Duisenberg school of finance

Financial stability and proper business conduct: Can supervisory structure help to achieve these objectives?

Dirk Schoenmaker, Duisenberg school of finance
&
Jeroen Kremers, RBS NV

Date: 26 May 2012, Hong Kong

Dutch reform

- Before reform of 2002
  - Blurring of sectoral boundaries (products/activities)
  - Lack of mission, turf battles

- Reform: Twin Peaks
  - Central bank (DNB): macro- and micro-prudential
  - Authority for Financial Markets: conduct of business

- Key considerations
  - Create excellence in financial stability (macro and micro at central bank)
  - Prudential and conduct of business are different

Duisenberg school of finance

Policy framework

Policy	**Objective**	**Ultimate goal (level of impact)**
Monetary policy	Monetary stability	Stable economic growth (economic system)
Macro-prudential	Financial stability	
Micro-prudential	Soundness of financial institutions	Protection of consumers (individual institutions)
Conduct of business	Orderly markets and fair treatment of consumers	

Duisenberg school of finance

Fallacy of composition

- Implicit: system is safe by making individual financial firms safe
  - But that is wrong!

- Financial firms can behave collectively in a way that undermines system
  - Micro: sell an asset when price of risk increases
  - Macro: if many banks sell -> drop in asset price
  - Downward spiral of asset prices (CDOs, houses, …)

- When conflict: macro should drive/override micro

Duisenberg school of finance

Macro vs. micro prudential perspectives

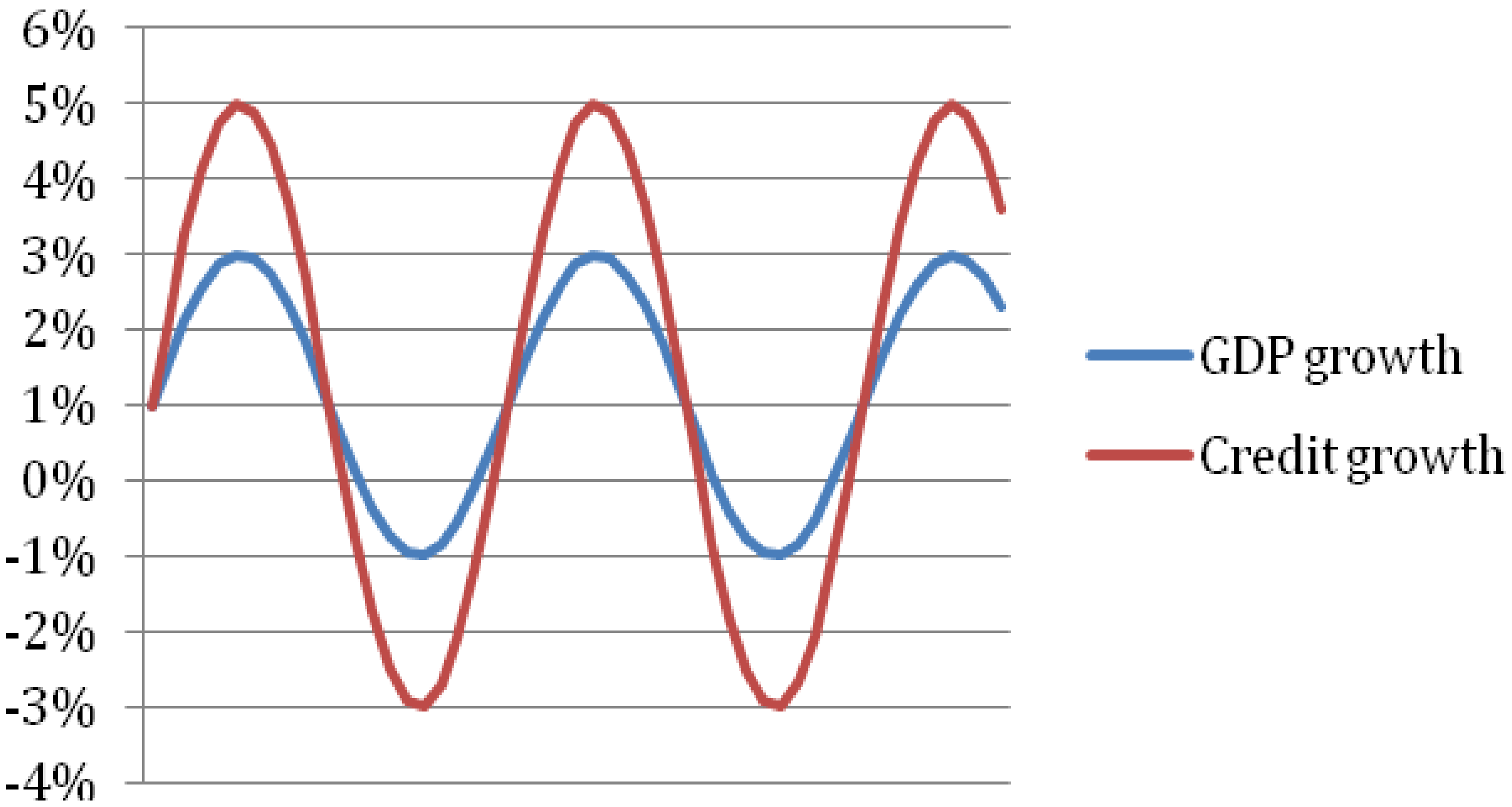
	Macroprudential	**Microprudential**
Policy objective	**Limit financial system-wide distress**	**Limit distress of individual firms**
Ultimate goal	**Avoid output (GDP) costs linked to financial instability**	**Consumer (depositor/ investor/ policyholder) protection**
Characterisation of risk	**Dependent on collective behaviour; endogenous**	**Independent of individual agents' behaviour; exogenous**
Correlations and common exposures across firms	**Important**	**Irrelevant**
Calibration of prudential controls	**In terms of system-wide risk; top-down**	**In terms of firm risks; bottom-up**

Source: Borio (2003)

Hierarchy of objectives

Level	Objectives			
Economy	Monetary stability	↔	Financial stability: macro-prudential	
			↕	
Individual institutions			Financial soundness: micro-prudential	Conduct of business

Financial system is pro-cyclical



Monetary and Macro-prudential

- The pro-cyclical nature of the financial system requires new thinking on the macro front
- Monetary policy affects entire economy and looks at retail price inflation (expectations)
- Macro-prudential used for targetted sectors with excessively rising asset prices
  - Asia is ahead of Europe/US
  - Example: HKMA decreased LTV to contain rising housing prices in June 2011

Conduct of business: focus

- Focused approach by single dedicated supervisor
  - Clear external accountability
  - Skill set has more legal profile
  - Investigative stance (e.g. SEC)

- Critical success factor: credible public stature
  - Heavyweight founder CEO

- High profile cases
  - Due attention given to conduct of business (e.g. insurance and share-lease mis-selling)
  - Informing DNB about potential solvency impact

Financial stability: focus

- Strong role for central bank
  - Interaction macro- and micro-prudential
  - Macro should drive/override micro
- Institutional challenges
  - Economic (bus cycle) vs legal (rule driven) thinking
  - Skill set: macro -> economists; micro -> also accountants and lawyers
- International
  - Also international: FSB vs Basel (BCBS)
  - Will the ECB get full macro-prudential/financial stability role? Or will the ECB remain a monetary entity?

Conclusions

Supervisory structure can help to achieve objectives:

- Strong focus on conduct of business
  - Supervisor acts in interest of customers/investors
  - No trade-offs
- Strong central bank
  - Interaction monetary and macro-prudential
  - Macro driving micro
  - No crisis management by committee

DISCUSSION

Thank you for your time

For more information go to our website

www.dsf.nl