will be the toxic ingredients of tomorrow?

Perhaps the most important aspect of forward-looking risk management and supervision is the recognition that there are certain risks and dangers that will escape our attention, even when they are in plain view. That is why we have capital requirements. Sufficiently high capital buffers are ultimately the last line of defense of absorbing unforeseen losses. And when this is not enough, it is time for orderly resolution. In recent years every effort has been made to develop effective resolution tools for banks.

So all in all, although the outlook is moderately positive, leading a bank is certainly not a walk in the park… See it more as a challenging hike, with some nice plush meadows in sight, but also some steep cliffs and canyons to be crossed.

In DNB, as always, you find a critical travel companion, with our familiar approach. We value an open working relationship, based on dialogue and mutual trust, which I think is a good Dutch tradition. We are clear about the supervisory expectations and legal requirements, and we offer information and suggestions, and bring together good practices through seminars and roundtables. In case of shortcomings we intervene proportionally and effectively, which also means we act with increasing force if needed.

Finally: The SSM
Of course, and this is perhaps one of the greatest changes of all over the past twelve years, we are not going about this alone. Today, if you are entering your head offices, you may see not one bicycle, but two. Or a whole lot, if an on-site inspection is taking place. (Actually, this is a figure of speech. We have not yet completely succeeded in transferring our love for cycling to all our good colleagues within the SSM.)

Because I am talking about the SSM of course. I think the SSM has been a great improvement in the way we exercise supervision. If I only think back at the situation we were in, back in 2012, when the European Council's decision about the banking union was taken. And in November 2013 the SSM was formally established.It is hard to believe how much progress we've made in just a few years.

Many highly qualified staff had to be recruited. A complete supervisory framework had to be designed and be made operational, incorporating the best elements of each nation's approach to supervision. And a close collaborative relationship with national supervisory authorities developed. It was an astounding achievement, and the ECB deserves much credit for this.

We are now in a transitional phase. A phase in which the banking union is steadily taking shape, and the SSM is consolidating into a truly harmonized European supervisor. Based on past experience, I look forward to this new phase with confidence and I am eager to take part in it. That’s how we are continuing, safeguarding a sound banking sector in the interest of depositors and a prosperous economy.

Only one last thing: I would love to see more supervisors taking the bicycle when moving around in Frankfurt...