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Reshaping the Supervisory Role in the Financial Sector: The Case of Holland

Excellencies, Distinguished Guests, Ladies and Gentlemen,

I am delighted to join you at this annual conference. My thanks go to Mr. Al Turifi for inviting me to share my knowledge of the Netherland's regulatory structure within which I have spent the majority of my career. Today, I shall first provide a brief introduction to the Netherlands, explain how financial services regulation is created in Europe and provide an overview of the Netherlands regulatory structure before exploring the impact and outcomes of the global financial crisis on the Netherlands. I will conclude my speech with some of the arguments for and against differing regulatory models.

1. Introduction to the Netherlands

For those of you who are not familiar, the Netherlands is located in north-west Europe and has a population of almost 17 million people¹. It is a founding member of the European Union and one of the 17 sovereign states that make up the Eurozone.

¹ Netherlands Central Bureau of Statistics, November 2010

According to the IMF, the Netherlands has the 16th largest economy in the world² with financial services being one of its leading sectors. The Netherlands' financial sector is dominated by systemically important institutions which operate across various markets. These institutions bring both considerable benefits and sizeable risks to the country. An IMF study has concluded that the Netherlands is the seventh most financially interconnected country in the world³. Mitigating such risks requires a regulatory structure which can ensure careful and comprehensive monitoring and supervision of its financial sector.

2. Financial Services Regulation in Europe

Before I describe to you the Netherlands' regulatory structure, I think it is important that I first explain the process for creating regulation in Europe.

European financial services regulation is increasingly determined at the European level. Directives are proposed by the European Commission and, after negotiation, are adopted by the European Parliament and the European Council, representing the Member States. Once adopted, they must be transposed by Member States into their national law. There are also some European instruments, called Regulations, which have direct effect in the Member States, but this process is much less used than the Directive process. Under the so-called Lamfalussy process, much of the supporting detail of Directives is worked out in committees of national supervisors. The status of these committees was substantially upgraded at the beginning of the year, into Authorities which are responsible for coordination, monitoring and, if necessary, arbitration between the national authorities.

So at the level of legislation, much of the Netherlands' regulatory regime is an implementation of European law.

One major reason for the creation of this European law was to allow the free movement of goods and services within Europe. This occurs through the so-called

² International Monetary Fund, World Economic Outlook Database, October 2010: Nominal GDP list of countries. Data for the year 2010

³ IMF Preliminary Conclusions of Netherlands' FSAP, December 2010

passporting regime. So if, for example, a bank is headquartered in Germany, it has the right to set up branches in the Netherlands without any approval from Dutch regulators, and its prudential supervision will be in the hands of the German regulator. This may be where the GCC will move eventually.

Initially, the European regime was more comprehensive in prudential than in conduct of business areas, and there was room for national regulators to deal with conduct of business matters even for firms passporting in. However, these gaps are increasingly being filled, especially in markets areas.

3. History of the Netherlands' Regulatory Structure

I will now give you provide you with some history of the regulatory structure in the Netherlands. Prior to 2002, the Netherlands had a functional, otherwise known as a sectoral model, with separate supervisors for banks, insurance companies and securities firms. In 1999, an oversight or cross-sectoral body was formed, the Board of Financial Supervisors, in which the existing supervisors shared responsibility for cross-sectoral issues such as the supervision of financial conglomerates and the harmonisation of disclosure requirements for financial products. During this period, it became clear that cross-sectoral issues dominated the policy debate, and a consensus emerged that a more fundamental reform of the regulatory structure was necessary⁴.

In 2002, the twin peaks regulatory model was introduced in the Netherlands. The functional approach had become redundant due to the blurring of sector boundaries and was no longer sustainable. The decision was taken in response to two predominant trends: the consolidation of the Netherlands' financial sector into one dominated by a few large institutions conducting business across multiple product types and lines and the development of complex financial products with cross-sectoral elements⁵.

⁴ Jeroen Kremers, Dirk Schoenmaker & Peter Wiertz, "*Cross Sector Supervision: Which Model?*",

⁵ Group of Thirty, "*The Structure of Financial Supervision*" aka (Paul) Volcker Report, October 2008.

The regulatory reform separated the responsibilities for prudential and conduct of business supervision. The decision was made to assign the prudential supervision for all financial institutions to the existing central bank, De Nederlandsche Bank (DNB), leveraging on the synergies between the macro monitoring and micro supervisory aspects, as well as on its long-standing credibility. A new conduct of business supervisor, the Authority for Financial Markets (AFM) was created with a strong focus on market behaviour and investor protection. The existing securities regulator was absorbed by the AFM and most of the insurance and pensions regulator⁶ merged with the DNB in 2004.

4. Impact of GFC on the Netherlands & Parliamentary Inquiries

Now that I have described the history of Netherlands' regulatory structure I am now going to discuss the impact the global financial crisis has had upon its economy.

The Netherlands is one of the five largest investors in the United States⁷ and as I mentioned previously is one of the most financially interconnected countries in the world. As a consequence, its economy was heavily affected by the crisis primarily through three channels: plummeting global demand, problems with bank balance sheets, and the decline in producer and consumer confidence. The country's economy was relatively vulnerable to each of these channels in comparison to other European countries⁸. The economic slowdown pushed the country into a recession in a late 2008⁹ and few large financial institutions survived without substantial state support. The state was forced to nationalise ABN AMRO and Fortis banks and make loans of around €14 billion to ING, Aegon and SNS Reaal¹⁰. In relative terms, the government's rescue package was amongst the highest in the world.¹¹

These high profile domestic failures have tested the credibility of the DNB and led to the launch of a parliamentary inquiry in late 2009. The purpose of the De Wit

⁶ Pensions and Insurance Supervisory Authority Foundation

⁷ US Department of State, 13 December 2010.

⁸ Maaren Masselink and Paul van den Noord, "*The Global Financial Crisis and its effects on the Netherlands*", December 2009.

⁹ A.M. Best Country Risk Report, October 2010.

¹⁰ <http://www.reuters.com/article/idUSTRE4AC2R920081113>

¹¹ Hans Hoogervorst, Chairman, Netherlands Authority for the Financial Markets, "*The Global Regulatory Reform Agenda: Revolution or Evolution? What's going on?*", speech at the ASIC Summer School, March 2010.

Inquiry, named after its chairman, was to explore the emergency measures taken by the Dutch government during late 2008 and early 2009 to deal with the urgent problems of the financial system in Netherlands. The committee conducted numerous public hearings and reviewed the takeover approval of ABN AMRO in 2007 and the introduction in the Netherlands of Icesave, an internet based branch of an Icelandic bank, and its subsequent collapse. In May 2010, the committee released its report¹² outlining some general conclusions including what it regarded as the country's unsavoury banking culture, regulatory gaps and limited international cooperation¹³. The results of this report were used as a foundation upon which to formulate recommendations for improvements to the country's financial system. These included, amongst other recommendations, improvements to the recognition of macro-economic risks; closer cooperation between supervisory authorities and internal review of the culture within the supervisory authorities with attention paid to the balance of interests of various stakeholders including society, investors, financial institutions and shareholders.

5. Outcomes since GFC and Commissions

Although the Netherlands' economy has experienced many difficulties over the past two years, it has weathered the crisis better than some other European countries. Plans are under way to facilitate the exit from the current state support arrangements. The banks and insurance companies that have received state aid are working under plans to pay back loans and other arrangements made so that the state can recoup at least a large part of its financial support.

In its recent FSAP preliminary findings report, the IMF welcomed the steps taken so far by the country's regulators to enhance their supervisory practices. Going forward, the IMF has recommended the implementation of a framework to closely coordinate the actions of the DNB, AFM and the Ministry of Finance to facilitate essential decision making in the event of a future crisis.

¹² The Dutch House of Representatives press release

¹³ www.dutchnews.nl, "De Wit Commission Report into Financial Crisis Published Today", 10 May 2010.

The DNB has demonstrated its commitment to instigate a cultural change within its organisation and to carry out a more intrusive supervisory approach. The IMF has recognised the DNB's efforts in addressing its earlier criticisms.

By way of contrast, I will briefly comment on the experience of the twin peaks model which has also been adopted in Australia for over a decade. Australia is the only other major country with substantial experience of this model. Unlike the Netherlands, the responsibilities for macroprudential and microprudential supervision are separated. The two principal authorities are the Australian Prudential Regulation Authority (APRA), which is responsible for prudential supervision at the firm level, and the Australian Securities and Investments Commission (ASIC), which is responsible for market conduct in relation to financial services and general corporate legal standards. The central bank, the Reserve Bank of Australia, is responsible for macroprudential matters.

Both the Australian economy and its regulatory model are regarded as having been highly effective during the financial crisis. The regulatory model did assist in insulating the country's financial markets from the brunt of the crisis by enabling timely intervention and promoting confidence in the system. However, there was a range of other important contributing factors – such as the financial strength of Australia's national banks, its natural resources and its strong trade links to China and other parts of Asia – which contributed to the country's performance during the crisis.

As you can see, the experience of the twin peaks model during the crisis was somewhat different in Australia and the Netherlands. The conclusion I draw from this is that the crisis does give us a clear argument either for or against twin peaks in itself.

6. Arguments for and against various Regulatory Models

I shall now turn to the various regulatory structures which are implemented throughout the world.

The functional approach to supervision, whereby institutions are supervised according to the sector within which they operate, has merit in that there is technical expertise within the sectoral regulator.¹⁴ A major disadvantage of this model is that the regulators may not have sufficient information concerning all the activities of a particular financial institution and effective communication amongst the sectoral regulators is imperative for monitoring systematic risk. The functional approach has other criticisms such that it is inefficient due to tendencies for regulators to duplicate efforts and that some institutions are required to deal with multiple regulators.

The recent experience of regulatory gaps and arbitrage does appear to have reinforced a continuing move towards integrated regulation, on either a full integration or a twin peaks basis. The Belgian government has decided to move towards the twin peaks model by integrating the prudential supervision of its financial institutions into its central bank. In contrast, Ireland has already formed a unitary integrated regulatory institution and France recently established a prudential control authority connected to its central bank as the single licensing and supervisory authority for its banking, investment services and insurance sectors¹⁵. These developments appear to have been provoked by the global financial crisis.

Even though there is no ideal regulatory framework, there is certainly a determination to ensure that entities offering similar products and services irrespective of whichever jurisdiction they operate, receive the same supervision and oversight. At national level, there are also attempts to eliminate regulatory arbitrage. For example, in some areas banks and insurers take similar risks, and should hold similar capital against those risks. Similarly, the disclosures to the buyer of a mutual fund should be similar whether it is sold simply as a fund or with a life insurance wrapper. There is thus continuing pressure against purely sectoral regulation.

At national level also, there is pressure at least to define responsibility for macroprudential regulation. Because of its link to macroeconomic policy, the natural location in many jurisdictions will be the central bank. This will tend to strengthen the

¹⁴ Group of Thirty, *"The Structure of Financial Supervision" aka (Paul) Volcker Report*, October 2008.

¹⁵ European Central Bank, *"Recent Developments in the Supervisory Structures in the EU Members States (2007-10)"*, October 2010

claim of the central bank to be the integrated regulator, where one is being created, though there is concern in large jurisdictions about whether a single institution can manage fully integrated regulation, both macro and micro, as well as monetary policy.

At the European level, a sectoral approach to micro-prudential regulation will continue, and in addition to the Authorities I have mentioned, the European Systemic Risk Board (ESRB) has been created to “monitor and assess potential threats to financial stability and, where necessary, issue risk warnings and recommendations for action and monitor their implementation.”¹⁶ This body will be without any legal power and thus will rely on moral persuasion. While this may be effective under normal conditions, we should not overestimate what it can achieve in a crisis, when real money is at stake and the natural instincts of Governments are to protect national interests and national treasuries. The saga of ABN AMRO and Fortis offers a useful case study in this respect.¹⁷

Integrated models also have conflicting objectives which require careful consideration. Firstly, a prudential supervisor is focused on the financial soundness of institutions while the conduct of business supervisor is focused on clients’ interests. Combining the responsibilities of financial stability and conduct of business may create incentives for the supervisor to give preference to one objective over the other. Secondly, there is a possible conflict between macroprudential and microprudential supervision. This relates to lender of last resort operations and balancing its benefits, such as avoiding systemic risk, against its costs, such as creating moral hazard. Furthermore, the stability objective is consistent with preserving public confidence and may require discretion and confidentiality, which could be counterproductive to the transparency objective of conduct of business supervision. Segregating these objectives and creating clear mandates enables the potential conflicts to be effectively managed.¹⁸

¹⁶ Brussels European Council 18/19 June 2009 Presidency Conclusions, *Europa*, 18 June 2009

¹⁷ ABN AMRO gets new €4.4 billion bail-out, *BBC News*, 19 November 2009

¹⁸ Jeroen Kremers, Dirk Schoemaker & Peter Wierts, “*Cross Sector Supervision: Which Model?*”,

There are also significant advantages of integrated supervision in that it promotes cross-sectoral consistency of supervision; allows for rapid policy responses; reduces the scope for regulatory overlap; strengthens accountability; and maximises economies of scale and scope in supervision. For example, market misconduct is traditionally regarded as a conduct of business issue. But where there is an attempt to manipulate sovereign bond markets, it can rapidly become a macroprudential issue, as we have seen in Europe. Such issues are easier to deal with in a fully integrated framework.

I now conclude by reiterating that the financial crisis has not provided evidence of an optimal regulatory structure.

In the case of the Netherlands, the IMF concluded in its recent preliminary findings report that the twin peaks model remains appropriate. The concentration of all prudential oversight within the central bank provides it with the ability to take a systematic view across the entire financial sector and to react quickly and decisively. But the same would be true in a fully integrated model.

I believe that the optimal model for any country depends on several factors, including the size and nature of a country's financial sector and the extent to which firms are active across traditional sectoral boundaries.

Thank you.