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the easier it is to circumvent them’

Hans Hoogervorst

‘Shocked’ is how Hans Hoogervorst describes his reaction to the current global financial crisis: shocked by the often bad financial products that came on the market, and shocked, too, that the crisis arose largely through a lack of transparency in the market. ‘The scale on which this happened, the mistakes that piled up one after another – it’s astounding.’ Nevertheless, Hoogervorst, who is chairman of the Dutch financial markets regulatory body, AFM, finds it ‘incomprehensible’ that the financial world should have developed such serious integrity problems. The explanation of how this happened must, he believes, lie somewhere within the system. And as for the solution, it is Hoogervorst’s view that better regulation, although not necessarily more regulation, is the answer.

When Hans Hoogervorst joined the Autoriteit Financiële Markten (AFM), the Dutch financial-markets regulator, he imagined that his new field of work would be a great deal more transparent than the healthcare sector he had just left. 'I remember saying to my new staff, when I met them for the first time, that I had found the healthcare sector to be one of the most opaque in the world, and how I was looking forward to working with the financial sector, with its high degree of transparency. They looked at each other, puzzled; they must have been thinking, "High degree of transparency? If that's the case, what's left for us to do?" Of course, events soon put me right.'

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Shocking

Hoogervorst took on his new position before the credit crunch had begun to manifest itself. That meant that he was confronted with some nasty surprises when things started to go wrong. 'The main cause of the crisis was indeed a lack of transparency in the market,' he says. 'AFM reports showed that mortgages and investment insurance policies were too complex and were often inadequately explained.' What he found particularly shocking was that many of the products were actually often quite bad, in that they could only deliver a decent return on investment in market conditions that were euphoric. The scale on which this was happening was also worse than he had initially suspected. 'Of course, the current credit crisis is an abnormal event: we had a number of smaller bubbles bursting over the past thirty years or so, but this one is really very big. As an economic liberal, I suppose I'd been somewhat sceptical about the need for regulation. But that scepticism has now completely gone.'

What went wrong?

Some people suggest that the crisis was caused by a lack of personal integrity on the part of people in corporate high places. Does Hoogervorst agree? No, that would be putting it too strongly, he says. 'And anyway, to what extent can you guarantee that directors of financial institutions will act with integrity? We expect them to do so, of course, and the AFM, together with the Dutch central bank (DNB), carefully screens candidates to reduce the chances of a "bad apple" getting through. But such screening can never tell us much about a person's character: that's not something you can test for.' Rather than look for the causes of the crisis in individual shortcomings, Hoogervorst is instead inclined to ascribe the present difficulties to a failure of the system in which those individuals worked.

Ignoring the downside

As an example of how the system, in essence, 'seduced' financial service providers into behaving unscrupulously, he cites the boom in insurance-based investment products. These were mortgages, saving schemes and other products whereby much of the premium was not actually invested but went to paying costs and commissions. 'These were certainly not good examples of integrity in action,' says Hoogervorst. 'Financial institutions were sucked into a process of competition, in which they find themselves racing not towards the top but towards the bottom. No one felt that they were selling anything inappropriate, because stock markets were rising steadily, and there seemed no end in sight. But they should have been asking themselves fundamental questions, such as, "Is this something that my client can cope with? Is it in line with the client's risk profile? What will happen to them in a bear market?" No one asked those questions. They either simply suppressed all thoughts of a downturn, or deliberately refused to accept any responsibility for what might happen if – or, more likely, when – one occurred.'

Paternalistic legislation required

The problem is that the often complex nature of financial products today puts consumers at a disadvantage, and it is one of the AFM's main tasks to redress this imbalance between provider and consumer. 'Take mortgages, for instance,' says Hoogervorst. 'No matter how simple you try to make a mortgage, it remains a complex product. It's something most people only ever buy once or twice in their lives, so they rarely have much experience at it. Compared to the professional who's trying to sell the product, the consumer has a substantial knowledge deficit.' Hoogervorst believes that paternalistic legislation is needed to protect consumers in their dealings with financial services companies. The Netherlands Act on Financial Supervision (WFT), which came into effect in 2007, is an important step in the right direction, he says. This Act brings together and aligns all the rules and regulations relating to the financial markets and their supervision. 'Basically, such legislation requires the seller to look closely at the risks, to explain them to customers accurately and in

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terms that are easily understood, and not to sell anything that's not in line with the customer's risk profile.'

Stricter criteria unnecessary

Does the AFM need greater powers in order to be able to perform this task? No, says Hoogervorst. 'I'm quite content with the powers we already have. I think that we, in the Netherlands, have an effective, well-balanced watchdog system. In the USA, by contrast, there is no regulation for behaviour in the financial services sector at all. It's inconceivable that the sort of loans that were made in America could have been made here – we would have spotted them quite quickly. Apart from one or two small matters, which I've sent to parliament, I see no need for our powers to be extended. Rather, it's a question of becoming better at doing what we're already doing.' Of course, says Hoogervorst, people will always look for the best possible return on their money.
'You won't ever be able to prevent every crisis, but if we plug the obvious holes, we can avoid a great deal of trouble.' It will not, he believes, require complicated regulation. 'And it would actually be better if it didn't, because the more rules there are, the easier it is to circumvent them. It's rather a question of getting institutions to follow a few simple principles, such as only selling products they understand.'

Banking sector not a free market

Another contributory factor in the present crisis, says Hoogervorst, has been the enormous competition between financial markets, such as Wall Street and London. 'This competition led to regulators often being tempted to overlook things,' he says. 'To prevent the same sort of internal competition arising within Europe, we need to start organising regulation more centrally. That would be more effective and earn us public credibility. I believe the banking sector needs to be regulated more tightly – as I say, not necessarily with more rules, but rather stricter rules, with tougher conditions imposed by government. I don't see any other option.' The banking sector, he points out, is not a free market. It is a market with a number of safety nets (provided by central banks and other authorities) that are deployed when the system is endangered. 'Having those safety nets can tempt people into taking all sorts of stupid risks. That's when you get what's been called "the privatising of profits and the socialising of losses". It's what we have now, on a large scale. In social terms, this is obviously quite unacceptable, and a completely different approach is needed.'

Remuneration

A spirit of reckless risk-taking was also encouraged by the system of remuneration in place in the financial sector. It wasn't uncommon, says Hoogervorst, for more than half a company's profits to be paid out in the form of bonuses. To make sure they got these bonuses, people were taking unnecessary and irresponsible risks, and then, when things went wrong, they tried to cover up what they'd done. 'And what do you do when bonuses that have already been paid turn out to have been earned by taking undue risks?' he asks. 'There's often no way you can get the bonuses back: the whole system lacks integrity. I hope people will take due note of the justifiable public anger about this. The financial sector needs to find a better way of attracting and motivating its workforce. It can't be right to put temptation into people's way like that.'

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Restoring trust

Clearly, the present crisis has seriously damaged public trust in the financial sector. Companies themselves need to restore that trust, says Hoogervorst. It is not simply a question of satisfying the regulator; it is in their own commercial self-interest. He suggests a number of measures they might take to accomplish this, including introducing a system of accreditation, making product explanations clearer, and simplifying the products themselves. Simpler products, he says, would mean that product providers would be able to supervise intermediaries better. 'In fact, this is already happening,' says Hoogervorst. 'It confirms my confidence in market forces: even if a company manages to achieve success in the short term by being unscrupulous, the old proverb "Honesty is the best policy" will prove true in the end. Sustainable profitability is only possible if you give integrity top priority. Trust is vital when you're doing business with people who are going to be dependent on your product for many years.'

Company values

Ultimately, says Hoogervorst, it is up to companies themselves to ensure that they maintain a high level of integrity. 'The CEO bears most responsibility, but the CFO is often very important, too, acting as a sort of "shadow CEO" – an important but independent role. My message, then, to CFOs regarding both integrity and the interest of the company is this: Don't view integrity as a necessary evil that you have to watch out for; see it instead as a core value of the company. Far from limiting commercial profitability, it is actually vital for the long-term commercial profitability of the organisation. This is how CEOs and CFOs should view integrity, and why they should embed it deeply within their organisation.'

Hans Hoogervorst is chair of Autoriteit Financiële Markten (AFM, the Dutch financial markets regulator). Prior to his present position, Hans Hoogervorst was an MP and then Deputy Minister of Social Affairs, Minister of Finance and Employment, and Minister of Health, Welfare and Sport in successive Dutch governments from 1998 to 2007.