Banking Supervision at the Crossroads: Background and Overview

This volume contains the proceedings of a conference hosted by De Nederlandsche Bank (DNB) on 24 and 25 April 2002. The conference has been organized to celebrate the adoption of the Act on the Supervision of the Credit System in the Netherlands 50 years ago, when banking supervision was first formalized.

Banking supervision …

The first Act on the Supervision of the Credit System in the Netherlands replaced a system of voluntary arrangements between DNB and the private banks. It was a response to the major changes in the financial and economic environment that had taken place in the interbellum. The increasing role of the banking sector in the economy and the unfortunate experience of the great depression made it clear that a sound functioning of the banking system was too important to be arranged informally. In chapter X of this volume, Henriëtte Prast en Joke Mooij – both from De Nederlandsche Bank – sketch the historical evolution of banking supervision in the Netherlands, including the run-up to and the consequences of the coming into force of the Act in 1952.

Over time, DNB’s tasks and responsibilities in the area of banking supervision have increasingly been viewed as integral part of its broader mandate for maintaining financial stability in the Netherlands. This concern with the stability of the financial system has also broadened the focus of banking regulation from comparatively narrow creditor protection issues toward problems of systemic risk. While these problems are connected to the financial system more broadly (encompassing markets, several types of financial institutions, and payment systems) the banking system is of particular relevance as it can be prone to contagion through credit and/or liquidity channels with widespread financial fragility as a result.

The established economic theory of regulation is built on the notion of market failure. Regulation is justified in order to prevent or mitigate the potentially adverse effects of market power, externalities, and asymmetric information between market participants. For bank depositors in particular, the value of longer-term investments that are not publicly traded is difficult to establish. The first-come-first-served constraint applicable for demand deposits
implies a strong incentive for depositors to be in the front of the queue, should their confidence in the safety and soundness of the institution fade.¹

In order to be able to safeguard financial stability under such circumstances, it is vital to establish a financial safety net. Such a safety net typically includes prudential supervision, deposit insurance, emergency liquidity assistance, and orderly winding-down procedures.² It is worth noting that a well-devised safety net combines elements aimed at preventing as well as resolving financial crises. In the absence of either of these elements, (perceived) risks of destabilization of the banking system will grow. This, in turn, may lead to international repercussions such as the reluctance on the part of foreign institutions to hold claims on domestic banks and the emergence of a country premium for international interbank deposits.

The main risk of any financial safety net, however, is that it encourages moral hazard. Financial discipline may be reduced by providing incentives for excessive risk-taking by banks and insufficient monitoring by depositors whose claims are protected by the safety net. To the extent that the specific features of a deposit insurance scheme cannot sufficiently mitigate the occurrence of moral hazard (i.e. where risk-based funding is deemed infeasible or inappropriate), the case for public oversight of banks’ major activities is reinforced. Otherwise banks would be incented to accumulate overly risky assets, since the downside of their investments is covered by the deposit insurance guarantee. In chapter X of this volume, Gillian Garcia – international financial consultant – discusses the effectiveness of deposit insurance schemes as well as its interplay with banking supervision.

While this ‘classical’ line of thought tends to focus on creditor protection in order to prevent bank failures and consequent runs, recent thinking on banking supervision is much more couched in terms of reducing systemic risk and maintaining financial stability. Financial instability is usually thought to be of a systemic nature when significant portions of financial markets break down, causing widespread and substantial losses both in financial markets and, critically, the real economy. Systemic risk typically refers to the ex-ante probability and expected severity of such systemic financial instability.

Systemic financial instability may have its origins in the banking sector when credit or liquidity problems of one or more institutions create widespread and substantial credit or liquidity problems for participants elsewhere in the financial system. On top of contagion through direct and ‘real’ linkages, financial stress emerging in one bank may also *insinuate* and thereby prompt similar difficulties in others, as it is often impossible for individual creditors to distinguish bank-specific from industry-wide shocks (a confidence channel). Markets may then break down because institutions being run upon hold assets that cannot be easily liquidated to meet the demands of those participating in the run.

Failure or financial distress of a number of key large banks could result in a credit or liquidity crunch in which market participants are temporarily unable to obtain sufficient working capital or back-up lines of credit to trade in public equity, debt, commodities, currency, or derivatives markets. The likelihood of these systemic effects occurring as the result of a *single* bank failure logically increases with the degree of concentration in the banking industry.

In view of the ongoing consolidation within the financial services industry, nowadays three core objectives of financial regulation can be distinguished:³

1. to sustain systemic stability (i.e. limiting the risk of correlated failures as laid out above);
2. to maintain the safety and soundness of financial institutions (i.e. limiting idiosyncratic rather than systemic risk); and
3. to protect the consumer. Consumer protection issues arise for two main reasons: because an institution where clients hold funds might fail, or because of unsatisfactory conduct of business of a firm with its customers (depositors and investors alike).

By and large, these objectives translate into three generic types of financial regulation and supervision/oversight:

1. systemic regulation and oversight, which focuses on the safety and soundness of the financial system as a whole;
2. microprudential regulation and supervision, which focuses on the safety and soundness of individual financial institutions; and
3. conduct-of-business regulation and supervision, which focuses on how financial firms conduct business with their customers.
While it is difficult to provide a clearly delineated definition of what constitutes systemic oversight, it is clear that it entails typical central banking functions such as ongoing assessment of financial vulnerabilities, the lender-of-last-resort facility, and oversight of the payments system. To bring out the contrast with microprudential supervision, Crockett (2001) suggests thinking of the financial system as a (mixed) portfolio of institutions. The macroprudential or systemic perspective would focus on the overall performance of the portfolio; the microprudential vision would give separate weight to the performance of each of its constituencies.\(^4\)

\(...at the crossroads\)

The theme of the conference has given rise to multiple interpretations, as is reflected in several of the papers. The leitmotiv has been to chart the consequences for banking supervision of two stylized developments that, over the last decade or so, have characterized the financial landscape within the Netherlands and elsewhere: the joint occurrence of cross-sector and cross-border integration of financial services. Both developments inevitably call for a supervisory response. The somewhat orthogonal relation between the two, however, implies that banking supervision currently indeed stands ‘at the crossroads’. This is not to say that policymakers must choose one of either directions and turn their backs to the other. The theme developed inter alia by David Llewellyn in chapter X of this volume is precisely the opposite: regulators need to proceed in several directions simultaneously by optimizing the combination of the several components of what he terms the ‘regulatory regime’.

Recent discussions on the optimal institutional structure of financial services regulation and supervision in the Netherlands and elsewhere have been dominated by the desire to formulate a response to the blurring of distinctions between banking, insurance, and securities activities. After all, consistency in regulation and supervisory practice is an important prerequisite for achieving a level playing field between various financial services providers. In chapter X of this volume, Kees van Dijkhuizen – treasurer-general of the Dutch Ministry of Finance – highlights the main features of the new institutional set-up of financial supervision in the Netherlands. In a nutshell, the new model acknowledges the predominance of financial conglomerates in the Dutch financial landscape, the fundamental difference between


\(^4\) A. Crockett (2001), \textit{Marrying the micro- and macroprudential dimensions of financial stability}, Basel: BIS
prudential supervision and conduct-of-business supervision, and the close linkages between systemic stability and microprudential supervision in a highly concentrated financial sector.

In chapter X of this volume, Jochen Sanio – president of the newly established Bundesanstalt für Finanzdienstleistungsaufsicht (BAFin) – compares the new Dutch model with the recently approved German model of a cross-sector structure for financial supervision. For roughly the same reasons that led to the institutional reform in the Netherlands, the German legislator drew a rather different conclusion. Whereas the Dutch model combines systemic and microprudential supervision and separates conduct-of-business supervision, the German model combines microprudential and conduct-of-business supervision within a newly established supervisory authority (BAFin) separate from the Bundesbank’s systemic responsibilities. A Financial Markets Regulation Forum representing both institutions will be responsible for the coordination of micro- and macroprudential issues. The comparison between the two countries illustrates that, at the end of the day, each new regime will have its peculiarities often tailored to meet specific national characteristics. It will be interesting to monitor how, over the coming years, the different supervisory strategies will succeed in meeting the fundamental objectives of financial regulation as defined above.

The current supervisory landscape in other European Union countries, as well as at the Community level, is also far from being static. In chapter X of this volume, Wim Duisenberg – president of the European Central Bank – reviews these developments concentrating on the role of national central banks and the European System of Central Banks (ESCB) in prudential supervision. The role of the ESCB is rooted in the Maastricht Treaty, which assigns it the task of contributing to microprudential supervision and financial stability, while keeping the primary responsibilities in these areas at the national level. Having reviewed pros and cons of the various institutional structures, the ESCB strongly supports a continued involvement of national central banks in prudential supervision. Any solution other than direct responsibility would have to be coupled with close co-operation and operational involvement of central banks in order to allow the potential synergies between central banking and microprudential supervision to be exploited.

While the blurring of sectoral distinctions has had far-reaching consequences for the institutional set-up of financial supervision, the blurring of geographical distinctions has thus
far mainly evoked calls for increasing international co-operation. Prime examples of the fruits of such co-operation are the supervisory standards developed by the Basel Committee on Banking Supervision (BCBS). Under the leadership of its chairman Bill McDonough, the BCBS is currently finalizing the new capital adequacy framework for large internationally active banks (‘Basel 2’). In chapter X of this volume, Tom de Swaan – chief financial officer at ABN AMRO and former chairman of the BCBS – stresses the importance of the convergence of supervisory practices around the globe. As Basel 2 would entail an increase in supervisory discretion relative to the old Accord, the international level playing field can only be maintained by further convergence of supervisory practices.

In chapter X of this volume, David Llewellyn – professor of Money and Banking at Loughboro University – argues that the real significance of the Basel 2 proposals is the setting of regulation within the wider context of the ‘regulatory regime’ with a clear recognition that mechanisms other than rules are important in sustaining the safety and soundness of banks and systemic stability. In terms of the ‘regulatory regime’ paradigm, Basel 2 offers more precision in the regulation component while at the same time also gives emphasis to other mechanisms such as market discipline. His theme is that, while much attention has been given to refining the many and very detailed capital adequacy rules in pillar 1 (refinement of risk weights, etc.), the real challenge lies in how the three proposed pillars (1. minimum capital requirements; 2. supervisory review; and 3. market discipline) are related and are to be coordinated. In particular, it is deemed likely that pillars 2 and 3 will prove to be more important and significant than the details of capital adequacy rules in pillar 1.

Philip Lowe – from the Bank for International Settlements – evaluates a different aspect of Basel 2’s capital adequacy rules: its inherent degree of procyclicality. As such, chapter X of this volume provides a telling example of the natural interplay between microprudential regulation and macroeconomic ramifications. It examines the two-way linkages between the credit risk measurement approach underlying Basel 2 and macroeconomic fluctuations. Lowe concludes that much remains to be done in integrating macroeconomic considerations into risk measurement, particularly during the upswing of business cycles that are characterized by rapid increases in credit lending and asset prices.
Finally, in chapter X of this volume Jaap Bikker and Iman van Lelyveld – both from De Nederlandsche Bank – investigate the extent to which Basel 2’s increasing reliance on internal risk measurement approaches can be extrapolated to the group-wide supervision of financial conglomerates. Internal risk models are relatively well developed for market and credit risk but for other risks many issues remain to be resolved. An even greater challenge is the development of models that aggregate risks across risk areas and business units, in particular across bank and insurance activities. An important building block of such models is the diversification effect that the combination of different activities might offer. The results suggest substantial potential for diversification that may however be offset by increased contagion risks.

In closing, I would like to thank everyone who helped make this conference so successful. We appreciate both the speakers giving their valuable time to share their expertise and the discussants as well as the audience participants who actively contributed to the policy debates. In this context, I should specifically mention Arnoud Boot, Wilko Bolt, Henriëtte Prast, Gaston Siegelaer, and Annemarie van der Zwet. I also want to thank the members of DNB’s staff who devoted so many hours to developing the program, organizing, and directing the conference. In this context, a special articulation of gratitude is owed to Thea Kuppens, Henriëtte Prast, and Sandra Wesseling. Once again, the conference provided an excellent forum to address the regulatory and supervisory consequences of cross-sector and cross-border integration of financial services.

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