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in the Netherlands**

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Jeroen Kremers and Dirk Schoenmaker in the Netherlands Treasury were responsible for financial regulatory reform introducing the Dutch twin peaks model in 2002. Since then they moved on to the IMF and then RBS and to the Duisenberg School of Finance, respectively. Jeroen Kremers is now managing board member of RBS N.V. and head of global country risk exposure for RBS Group and also chairs the Tinbergen Institute. Dirk Schoenmaker is Dean of the Duisenberg School of Finance, Amsterdam, and Professor of Finance, Banking and Insurance at the VU University Amsterdam. Any opinions expressed here are those of the authors and not necessarily those of the FMG. The research findings reported in this paper are the result of the independent research of the authors and do not necessarily reflect the views of the LSE.

Twin Peaks: Experiences in the Netherlands

By Jeroen Kremers and Dirk Schoenmaker¹

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1. Introduction

Bankers, supervisors and policymakers have reason to be modest these days. A modest assessment of experiences with the Twin Peaks supervisory model in the Netherlands would be that – other than in some countries with a different setup – the model itself has not been a factor contributing to financial disarray. Nevertheless also the Netherlands has had its share of profound financial sector failure, which Twin Peaks has not prevented. This paper explores in what areas the model has helped, and in what areas the Dutch experience points to possible improvements.

Thus the scope of the paper is not to assess what went right and wrong in financial supervision in the Netherlands in a broad sense, but only to provide a first inventory of issues possibly related to the Twin Peaks model as introduced in the Netherlands in 2002. In doing so, we can rely on recent work evaluating the adequacy of the two Dutch supervisors' performance, notably the parliamentary De Wit (2010) report about causes of the financial crisis and the Scheltema (2010) report about the failure of DSB Bank.

Let's start with a brief summary of the Dutch Twin Peaks model. Prior to the reform, there was a traditional sectoral setup with a banking supervisor (De Nederlandsche Bank (DNB), member of the ESCB within the euro area), an insurance and pensions supervisor, and a securities supervisor. With the blurring of sectoral boundaries between financial firms, between markets and between products, the effectiveness of this model had come under pressure and the three sectoral supervisors for lack of a clear mission had begun to lose energy on turf battles instead of putting their effort into being pre-eminent in their own domain.

The reform created a simple objectives-based setup, with DNB permutated into a single supervisor responsible for prudential stability of all financial institutions (so-called micro-prudential) as well as for stability of the financial system (so-called macro-prudential) and a new supervisor, the Authority for Financial Markets (AFM)

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responsible for conduct of business supervision of all financial firms. The securities regulator was developed into the AFM, while the insurance and pensions supervisor was abolished with large part of its organisation merged with DNB.

Two underlying considerations were the driver of this reform. First, there was the conviction that prudential and conduct of business are really two different objectives, requiring a different skill set, a different external profile and distinct decision responsibilities to do justice to both of these objectives. Second, there was the conviction that financial system stability must be closely linked with micro-prudential stability of individual firms, especially in a fairly concentrated market - with systemically important financial institutions - such as that of the Netherlands at the time, and also with monetary policy with its decisive influence on financial market conditions. DNB was made responsible for system stability and micro-prudential, thereby also offering some link with monetary policy through its role in the ESCB/ECB.

As a result of the reform, two key improvements to the quality of supervision were envisaged. First, by defining distinct objectives for the two supervisors and thus taking away any ground for turf battle, it was envisaged that all energy would be spent on excellence in the respective domains. Second, by combining financial system stability with micro-prudential at DNB and, though more distantly, with monetary policy of the ECB, it was envisaged that this would empower DNB to give full attention to financial stability and be innovative and internationally prominent in this area. Having been given micro-prudential responsibility for not only banks, insurance firms and securities firms but also for the very large pension funds with their huge financial market impact in the Netherlands, DNB became amongst the best placed of supervisors internationally to deliver on this challenge.

Having thus created two supervisors with each its own motorway lying open for full throttle ahead, it is interesting to assess what progress this Twin Peaks model subsequently enabled in the years prior to the financial crisis and how the model held up during the crisis itself.

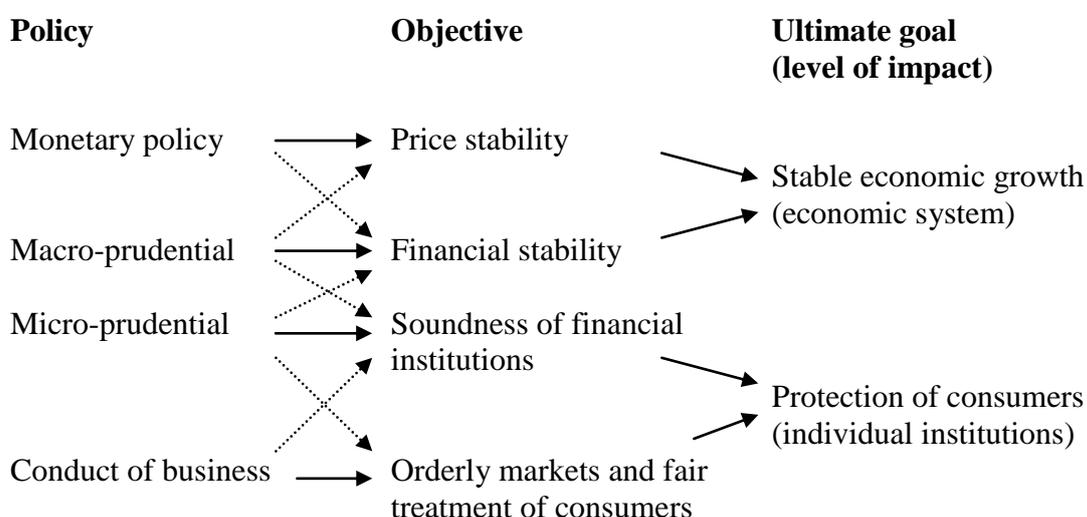
2. Supervisory objectives and structure

Before moving to these experiences, the analytical background of the objectives-based supervisory structure is briefly reviewed. Four distinct objectives can be observed for the broader monetary and financial system: monetary stability, financial stability (macro-prudential), soundness of financial institutions (micro-prudential) and orderly and well functioning markets and fair treatment of consumers (conduct of business).² Kremers, Schoenmaker and Wierdsma (2003) and Herring and Carmassi (2008) provide a general overview of supervisory objectives and compare different supervisory structures. This paper focuses on the Twin Peaks model.

² A fifth objective of competition policy is not discussed here. While competition policy for the financial sector used to be part of the work domain of financial supervisors in several countries up to the 1990s, competition policy has been upgraded to a generic policy applying to all economic sectors, including the financial sector, and executed by the competition authorities.

Tinbergen, the first winner of the Nobel prize for economics, argued that you need at least one policy instrument for each policy objective. In practice, the different policy tools and objectives are interrelated. An appropriate institutional structure should obtain the main synergies between the objectives and allow for an orderly and transparent resolution of the main conflicts. So, the challenge is to combine objectives within an authority where the synergies dominate and to assign objectives to different authorities where the conflicts dominate. Figure 1 illustrates the policy framework for the monetary and financial system. To keep it simple, each policy has a primary impact on its direct objective and a secondary impact on the objective(s) next to it. The solid lines in figure 1 illustrate the primary impact and the dotted lines the secondary impact.

Figure 1: Policy framework

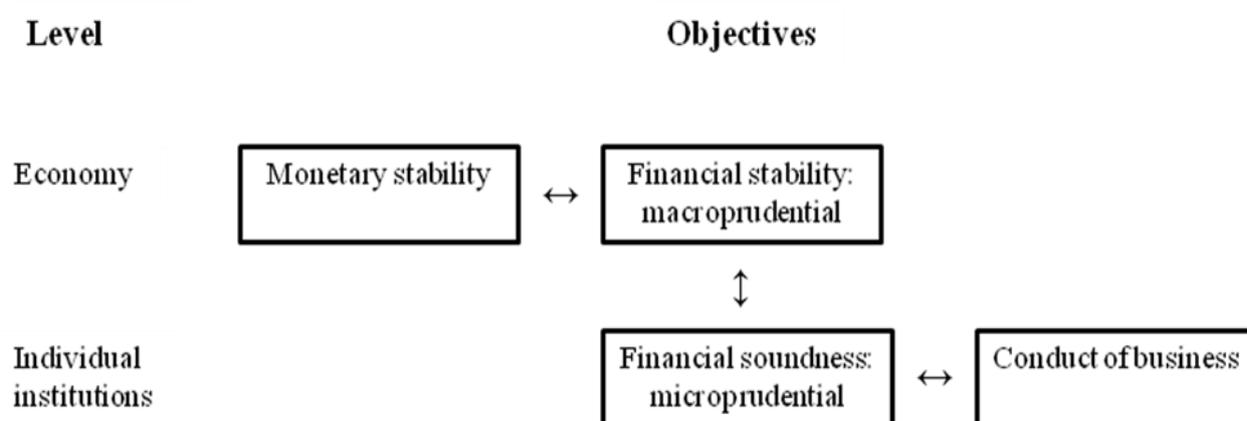


Discussions about supervisory structure often assume that these four policy areas can all be separated, and that instruments used to promote one objective do not undermine the other. The prevalent approach to financial stability, for example, implicitly assumes that the system as a whole can be made safe by making individual financial institutions safe. But this is wrong. As indicated below, this represents a fallacy of composition. It is more appropriate to think in terms of a hierarchy of objectives. The first two objectives, price and financial stability, are equally important and affect the economy at large. The latter two objectives, sound financial institutions and orderly markets/fair treatment, are also equally important. These are addressed at individual financial institutions and aim to protect individual consumers. The first two objectives aimed at the ‘system’ are more important than the latter two objectives aimed at ‘individuals’, for the simple reason that when the system goes down its individual components will go down as well. Moreover, the stability of the financial system is more important than the soundness of its individual components. In a market driven economy, firms – including financial firms – should be allowed to fail to contain moral hazard, unless there is a systemic threat.

The fallacy of composition (Brunnermeier *et al.*, 2009) concerns the idea, fundamentally at the basis of Basel banking supervision so far, that to safeguard the system it suffices to safeguard the components. But in trying to make themselves safer, financial institutions can behave in a way that collectively undermines the system. Selling an asset when the price of risk increase may be a prudent response from the perspective of an individual bank. However if many banks act in this way, the asset price will collapse, forcing financial institutions to take yet further steps to rectify the situation. The responses of the banks themselves to such pressures lead to generalised declines in asset prices, and enhanced correlations and volatility in asset markets. The micro policies can thus be destructive at the macro level.

This, in terms of Tinbergen, raises two issues. First, it is important to take into account the impact of using one area's instrument not only on that area's own objective, but also on the objectives of the other areas. Being cognisant of such cross-effects may lead to a choice and use of instrument that is less damaging to other areas, and thus to better overall results. Second, it may not always be possible in this way to avoid conflict of objectives. In that case it is unavoidable to define a hierarchy of objectives. In such situations, the macro-prudential concerns should clearly override the micro-prudential concerns. Figure 2 depicts the proposed hierarchy of objectives.

Figure 2: Hierarchy of objectives



Underpinning the case for Twin Peaks, if conduct of business and micro-prudential can be separated in practice, no hierarchy between the two is needed and each can best be served by a separate supervisor (for sure, conduct of business ought not to be dominated by micro-prudential – a bank with a consumer-unfriendly business model should be allowed to disappear from the market).³ By contrast, macro-prudential cannot be separated from micro-prudential and indeed the former must be dominant,

³ Which one dominates depends on the perspective. In a single supervisor setting, separate from the central bank, the conduct of business objective may dominate (Taylor, 2009). In a single supervisor setting, within the central bank, the macro prudential objective may dominate (Kremers, Schoenmaker and Wierds, 2003). In the first setting, lawyers set the dominant culture; in the second, economists are the dominant players (Goodhart, Schoenmaker and Dasgupta, 2002).

implying the need for an institutional setting where macro-prudential can drive micro-prudential.

Conduct of business can thus be seen as a separate objective with its own supervisor and its own instruments. But where does that leave us regarding the relation between monetary policy with price stability as its objective and the interest rate as its traditional instrument on the one hand, and macro-prudential supervision with financial stability as its objective and instruments which are highly complimentary to micro-prudential instruments (capital and liquidity requirements, etc) on the other?⁴ We believe the crisis has shown that this is *not* simply a matter of two separate objectives each with its own separable instrument, but rather of an *interrelation* involving two objectives and two instruments.

This brings us into uncharted territory, where monetary policy must systematically take into account its consequences not just for price stability but also for financial stability, and macro-prudential supervision must serve not only financial stability but also help avoid bubble-induced inflation (see *e.g.* Brunnermeier (2010) and Soros (2010) for some early thoughts). Financial crises such as that in Asia and the current global one have made abundantly clear that narrow monetary policy *à-la*-Greenspan must be replaced by a new monetary policy approach integrating macro-prudential supervision and hence relying, next to the interest rate, also on the instruments of macro- and micro-prudential supervision. In terms of the organisation of supervision, this points to a need for a close relationship between the monetary authority and the macro- and micro-prudential supervisor.

The application of these arguments in the Dutch Twin Peaks model is discussed in the next sections.

3. Conduct of business: experiences

The Dutch reform had been thought out pretty much on the drawing board, assuming that in practice a clear line could be drawn between prudential and conduct of business. This has worked out well. Turf battles have stopped, this is confirmed by both the two supervisors and also by the subjects of supervision, financial firms across the spectrum of the various sectors. While initially there was scepticism as to whether separation could work in practice and whether having a single supervisory entry point per firm might not be preferable, this has made place for a broad perception that there are now for each firm two different entry points for two different relationships. When designed properly, it is doable and efficient.

The Scheltema (2010) report about the failure of DSB Bank on the whole judges positively about the performance of the AFM in acting against inappropriate treatment of consumers and in challenging a client-adverse business model. That DSB ended in

⁴ Macro-prudential instruments are still being developed. On the capital front, one can think of an anti-cyclical capital add-on for macro-prudential reasons and a minimum capital requirement based on micro-considerations. Similarly, a liquidity risk charge to influence short-term funding is suggested by Perotti and Suarez (2010). More broadly, a quarterly or semi-annual review of the financial system can be seen as a macro-prudential instrument, publishing newly collated data relevant for fostering macro-prudential stability (*e.g.* on system-wide or sub-sector exposures that are deemed vulnerable).

failure in the analysis of the report raises questions about the adequacy of micro-prudential supervision, taking as given that the (client-adverse) business model was unsustainable. Also in highly-publicised cases of insurance and share-lease products mis-selling, it has proven advantageous to have a separate and critical conduct of business supervisor in place. Separating conduct of business from micro-prudential on an equal footing thus worked out well.

The critical success factor for this to fall into place has been to apply right from the start a purely substance-driven, uncompromised separation. Of course one can never be sure about the details and there will always remain perceptions of overlap, hence it was also useful that the two supervisors installed an overlap reporting centre where issues of possible overlap can be reported and dealt with. Moreover, a high-level committee of former bank executives was formed to investigate overlap. Their finding was that supervisors had full awareness at board level to prevent overlap, but not always at the staff level. So, DNB and AFM embarked on an internal programme to install the new supervisory philosophy (two distinct objectives) and to highlight the importance of avoiding overlap when planning visits and special investigations at supervised institutions.

Both for the creation of the new conduct of business supervisor and for its functioning in practice, another critical success factor has been its credible public stature right from the start – with a leadership of comparable to that of DNB. This was embodied in heavyweight Arthur Docters van Leeuwen as the AFM’s founding CEO. Thus starting off on an equal footing, it is subsequently important that the two institutions work well together. A culture for doing so must be promoted right from the top.

With these positive experiences, what have proven to be the risks?

One specific weakness in the division of tasks between both supervisors was revealed by the DSB experience, namely concerning their role in fit and proper testing of directors. In a high-profile case, that of former Finance Minister Gerrit Zalm as DSB’s CFO, DNB’s positive fit and proper test in accordance with the law overruled AFM’s negative conclusion. Abstracting from the specifics of the case, it proved damaging to publicly see two supervisors disagree and one then overrule the other. But this can be easily resolved within the model by either obliging both supervisors to agree (keep disagreement behind closed doors), or by giving each a veto (rule out that one overrides the other).

4. Financial stability: experiences

While it is thus broadly acknowledged that the conduct of business objective has been well served in the Dutch experience with Twin Peaks, experiences have been more complex with regard to the micro- and macro-prudential objectives. In principle, having a separate cross-sector supervisor for micro-prudential and placing it within the central bank also responsible for macro-prudential and linked to the ECB should promote chances of success also for financial stability.

To what extent have mixed experiences reflected the generally difficult context for financial stability faced with the financial crisis, and to what extent have there been

model-specific factors as well? It is too early for a full evaluation, but perhaps for a first impression it is useful to distinguish between success in terms of innovating the framework for financial stability and success in terms of safeguarding financial stability in practice.

As to the latter, DNB in the financial crisis has had a challenging time, both regarding the micro-prudential stability of individual financial firms and regarding the stability of the system as a whole. As said in the introduction, this is not the place to assess what went right and wrong, but to explore possible Twin Peaks aspects. With that in mind, let's briefly consider the general handling of the financial crisis and the three most visible prudential supervisory cases of the past years: the takeover of ABN Amro followed by the taxpayer-financed rescue of Fortis, the failure of DSB Bank, and the pensions crisis.

The downfall of Lehman led to a collapse of the financial system in September 2008. In particular, the interbank market started to dysfunction and came to a halt. The ECB and the NCBs (including DNB) as part of the ESCB have been very pro-active in solving these liquidity problems. By being a broad central bank (both macro- and micro-prudential supervision), DNB was able to act swiftly and provide the Dutch banks with sufficient liquidity. To its credit, DNB had performed a liquidity stress test ahead of the 2007-2009 financial crisis.

DNB's performance in the ABN Amro takeover has been examined by the De Wit Commission (2010), and criticised for not exploiting to the full the room available to safeguard financial stability. DNB felt it was not in the position to block the takeover. From a legal perspective, the De Wit Commission (2010) argues that DNB could have taken a blocking decision, given responsibilities and instruments as allocated in the law. There are no indications that limitations in DNB's remit as micro- and macro-prudential supervisor played a role in the ABN Amro / Fortis case. DNB had oversight over all Dutch entities involved in the case and, through its role as macro-prudential supervisor and participant in the ECB, the broader financial system stability aspects of the case were fully in scope.

The failure of DSB Bank in 2009 has been evaluated by the Scheltema Commission (2010). Here again, no issues related to the Twin Peaks model have come to the fore. Instead, the evaluation pointed at a general need to strengthen DNB enforcement, *inter alia* related to organisational culture. DNB has acknowledged this and promised a culture improvement plan in the near future. The Finance Minister has announced that he will also be looking at strengthening governance.

The pensions crisis hit the fully funded Netherlands pension system hard. Coverage ratios were affected by the double whammy of the equity market collapse and the fall of interest rates to exceptionally low levels. DNB reacted by requiring pension funds to submit recovery plans. A recovery plan must set out how a pension fund intends to raise its coverage ratio to the statutory level in five years time. While perhaps warranted from the perspective of the micro-stability of the individual pension fund, this requirement worked out pro-cyclically from a macro-prudential perspective. Funds sold shares (or bought put options) thereby aggravating the market slump, while the pressure to reduce pensions and raise premiums affected consumer confidence and aggravated the macroeconomic downturn. This was magnified by the

use of the current low market interest rate as discount rate (Commission Don, 2009). While certainly the crisis will require a recovery effort over the medium term, the reality is that the system as a whole throughout the once in a lifetime crisis proved to be remarkably robust.

While there will no doubt be many lessons to be drawn from the financial crisis in general, DNB's experiences with ABN Amro, DSB Bank and the pensions crisis seem to point to three potential issues specifically for the Twin Peaks model.

First, when setting up the governance structure of the prudential supervisor, it seems important to pay careful attention to its ability in practice to take tough decisions particularly when of macro-prudential relevance. In DNB, all decisions about micro-prudential and macro-prudential issues as well as its input into ECB monetary policy decisions are relegated to a single internal managing board. There may be merit in exploring more sophisticated decision models carefully tailored to the challenges at hand. An example inspired by the Bank of England's Monetary Policy Committee could be to bring major prudential decisions, with potential system implications, to a dedicated financial stability board that, next to the internal directors responsible for micro-prudential supervision, macro-prudential supervision and monetary policy, also includes a few external directors. Openness and transparency may also help strengthen the independence of difficult decisions.

Second, there is the question of how to foster policy innovation in the interface between micro- and macro-prudential supervision and monetary policy. The crisis has made clear the crucial importance of this interface between hitherto materially separate policy areas. Many central banks produce financial stability reports, but this has not yet led to genuine integration. In the Netherlands experience, this refers in-house mostly to the interface between micro- and macro-prudential. The challenge of forcing innovation in the interface is even larger when encompassing also monetary policy. Hence, in judging a trade-off between keeping micro-prudential separate from macro-prudential and monetary (the Australian Twin Peaks variant) for considerations of organisational culture and reputational integrity of the central bank (Large, 2010), or placing both dimensions under a single roof, the need to force true progress in the crucial interface between prudential and monetary would suggest opting for the latter approach.

Third, there may be, nevertheless, some merit in separating the monetary and supervisory tasks within the central bank for reputational reasons. The Banque de France offers an interesting model. In January 2010, France moved to the Twin Peaks model by merging the Commission Bancaire and the Autorité de Contrôle des Assurances et des Mutuelles (the insurance supervisor) into a single prudential supervisor, Autorité de Contrôle Prudentiel (ACP). The second peak, Autorité des Marchés Financiers, is responsible for conduct of business supervision. The ACP is, as its predecessor the Commission Bancaire, closely associated with the Banque de France, and headed for day-to-day management by a Secretary General. The Governor of the Banque de France is the chairman of ACP. In business terms, the central bank is the parent company and the prudential supervisor is the subsidiary. As the Banque de France and the ACP are thus closely related (the website of ACP is, for example, hosted by the Banque de France), there can be a full exchange of information within the overarching central bank structure. This enhances both

preventive micro-and macro-supervision as well as crisis management capabilities. In the UK, a similar structure is envisaged. The new prudential supervisor will have its own management team, and be an entity within the Bank of England.

5. Concluding remarks

This paper has reviewed the experiences with the Twin Peaks model in the Netherlands. These experiences are part of the wider debate about the appropriate supervisory structure. The arguments for the single supervisor and for the Twin Peaks model can be summarised as follows:

- Three arguments for a single supervisor:
 1. A quick glance would suggest: the two ‘system’ objectives at the central bank and the two ‘individual’ objectives at a single supervisor;
 2. Separation between macro and micro would allow the central bank to focus on the system (the forest) and to avoid being lost by supervisory details (the trees);
 3. One stop for supervision of financial institutions (no overlap).
- Four counter arguments for Twin Peaks:
 1. The interaction between micro and macro prudential is very strong: without knowledge about the big players (the SIFIs), it is difficult to know really how the financial system is doing. A combination of macro- and micro-prudential supervision facilitates full and timely exchange of information;
 2. Related to the first argument, central banks combining macro and micro are more effective in crisis management;
 3. In the event of conflict, macro-concerns should overrule micro-concerns;
 4. Both supervisors are on equal footing. The twin peaks model avoids that conduct of business may overrule micro-prudential to the detriment of the latter’s quality, or vice versa.

The Dutch experience shows that separating conduct of business from micro-prudential makes sense and can be made to work well in practice. The real design challenge lies in how institutionally to link micro-prudential with macro-prudential and with monetary policy. This is where real policy innovation is required going forward. Institutionally linking micro-prudential with macro-prudential and with monetary policy creates a setting conducive to such innovation, but this is no guarantee that it will happen in practice. Close attention to the governance structure of the prudential and monetary authorities is warranted to optimise the chance of success.

Several countries have in recent years made a move to the Twin Peaks model. The Group of Thirty (2009) and Fischer (2009) recommended it, as did the Paulson Blueprint even though recent U.S. initiatives watered it down. In the euro area, France and Belgium like the Netherlands, have moved to Twin Peaks. Spain, Italy and Portugal already have Twin Peaks features (ECB, 2010). It will be interesting to see how this trend will influence the euro area regulatory landscape going forward. For the time being, however, Twin Peaks at the level of individual euro area countries

provides only a distant link with the monetary policy of the ECB. Therefore, given the full-fledged monetary policy role of the Bank of England, the move of the UK to Twin Peaks perhaps offers the nearest chance for much-needed innovation in the interface between prudential and monetary policies.

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