HIGH LEVEL COMMITTEE ON A NEW FINANCIAL ARCHITECTURE

FINAL REPORT

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LIST OF THE MEMBERS OF THE HIGH LEVEL COMMITTEE ON A NEW FINANCIAL ARCHITECTURE

Mr LAMFALUSSY Alexandre, Chairman

Mr CATS Jean-François

Mr GROS Daniel

Mr KIEKENS Willy

Mr LEFEBVRE Olivier

Mr NOELS Geert

Mr PRAET Peter

Mr WYMEERSCH Eddy

Secretariat

Mr KORTLEVEN Jozef, secretary
Mr GUIOT Bruno, deputy secretary
Ms DIDDEREN Delphine
Ms MITCHELL Janet

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EXECUTIVE SUMMARY

Belgium is a small open economy whose financial system is, as a result of the ongoing crisis, increasingly composed of large institutions with headquarters in other European Union member states. This observation constitutes the background against which this Committee conducted its analysis in response to the Belgian government's request for advice on protecting the country's financial system from a recurrence of devastating financial crises like the one we are currently experiencing. The present report reflects the unanimous view of the Committee's members.

The current crisis is undoubtedly global in nature, and also global in its origins. Excess liquidity and macro-economic imbalances in several countries created the conditions that led to the crisis. These imbalances led to an important structural mismatch between asset supply and demand, in addition to a frantic "search for yield". Adding to this, development of complex financial products in a poorly regulated financial environment, as well as perverse incentives, magnified the impact of the imbalances. It is for this reason that the Committee issued an interim report in February dealing with specific aspects of recent developments relating to financial products and markets. However, the Committee would like to stress that the emergence of global excess liquidity and financial imbalances was no excuse for the managers of individual financial firms to forego a thorough and continuous risk assessment. Moreover, it would be a mistake to believe that the errors of judgment and failure to act in these areas occurred only at the very top level of these firms.

It is thus in Belgium's interest to work for a more stable financial architecture. At the global level, a number of initiatives are already underway to strengthen coordination in supervision (G-20, FSB, etc.). However, one key element of the emerging global system has not been reformed; namely, the governance of the international institution which should serve as the primary guardian of global financial stability ─ the IMF. Enhancing the IMF's independence so that it can more effectively identify and address the sources of financial instability in even its largest member countries is thus one avenue to be pursued.

Yet, even a reformed global financial architecture cannot provide a guarantee of financial stability. More important changes need to occur at the European level. The framework for reform of the European financial architecture has been set out by the report of the group chaired by de Larosière, whose recommendations are now in the process of being translated into concrete legislative steps, soon to be on the agenda of the European Council. This Committee has expressed its full support for the recommendations of the de Larosière report (DLR) and urges the Belgian authorities to use their influence in the European decision making process to ensure that the structures of the newly created institutions (namely, the ESFS and the ESRC) remain as close as possible to the design proposed in the DLR.

At the same time, the issue of burden sharing between member states in the case of cross-border bank rescues has received insufficient attention by the DLR, and it would be highly desirable to develop a European framework in this dimension. A properly calibrated and pre-funded European Deposit Insurance Scheme would provide a significant step in this direction. It would also have the added advantages of providing an important degree of risk diversification and a level playing field between large and small countries.

At the Belgian level, the financial landscape has changed over time. Concentration in the banking system has increased, and a key consequence of the financial crisis has been that in terms of supervision Belgium has evolved from a primarily home country to a predominantly host country.

Any analysis of the shortcomings of the Belgian supervisory framework immediately reveals that a true macro-prudential supervision is lacking and that the functioning of the CBFA could be considerably improved. Along these lines, a question has recently been raised on several occasions, inter alia in the federal parliament: should the supervisory system be organised on the basis of a so-called "integrated model" (often called the "twin peaks" model) or a so-called "cooperative model"? In the integrated model the central bank would be competent for monetary policy, micro-prudential supervision and macro-prudential supervision (micro and macro supervision would be located within the same institution, giving the model its name), while an independent

institution outside the central bank would be responsible for the oversight of market integrity and investor protection. In the cooperative model the central bank would be responsible for monetary policy, while micro-prudential supervision and market integrity and investor protection would be the remit of an institution outside the central bank; macro-prudential supervision would be entrusted either to the central bank or an independent institution, closely linked to the central bank. In Belgium the supervisory framework is clearly based on a cooperative model.

For reasons that are explained in the full report, the Committee accepts at this stage not to switch to an integrated model but to clearly reinforce the present cooperative model. At the same time, it recommends that a group of independent experts be created to regularly assess whether the reinforced cooperative model is delivering. If this is not the case, the group may recommend a transition towards an integrated model.

Reinforcing the existing model would require changes in three areas.

Macro-prudential policy

The absence of macro-prudential policy is the main shortcoming of the present Belgian framework. The primary objective should be to put in place a system that:

- **has the legal power to collect all the information deemed necessary;**
- **has the expertise to conduct an independent analysis of the information;**
- **can take clear decisions, has the power to have them implemented, and can follow up on them;**
- **can make adjustments to its own functioning in response to outside monitoring of its performance.**

In this regard, the Committee concludes that the existing Financial Stability Committee (FSC) should be replaced by a Systemic Risk Committee (SRC) in charge of crisis prevention; i.e. preventing, limiting and redressing systemic risks. The SRC would have six members and be chaired by the governor of the National Bank of Belgium (NBB). It should be operationally independent while having intimate links with the NBB.

The SRC would not be a paper tiger but one that can bite. Indeed, it could legally require the CBFA and the NBB (the latter without infringing on its duties in the framework of the EMU), if necessary, to take measures to manage and redress systemic risks. Attributing such legal powers to the SRC would imply amendments to existing financial legislation.

In order to implement its tasks effectively, the SRC would have its own secretariat, which would be entitled to obtain all information that it deems relevant and to have direct access to individual financial institutions, in order to develop a good understanding of activities and trends in financial markets. Moreover, in order to guarantee effectiveness, decisions of the SRC would not necessarily be taken by consensus but by a voting procedure, if necessary. The activity of the SRC would also be subject to a strong follow-up process.

Micro-prudential policy

The Committee believes that the micro-prudential framework, and notably the functioning of the CBFA, could be considerably improved. Changes recommended by the committee include, inter alia:

- **modifying the appointment process of the executive committee, which should become more transparent; members should be appointed for a non-renewable term of eight years;**

- **strengthening the powers of the supervisory board, which should also better reflect the required technical expertise;**

- **greater internal and external mobility of the staff and enhanced diversification of skills;**

- **internal delegation mechanisms should ensure a more focused functioning of the executive committee**

Market integrity and consumer protection

The Committee judges that it is important to resolve two key problems with respect to market integrity and consumer protection. First, no explicit legal underpinning exists for the CBFA's responsibility for investor protection, which weakens the CBFA's role in this area. An explicit legal foundation should be provided as soon as possible. Second, the present structure of the CBFA does not allow for effective identification of conflicts of interest between investor protection and micro-prudential supervision or for appropriate communication of these issues to the top management. The organisation of the CBFA should be reformed in such a way as to achieve a better balance between the concerns of micro-prudential supervision and consumer protection.

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Lastly, the Committee wishes to communicate three general considerations which, although they are not part of the report itself, may be crucial for the future of the Belgian financial system. The Committee has chosen not to formulate concrete policy proposals in these areas, as the financial situation is still in flux and the Committee feels that it would be preferable to wait until the "dust has settled".

The *first consideration* relates to the delicate tradeoff Belgian authorities face (as do authorities in most member countries) between greater emphasis on host country influence versus the desire to maintain the integrity of the internal market in financial services and, in particular, banking. In practice, emphasising the former would mean forcing foreign subsidiaries and branches to become more independent by "ring fencing" assets and, more generally, insisting on arms-length transactions between the foreign parent and the domestic subsidiary/branch. However, doing so would undermine the internal market, which is essential for the Belgian, and the European economy. This consideration highlights once again the importance for Belgium of the European dimension. Belgium has much to gain from a strengthening of the European architecture along the lines described above. As the outcome of the reform process that has been initiated by the DLR is still uncertain, it would be premature to take a stance on whether greater emphasis on host country control will eventually become unavoidable. The

Committee hopes that the modified European financial architecture will be strong enough to maintain the integrity of the internal market in financial services.

The *second consideration* relates to the size of the Belgian financial sector. In many countries the overarching policy goal with respect to the financial sector appears to have been to create large national "champions" which are able to compete with other large players. The underlying assumption was that the creation of large domestically-based institutions would lead not only to a more efficient capital market at home but also to greater employment in high value-added services. One may question whether these policy aims were actually achieved; one could even further question whether there is much evidence of economies of scale in banking beyond a certain minimum size. On the other hand, it would be incongruous if only large member states would be "entitled" to have large banks, which, if well managed and supervised, can contribute considerably to the country's prosperity. The Committee believes that the jury is still out with respect to the question of the appropriate size of national financial systems; it is too early to draw hard conclusions.

The *third consideration* relates to the second. The creation of large national champions has a cost; in times of stress it can lead to a very large fiscal burden. Even if it must be conceded that all the member states of the European Union, including those with less sound budgetary conditions, have recently been able to come to the rescue of their national financial systems in one way or another, it is probably safe to say that the member states with the strongest public finances had greater leeway to apply conditions that best served their economic, financial and social interests. Because the situation is still unfolding, the Committee decided not to analyse this aspect of the financial crisis, nor did it have the time to do so. However, it is crucial that, once the financial crisis is past, European decision makers develop a European framework for fiscal support for bank rescue operations. This is a question of finding the political will to devise solutions which are currently worked out ex post, in an unsatisfactory manner.

INTRODUCTION

The present financial crisis has enormous ramifications, with implications at national, European and global (i.e. world) levels. Therefore, in order to fulfil its mandate, the committee has set out to highlight important elements in each of these three dimensions. The challenge that it has faced is to avoid a trap, where the drive to disentangle and assess all of the ramifications of the crisis leads to a very thick report, preventing the reader from distinguishing the forest from the trees. Consequently, the committee has been selective in the topics addressed in this report, limiting itself to the areas it judges of critical importance.

1. GLOBAL POLICY CONSIDERATIONS

1.1 THE OVERRIDING PROBLEM OF EXCESS LIQUIDITY AND MACRO-ECONOMIC IMBALANCES

By now it has been widely recognized that the intensity of the financial exuberance prevailing during the years 2004-2007 played a major role in producing the most severe financial crisis since the nineteen thirties. There can also be no doubt that excessive market liquidity materially contributed to market participants' voracious appetite for risk which characterised those years. When markets are "awash with liquidity" (as was so often said during the winter of 2006/7) the unbridled search for yield becomes a way of life.

Admittedly, there is no generally accepted definition of excessive liquidity (or, for that matter, of liquidity itself) and there is even less agreement on its measurement. But anyone who cares to remember the often frantic search during those years for assets yielding a return only a shade higher than that of treasury bills — yet carrying a substantially higher risk — knows what excess liquidity means.

Is it justified to worry about excessive liquidity in the midst of a crisis which is dominated by de-leveraging? The answer is, yes. While the immediate priority is obviously the efficient management of the crisis, this has implied the spectacular increase in the balance sheets of central banks, including that of the ECB. This build-up has been, quite rightly, accepted as the price to pay for preventing a deep and severe crisis from turning into a full-blown systemic crisis. But it is the duty of the authorities – central banks, governments and international organizations – to prepare themselves for the exit scenario which will have to include the absorption of monetary excess liquidity, short of which we run the risk of paving the way for the next crisis. This will not be an easy exercise, for two reasons. One is that with the quantitative easing undertaken by some major central banks, and the use of non-conventional liquidity creation processes by all of them, it is not only the size of their balance sheets but also the structure of

these balance sheets that has undergone radical change. A second, more complex reason is that there is no simple and easily identifiable link between a restrictive monetary policy and the reduction of market liquidity. The Committee's concerns in this respect can be classified under four headings.

First, as a starting point, let us make the radically simplistic assumption that the monetary area in which the central bank operates is a closed economy. Even in this completely unrealistic case there is no reason to believe that market liquidity will respond in a linear fashion to a restrictive monetary policy. A "gentle" tightening of policy is unlikely to have a "gentle" impact on an asset price bubble or on any other manifestation of financial euphoria. The more complex and innovative is the financial structure of this closed economy, the more unpredictable will be the response of market liquidity to a shift in monetary policy. Expectations play a crucial role in this regard, and expectations are highly volatile. This pleads in favour of a "steady hand"; that is, predictable monetary policy, and a fiscal policy of a similar nature – as the only way to stabilize expectations.

Second, we have to realize that the use of monetary policy to rein in "irrational exuberance" is likely to receive much weaker public support (and this is an understatement) than a monetary policy designed to ensure price stability as conventionally defined. It is no wonder that, in spite of our recent experience – or of the more distant experience of Japan, when a BIS report warned about the danger of accepting the "levitation" of Japanese asset prices on the grounds that it was not accompanied by any upsurge of inflation – central bankers are unenthusiastic about the prospect of being entrusted with the task of piercing a bubble. Yet it is not clear what the appropriate alternative is. Direct regulatory measures would not appear to be acceptable.

Third, we do not live in a financially closed economy, but in a world with global money and financial markets. For monetary policy tightening by the ECB to be successful in calming financial euphoria, it would require the cooperation of the major central banks, and most certainly that of the Fed. Admittedly, no such coordination is needed (or at least not to the same degree) for ensuring price stability in the euro area. In terms of production and exchange of goods and services, the euro area is a relatively closed

economy. This is not true for financial markets, where the very high degree of integration of wholesale markets leads to contagion at lightning speed. Add to this the sheer weight of US financial markets, and it would seem essential that whatever the desired monetary policy action, it should be carried out through close cooperation between the US and European monetary authorities. Looking back at the bursting of the dot-com bubble and the subsequent period of euphoria, there are reasons to be worried about the prospect of achieving such close cooperation.

Fourth, even in the case of coordinated central bank action it may well happen that market liquidity is not brought under control. A key reason could be the survival or reappearance of the strange pattern of payments imbalances which created a genuine savings glut : the extraordinarily high savings rates of China and (to a lesser extent) of some east-Asian countries which were not absorbed by domestic spending and which found a convenient (but still insufficient) counterpart in the miserable savings performance of the US household sector. The excess saving at the global level (to which some frugal countries in Europe also contributed) led investors to a frantic search for even minimal yield differentials, with no serious attempt to assess the riskiness of their purchases. As long as saving and spending are not more balanced on a world scale and not more evenly distributed, it must be feared that at some point in the future, the chase for yield could start all over again. It is thus crucial to tackle external imbalances.

Yet, correction of these imbalances is unlikely to be achieved solely by global monetary policy coordination; it would also require a much broader macro-policy coordination, with a strong fiscal policy component. Regrettably, despite what is at stake, there seems to be even less inclination to follow this path than that of monetary policy coordination.

The institution that would appear the most appropriate to study, analyze and survey both macro-economic and macro-financial imbalances is the International Monetary Fund. However, its ability to act is limited, in part because the main contributors to the imbalances problem are in a position where they can rather easily ignore the IMF's proposals of remedies to redress these imbalances. The IMF's influence is even more constrained by the fact that its governance and functioning reflect the intergovernmental nature of the institution and the reliance on quota shares. While in principle the Fund should be in a position of undisputed intellectual and moral

authority, it is hindered by its present governance, which to many countries seems biased at times. As a consequence, the independence of the IMF as an institution needs to be considerably strengthened. There are several potential ways of accomplishing this, but the committee has not found it desirable to provide elaborate opinions on this subject preferring to concentrate its energy on topics of more immediate relevance to the surveillance of the financial system. Nevertheless, one obvious mechanism would be to appoint independent members (for instance three) to the executive board of the IMF, with these members being selected on the basis of their professional expertise in international financial matters. It would also be important to increase the independence of the IMF staff with respect to the executive board.

In sum, the first genuine global crisis has highlighted the need for global policy action, not only in the management and resolution of the current crisis but also for the purpose of preventing the reappearance of a global crisis in the future. The Committee therefore recommends that the Belgian government: (a) call attention to the potential for a reappearance in the future of excessive market liquidity; (b) support all initiatives, at both the European and global levels, that could enhance effective macro-policy cooperation with the objective of keeping market liquidity under control; and (c) support initiatives at the IMF to tackle the imbalances and increase the independence of the IMF as an institution.

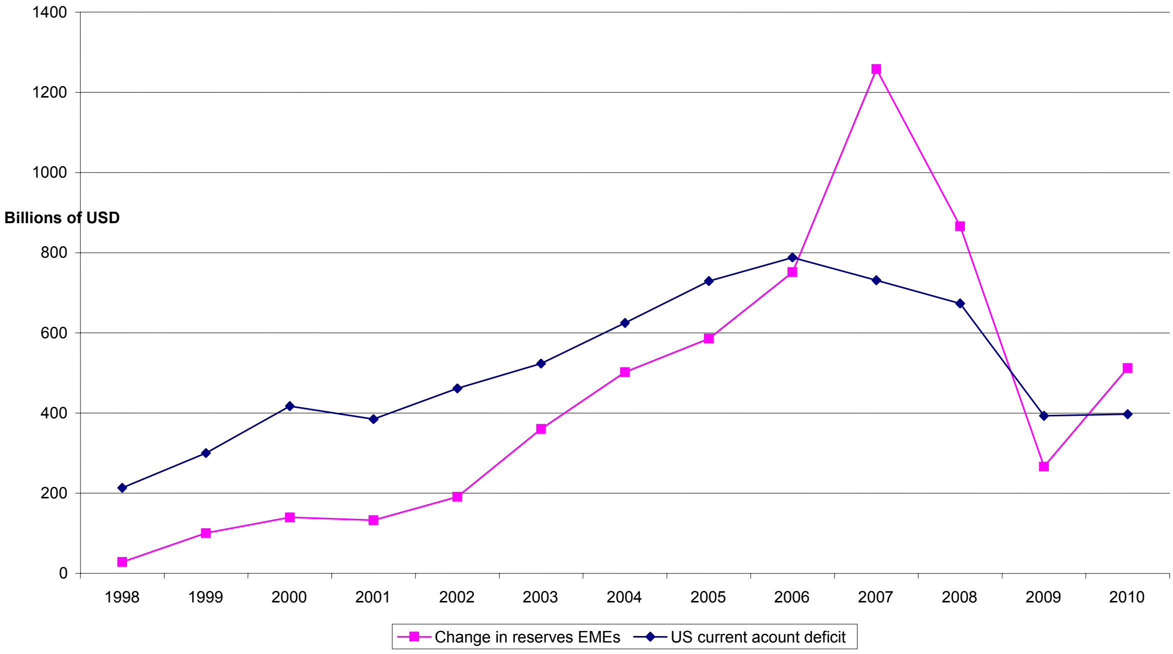
1.2 GLOBAL IMBALANCES AND THE ACCUMULATION OF RISK

The raison d'être of a financial system is to deal with imbalances (between savers and investors). Hence, one could ask how the existence of persistent current account "imbalances" provoked the biggest financial crisis in living history. The answer must lie in the massive, structural build-up of a mismatch between the supply and demand for assets. As is well known, the current account deficit of the US stemmed from an unsustainable increase in consumption (and residential construction). This excess of domestic spending was financed mainly through an increase in the mortgage debt of US households. A key characteristic of mortgages is that they are long-term (often with a maturity of 30 years). The consumption spree of US households thus led to a large additional supply of longer term (private) assets.

However, this supply of long-term assets was not matched by a corresponding demand for this type of asset. The excess savings from China (and other EMEs) were mostly intermediated by their central banks, which accumulated huge foreign exchange reserves. These reserves were (and still are) almost exclusively invested in short to medium-term, safe (i.e. government) and liquid securities (mostly in the US). There was thus a persistent excess demand for safe and liquid assets and a need for maturity transformation on a very large scale.

Chart 1 below illustrates the situation. This chart shows the high correlation between the US current account deficit and reserve accumulation. The correlation is not perfect, however, since the US deficit had already been very large for some time before the "search for yield" started. Prior to 2003, reserve accumulation was much lower than the US deficit (which had thus been financed largely by private capital transfers). After this date, reserve accumulation increased relative to the (increasing) US deficit and by 2006, reserve accumulation had actually surpassed the US deficit by far. There is thus certainly a link between the US current account deficit and the build-up of the crisis, but the connection is not as straightforward as is sometimes believed. Part of the increase in reserves also went into euros. Although IMF data suggest that the proportion was relatively minor (20-30 %), it may still have had an impact on government debt in the euro area. While securitisation started in the euro area around this date, it never acquired the same scale as in the US.

Chart 1 Reserve accumulation by emerging economies and the US current account deficit



Source: IMF, WEO data base April 2009, variable 'change in reserves'

Another way to look at the same phenomenon is to note that increased demand for government debt by EME central banks led to lower yields on US government debt (the Greenspan 'conundrum'), thus forcing those savers in the OECD countries who would normally have held government assets to begin a frantic search for yield. But this was a search for yield on safe (and liquid) assets. The AAA tranches on securitized US mortgages (and other debt) seemed to provide the desired "yield pick up" without any additional risk, at least in the sense that the securities were rated AAA.

As long as US house prices continued increasing and unemployment remained low, actual delinquencies also remained low and there seemed to be no reason for market participants to question the high ratings of these securities, despite the well known incentive for the ratings agencies to provide favourable ratings. AAA RMBS thus provided an important source of liquidity through the widespread use of these assets as collateral.

Now we turn from flows to stocks. Most analysis of global imbalances has focused on the size of the flows, namely the current account deficit of the US relative to US GDP or

world savings. Accordingly, most concerns about global imbalances have emphasised the magnitude of the exchange rate adjustment that would be required to rebalance US spending and absorption. However, the severity of the present crisis is due to the unprecedented magnitude of the accumulated imbalances in the stocks of assets and liabilities.

The magnitudes of the asset supply and demand imbalances that accumulated over time are enormous. The cumulative US current account deficit over the period 2000-07 amounted to almost 5 thousand billion USD, and US household debt increased by almost 7 thousand billion USD, approximately 5 thousand billion USD of which was in the form of mortgages. Meanwhile, the foreign exchange reserves of emerging markets increased by about 4 thousand billion USD (of which the Chinese central bank accounted for about a third). The financial system thus had to transform thousands of billions of dollars of US household mortgages into the type of assets in excess demand due to the reserve accumulation by EME central banks.

The key technology that permitted the transformation of US mortgages into safe, liquid assets was securitisation. Until 2007 it was widely believed that securitisation should lead to a better distribution of risk, since the 'originate to distribute' model – in its pure form - implies a full risk transfer to the buyers of the various forms of ABS and RMBS. However, in the context of global imbalances this could not have happened on a large scale since the massive buying of US government paper by EME central banks had displaced investors whose preference previously had been for safe, short-term and liquid assets. ABS, and especially RMBS, do not have these qualities a priori. A piece of a pool of mortgages represents a longer-term asset; it is only as safe as the underlying mortgages and is only liquid if there is a demand for this specific asset. Government paper of a given maturity is highly substitutable, but every asset-backed security represents a specific case and thus by its nature is much less liquid. Ultimately, an RMBS resembles more closely an investment in a regional mortgage lender than a government bond. It was not to be expected that the excess demand for short-term, safe and liquid assets created by the EMEs' accumulation of reserves could have been satisfied by the securitisation of US mortgages (and consumer credit) without massive credit and liquidity "enhancements" by the banking system. A clean securitisation with full risk transfer to the investor was thus not possible from a general equilibrium point of view.

How were RMBS made safe, short-term and liquid? The exact way in which this was achieved varied enormously from case to case, but the general rules of the game were the following:

a) Safe: As already mentioned above, the appearance of safety was created by the slicing of tranches coupled with high (AAA) ratings for the most senior tranches (in reality most often about 85 % of the total). This service was provided by the ratings agencies for whom it represented a major source of income.

b) Short-term: Banks or "shadow" banking institutions such as special investment vehicles used RMBS (and similar assets) to borrow short term, e.g. by issuing asset-backed commercial paper (ABCP), which is short-term and thus represents the kind of assets in excess demand. Issuance of ABCP, which surged after 2003 (around the same time as reserve accumulation by EMEs also increased, as shown above), constitutes a classic maturity transformation, which was very profitable (given the absence of capital requirements) as long as central banks kept short-term interest rates low and promised to increase them only at a "measured pace".

c) Liquid: ABCP were already more liquid than the assets with which they were backed. However, ABCP programs were usually possible only if a bank provided a back up liquidity line. Only the banking system could provide the back-stop liquidity that was required by the ultimate investors.

All of these elements were necessary to recycle excess EME savings to dis-saving US households. Banks had to provide the maturity transformation and the credit enhancement that later proved so costly to them. This transformation of course required a significant increase in the balance sheet of the banking (and "shadow banking") system and thus a large increase in leverage. The increase in leverage in turn acted as a powerful amplifier once risk returned.

This analysis implies that it is necessary to take into account the way in which current account deficits are financed when considering the risks to financial stability created by persistent, global current account imbalances. We now discuss how the development of specific financial products and incentives magnified the impact of the structural imbalance in asset supply and demand.

1.3 FINANCIAL PRODUCTS AND INCENTIVES

It must be stressed that the emergence of excess liquidity and financial imbalances sketched above was no excuse for the managers of financial firms to forego thorough and continuous risk assessment. However, soon after the outbreak of the financial crisis it became clear that, although excess liquidity had been at the root of the problem and had made the financial crisis possible, the extraordinarily strong development of poorly regulated financial products, combined with perverse incentives, threw oil on the fire.

The uncontrolled development of these products and the misalignment of incentives were phenomena that occurred on a global scale. It is therefore no surprise that global organisations such as the Financial Stability Forum and the Basel Committee began addressing these problems, even though the implementation of policy solutions would necessarily occur at a national or, for Europe, at an EU-level.

Since policy initiatives emerged very rapidly, the Committee found it useful to express its opinions on six topics which were being hotly debated at the time the Committee began its work:

- **the originate and distribute model**
- **the credit default swap market**
- **credit rating agencies**
- **risk management**
- **compensation schemes**
- **pro-cyclicality**

The committee made recommendations relating to each of these topics, and the recommendations were elaborated in an interim report that was submitted on 23 February 2009. This report is attached as an appendix to the current report.

The Committee is of the opinion that, four months after the submission of the interim report, all of its recommendations are still valid. However, with respect to derivatives

markets (specifically the CDS market), the Committee was persuaded at the time that it would not be politically feasible for public authorities to make a strong push towards regulated, exchange-traded derivatives. In this regard, the HLC has been pleasantly surprised by the recent moves of the US administration and therefore recommends that the EU follow suit.

1.4 THE ROLE OF THE IMF IN GLOBAL STABILITY

Our analysis has emphasised that global imbalances and their interaction with specific developments in financial markets were at the heart of the crisis. A question that naturally arises is why no warnings were issued concerning the risks that were continuing to accumulate. One might argue that the biggest "dog that did not bark" was the IMF.

In principle, the IMF has the mandate to act as a watchdog for global financial stability. However, when the core problem resides in imbalances in large member countries, the IMF is severely limited in what it can achieve. Concerns about global imbalances focused only on potential exchange rate adjustments, which led to an ineffective specific surveillance mechanism. The ability of the IMF to concern itself with financial market stability remained quite limited. For example, during the past seven years the US refused to submit to a financial sector assessment program (FSAP). Moreover, as a consequence of the influence of large countries, those within the IMF who warned early on of the emergence of substantial vulnerabilities associated with financial innovation did not have the means to follow up on their risk assessment.

There can be little doubt that the IMF is the right platform on which to build a structure of more effective global stability surveillance. While much has to be done to improve its expertise in linking different aspects of global financial and economic fragility, the IMF is the only institution with most of the basic building blocks in place: it has an in-depth knowledge of its member states (from bilateral surveillance) and has multilateral units which combine insights from individual member countries. Similarly, it has a staff with expertise in monetary, financial, regulatory, economic and fiscal issues, and significant experience in emerging markets, hence in the regions that are likely to increasingly

contribute to global economic fragility. Finally, the Fund's global membership enables it to identify inter-regional linkages between national imbalances and risks and to incorporate the views of those countries which are not likely to be at the centre of the multilateral policy dialogue for the foreseeable future.

Increasing early warning capacities alone will not result in change if the identified risks remain within the confines of the IMF. Greater independence of Fund surveillance is needed to ensure that national interests and veto rights do not prevent appropriate actions from being taken in response to a thorough analysis of global vulnerabilities.

In order to remedy the shortcomings mentioned above and to play a major role in the preservation of global financial stability, the Fund will have to make major changes in its organisation. These changes should enable it to deal more efficiently with what is at the heart of its mandate: the assessment of the problems and the implementation of the remedies.

2 EUROPEAN POLICY CONSIDERATIONS

2.1 EUROPE'S FINANCIAL MARKETS IN A GLOBAL PERSPECTIVE

Our analysis of global imbalances has emphasised the interplay between global asset supply/demand imbalances and the structure of the financial system. The excess demand for safe, liquid assets by EME central banks also affected Europe due to the existence of global financial markets and to the fact that part of the increase in EME reserves went into euros, thus contributing to lower European interest rates and an increase in liquidity.

The literature on financial crises has demonstrated that virtually all major crises are preceded by a combination of two phenomena: an increase in leverage (or credit expansion) and an unusual rise in asset prices. These two alarm signals were indeed observable in Europe, but unfortunately they were largely ignored. We discuss leverage and asset price bubbles in turn.

a) Leverage: Low levels of risk aversion invite financial institutions to increase their leverage, and this occurred on a large scale on both sides of the Atlantic. Excessive levels of leverage are a key element in most crises, and the present one is no exception. The crisis has affected Europe so strongly because the increase in the overall level of leverage was broadly similar to that in the US, although the leverage manifested itself in different sectors in the two regions. Tables 1 and 2 illustrate these stylized facts.

As Table 1 suggests, that the crisis should be as severe in Europe as in the US can be seen from the fact that the increase in overall (economy-wide) leverage amounted to around 100 % of GDP both in the euro area (EA) and the US (unfortunately these data are not available for the entire EU). The variables that depict leverage in Table 1 are slightly different between the EA (total liabilities) and the US (total debt), but the trend they suggest is clear: the level of leverage has traditionally been much higher in the EA, and the increase between 1999 and (end) 2007 was also greater (at 150 % of GDP) than

in the US, where it amounted to "only" 80 % of GDP.[1] Another similarity between the EA and the US, reflected in Panel b of Table 1, is the absence of an increase in leverage for the corporate sector (leverage in the EA non-financial corporate sector increased by 20 % of GDP by end 2007, but this increase was reversed by end 2008).

Table 1: Leverage: Transatlantic similarities

	a) Economy wide		b) Non-Financial Corporate sector	
	EA (Liabilities/GDP)	US (Debt/GDP)	EA (Liabilities/GDP)	US (Debt/GDP)
1999	6.7	2.1	1.5	0.5
2007	8.2	2.9	1.7	05
2008	7.6	2.9	1.5	0.5
Change 1999-2007	0.9	0.8	0.2	0.0

The differences between the US and the euro area show up in the leverage of households and the financial sector, as reported in Table 2. As one might expect, leverage increased considerably in the US household sector (40 % of GDP) but stayed constant in the euro area.

Another important, and surprising, difference between the EA and the US is the higher level of financial sector leverage in the EA, together with a more significant increase (120 % of GDP compared to 40 % of GDP in the US).

Table 2: Leverage: Transatlantic differences

	c) Financial sector		d) Households & small business	
	EA (Liabilities/GDP) [debt/GDP]	US (Debt/GDP)	EA (Liabilities/GDP)	US (Debt/GDP)
1999	3.2 [2.3]	0.8	2.0	0.9
2007	4.4 [3.1]	1.2	2.0	1.3
2008	4.2[3.3]	1.2	1.8	1.2
Change 1999-2007	1.2[0.8]	0.4	0	0.4

Notes: Economy wide includes Households & small business, Financial Co. and Non-financial Co.
Sources: ECB Statistical data Warehouse, balance sheet & Federal Reserve Z1. March 2009

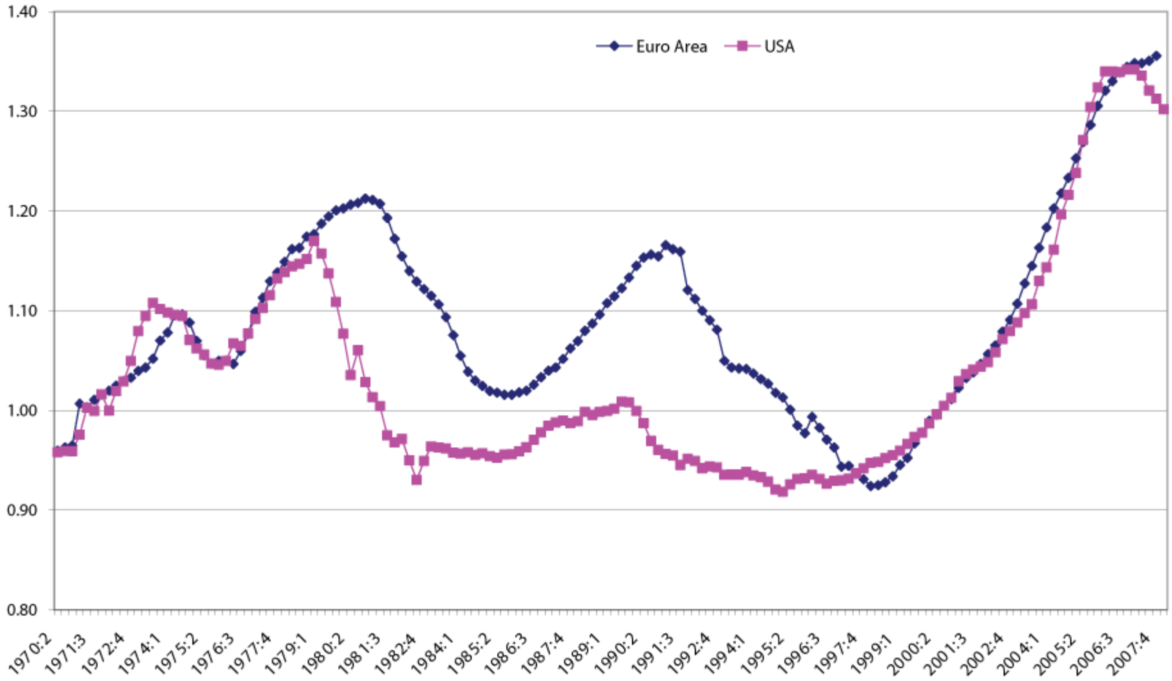
[1] Unfortunately, it is not possible to find exactly the same data to measure leverage for the EA and the US. The US data refer to the debt of different sectors, whereas the only EA data refer to overall liabilities. The latter are of course greater than the former, since liabilities include also capital and reserves. While the levels of the two variables are not directly comparable, changes in these levels should still be comparable across the Atlantic.

For the financial sector it is possible to construct directly comparable EA data for leverage, as measured by outstanding debt. This is reported in square brackets in Table 2. On this basis, the increase in leverage in the EA is somewhat smaller, namely 'only' 80 % of GDP, but remains much larger than in the US, both in levels and as a changes.

This high and increasing level of leverage in the EA financial system constitutes the key underlying cause of the widespread stress in the European banking system. The crisis may have originated in the US, but the European financial sector was also fragile and exposed to losses from US (and other) assets.

b) Asset price bubble: Another explanation for Europe's vulnerability to this crisis is that Europe experienced a similar real estate price bubble as did the US. Chart 2 below illustrates this observation, using the ratio of house prices to rents which (like the price/earnings ratio for stocks) would be expected to be stable over longer periods. It is apparent that since the mid-1990s house prices have increased by almost the same relative magnitudes on both sides of the Atlantic, reaching unprecedented levels. The only apparent difference between the US and the euro area is the greater decline in house prices in the US since 2006/7.

Chart 2 House Prices: Price Rent Ratio



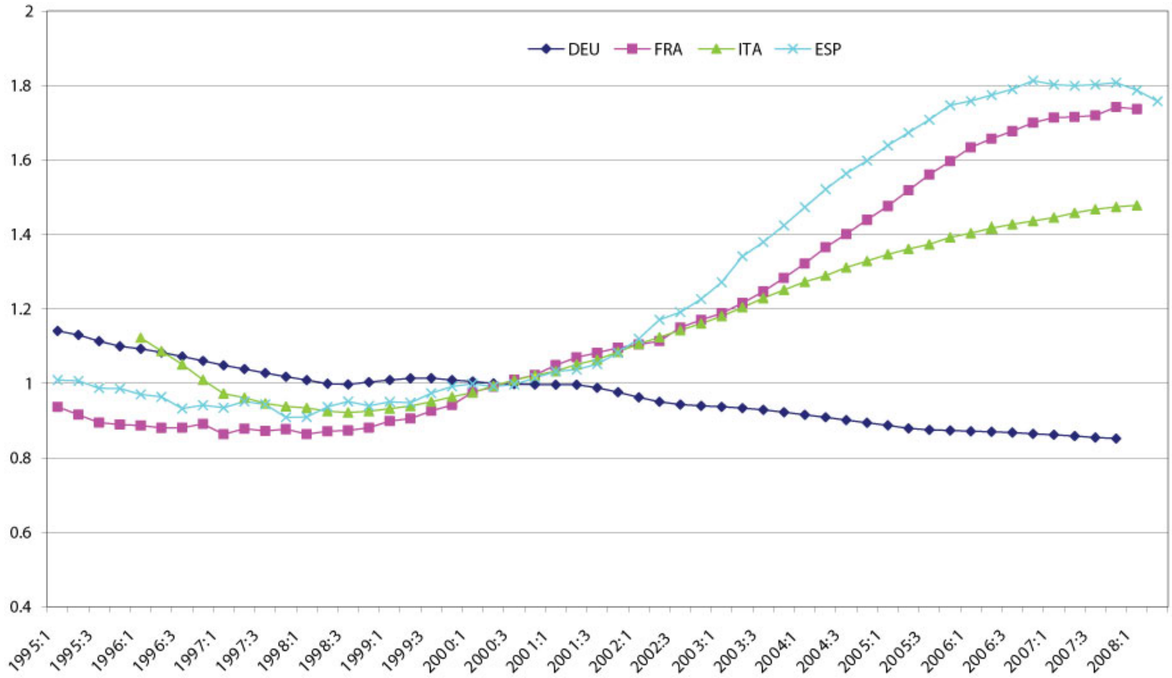
Source: OECD and own computations. The ratio for the Euro Area is defined as the average of the price rent ratio of Germany, France, Spain Finland and Nederland weighted by GDP.

These observations suggest that, in terms of leverage and house price bubbles, the euro area has suffered from the same crisis symptoms as the US. While our comparison between the US and the euro area has been motivated by the similar size of these two regions, we note that the UK also experienced similar symptoms: leverage and house prices increased in the UK by as much as in the euro area.

At the same time, the averages for the euro area hide important differences across countries, both in terms of leverage and house prices. Charts 3 and 4 report the relevant country-level data. Chart 3 reveals significant differences within the euro area in terms of the evolution of house prices (relative to rents), which have remained stable in Germany but have increased by over 80 % (and thus more than in the US) in France and Spain. At first sight, it might be surprising that the German banking system was also hard hit by the crisis. But the German banking system was also affected because it intermediated the large current account surplus of the country. Part of German surplus savings was invested in what appeared at the time to be the most promising instruments,

namely US securitised household debt. German banks, and thus also indirectly German savers, ended up having to take large losses when the US bubble burst (a similar effect seems to have operated in the case of Belgium).

Chart 3 House Prices: Price Rent Ratio



Source: OECD

Chart 4: Total MFI's Assets/Liabilities relative to GDP

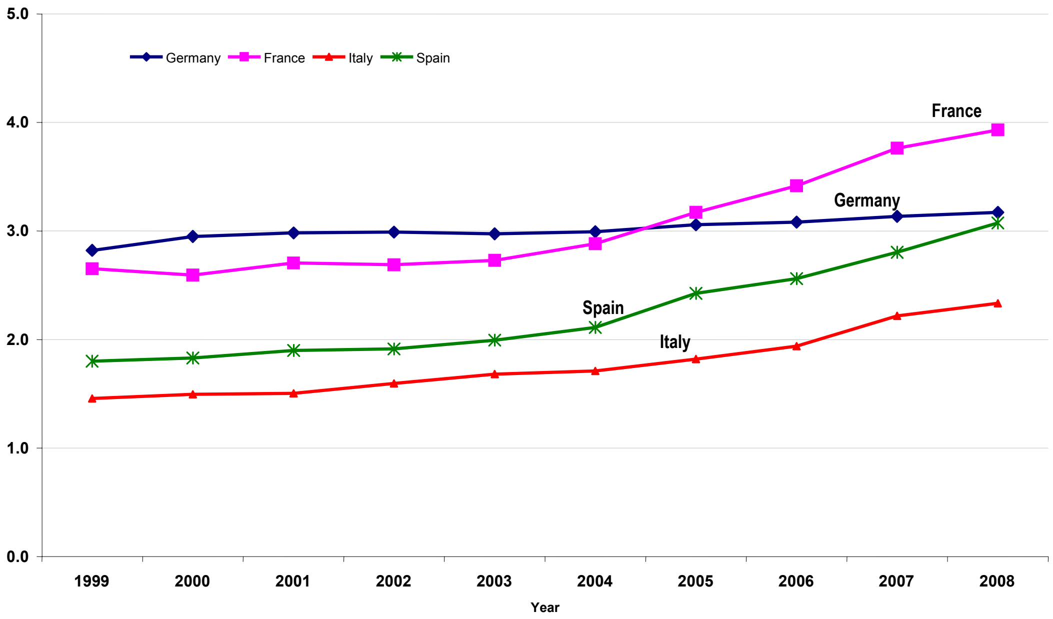


Chart 4 indicated that cross-country differences in leverage are similar: leverage (as measured by monetary financial institutions assets relative to GDP) was high but stable in Germany, whereas it increased considerably in those countries with increases in house prices.

2.2 TOWARDS A EUROPEAN SUPERVISORY FRAMEWORK: THE DE LAROSIERE REPORT

With respect to policy at the European level, many specific initiatives are currently under discussion, with the multiple aims of managing the financial crisis, preventing a similar crisis from re-occurring in the future, and protecting and improving the internal market for financial services. The Committee has nevertheless chosen to focus primarily on one overarching topic, which is of tremendous importance for the financial future of the European Union: namely, the design of a new European financial architecture as outlined in the so-called de Larosière report (DLR), submitted earlier this year.

In response to the DLR, the Committee found it useful to formulate both general and specific recommendations. With respect to the general considerations, the Committee acknowledges that the ongoing financial crisis has revealed the need for profound reforms, and the DLR is bound to become one of the main starting points for discussion between European policy makers in the coming weeks and months.

The first part of the DLR contains a series of punctual recommendations on topics which the Committee had already dealt with in its interim report. Since the differences between the recommendations in the two reports are rather limited, we have decided not to comment on this part of the DLR.

Rather, the Committee has focused extensively on the part of the report concerned with supervision, and which proposes a new European supervisory architecture. This new architecture would rely on two institutional pillars: the European Systemic Risk Council (ESRC) on the one hand, and the European System of Financial Supervision (ESFS) on the other hand. The ESRC would undertake macro-prudential supervision while the ESFS, which would be composed of three supervisory authorities (for banking, insurance and securities), and would primarily be concerned with micro-prudential and investor protection issues. These authorities would have binding powers with respect to a series of supervisory principles and practices. The supervision of large cross-border groups would be coordinated within supervisory colleges. Finally, streamlining of European financial regulation would take place, whereby most types of gold plating and national exceptions would be abolished.

In terms of global perspective, the financial crisis has highlighted two fundamental aspects of the Belgian financial system. First, from a supervisory point of view, developments over the past several years have caused Belgium to evolve from a predominantly "home country" to a primarily "host country". Second, it appears that larger member states of the European Union have a greater ability to support large financial conglomerates than do smaller member states. This could reduce the willingness of larger member states to strive for a pan-European banking regulator, including for large cross-border groups. At the same time, this development would seem to strengthen the interest of smaller member states in pushing for such a central regulator.

In this regard it has to be mentioned that the DLR does not propose such a pan-European regulator for large cross-border groups or systemic banks. Nevertheless, the supervisory option put forth by the DLR was probably the only one available in the absence of a pan-European scheme for fiscal support for insolvent banks. Instead of aiming for an unachievable European objective, the DLR proposes a realistic roadmap towards a considerably improved European financial architecture.

The report is based on a balance between centralised rule-making and local supervision, allowing national legal systems to adapt to the European-wide scheme without upsetting an often delicate institutional balance. However, an adequate and effective integration of decisions at these two levels must be ensured.

With these considerations in mind, the Committee judges that the DLR provides a good basis for solid progress towards a new European financial architecture. The proposals would indeed innovate by introducing a macro-prudential supervision component, which has been lacking until now and whose absence constitutes one of the main explanations for the failure to prevent the financial crisis. The new European architecture would also involve integration of micro-prudential regulation, while micro-prudential supervision would remain the prerogative of the member states. Finally, in the present context, the implementation of the DLR appears to offer the only realistic prospect for maintaining the overriding aim of achieving a single European financial market, which currently risks succumbing to tendencies towards national fragmentation.

While the establishment of the ESRC with its role in macro-prudential oversight is to be applauded, the devil will be in the details. Indeed, effective macro-prudential policy will require that large quantities of confidential data be transmitted to and processed by the secretariat of the ESRC. Previous experience suggests that one should not underestimate the reluctance of the data providers to transmit all requested data and in a prompt fashion. Furthermore, recommendations formulated by the ESR towards certain member states, rather than being of a general nature, should be crafted in very concrete, practical terms, with particular attention being paid to their implementation and enforcement.

With respect to micro-prudential supervision, one should also not underestimate the potential coordination problems between the new supervisory authorities, especially in light of the differing cultural backgrounds associated with each. Moreover, a considerable divergence of supervisory powers exists between the authorities at the level of Member States, and this may constitute an obstacle to the proper functioning of the micro-prudential pillar of the European financial architecture.

In terms of regulation, as was already stressed in our interim report, financial stability cannot be achieved without tackling in an appropriate way the unregulated, new categories of entities and financial instruments that are of systemic importance. As a rule, no financial activity should remain outside the purview of the supervisor.

Finally, and still in terms of general observations, the DLR does not propose a real breakthrough as far as crisis management is concerned, but rather lists a number of obstacles and problems to be solved. Given the importance of this issue and its link with supervision, it would appear necessary to continue working in order to make further progress in this area.

On the basis of these general remarks, our Committee deems it appropriate to offer the following recommendations:

2.2.1 General message

In view of the important steps forward contained in the DLR, and which have now been further developed in the Commission's proposal, one should welcome the design of a new European financial architecture.

Given the time required to work out all of the details, and in order to enhance the effect on confidence in financial markets, the recommendations in the DLR and the future proposals by the Commission should be dealt with rapidly so as to reach a consensus and to enable implementation as soon as possible. This is of particular importance for

the ESRC, which should be created quickly in order to assist in finding a way out of the ongoing crisis.

2.2.2 Macro-financial supervision

The creation of the European Systemic Risk Council should be strongly supported as an essential contribution to crisis prevention and an innovative, much needed tool for promoting financial stability in the Euro area and more widely in the EU.

In order to guarantee its efficient functioning:

- **the ESCR should have at its disposal a large number of highly qualified and well-paid staff with an independent status and working under clear confidentiality provisions;**

- **the ESCR must be provided with full, timely and up-to-date information by supervisors; the latter would have to feed a central data base according to clear and formal procedures, specified in regulation.**

- **ESRC staff members should attend the meetings of supervisors of systemically important financial institutions.**

- **the recommendations by the ESRC should be crafted in concrete and practical terms. While aimed at preserving the stability of the financial system, these recommendations may cover a broad array of policy areas, possibly offering a set of policy options to Member States.**

- **clear procedures are required in order to ensure both an appropriate follow-up of the risk warnings and effective corrective actions. If necessary, these elements should be underpinned with an appropriate legal or regulatory framework.**

In order to be effective, macro-financial supervision requires a clear mandate and full access to information, as well as adequate instruments and the authority to use them. The DLR is explicit with respect to the mandate but should be strengthened on the information side, as suggested above. Further work on strengthening the instruments is also needed, including the possibility of granting the ECB the authority to utilise additional tools in order to prevent excessive credit expansion or asset price bubbles.

2.2.3 Micro-financial supervision and regulation

In order for the new structure of micro-prudential supervision to work in an efficient way:

- **an adequate legal mechanism should be devised to ensure that the rules adopted by the new Authorities are legally binding.**

- **the powers given to supervisory authorities in the different member states should be harmonised. In addition, central bankers and supervisors in a number of Member States will need to work together much more closely than at present.**

- **the new authorities should offer expertise and human resources to national regulators, in order to foster convergence of practices and to avoid undue duplication of costs.**

- **one should rely on "enabling legislation" in order to permit a timely broadening of the scope of supervision to institutions and instruments that may be deemed relevant for financial stability.**

2.2.4 Crisis resolution

Efforts to facilitate crisis resolution should be enhanced:

- **the EU should establish more detailed procedures to be followed in order to facilitate the formulation of acceptable burden sharing arrangements once a crisis has erupted.**

- **intervention powers by host countries should be preserved in EU legislation and, if necessary, strengthened.**

In addition to the above recommendations, our Committee is of the view that three issues which are not dealt with directly in the DLR are of particular relevance and will deserve further consideration:

- **investor information and protection;**
- **specialisation of financial institutions**
- **policy instruments of the ECB.**

The Committee hopes, in view of the Belgian government's explicit request in the early spring for the Committee's advice regarding the DLR, that these considerations and recommendations, which are shared by all of the Committee members, will assist the Belgian government and its representatives in the various EU fora to articulate their positions in an informed and constructive way during the upcoming debates on the DLR and on the related proposals by the Commission.

2.2.5 European Deposit Insurance Scheme

While realising that the DLR remains vague with respect to a European framework for burden sharing arrangements between member states in the case of crisis management (the DLR recommends only that work on this issues needs to be carried on) and that a breakthrough in this area is probably a long way off, the Committee believes that a

European deposit guarantee scheme might be introduced as a first step. The financial crisis has demonstrated the vulnerability of small countries. Confronted with important banking problems, national governments have had to rely on their own resources to solve problems that extended beyond their national borders.

Belgium, like some other European member states (e.g. the UK, Ireland and Germany) has been hit hard by the crisis. The difficulties in Belgium have occurred for at least three reasons:

- **Belgium hosts an important number of international financial institutions because of its headquarter function.**
- **The high Belgian savings rate has naturally increased investment in foreign, including US assets, many of which have now lost their value.**
- **Belgian banks have looked outside of the country to achieve growth. As a consequence, Belgian banks have grown very large in relation to national GDP, which poses a risk in case of distress.**

Moreover, the high savings propensity of Belgian households has attracted an increasing number of foreign banks, often via branches. The problems in the Kaupthing case seem to be currently manageable, but this may not remain the case indefinitely.

Ensuring the safety of bank deposits is vital to maintaining confidence in the banking system. However, in the absence of a European deposit insurance scheme this is very difficult to achieve for a small to medium-sized state like Belgium, unless the financial sector becomes more inward-oriented and its size reduced. Belgium has much to gain in defending a European, or at least a eurozone, scheme.

The advantages of a European deposit insurance scheme for a small, open and savings-rich country are clear. It would provide important risk diversification benefits, and it could offer an important step towards further cooperation in supervision and control of the European banking sector. As such, the Committee recommends that the Belgian government support this initiative at the EU level.

One result of the financial crisis has been an upgrade of the national deposit insurance schemes in Europe, which are converging towards a level of 100.000 €. A truly European

scheme could build on this convergence, together with the existence in some member states of pre-funded schemes.

The Committee proposes the following key principles for a European deposit insurance scheme:

- **The scheme should be pre-funded to ensure rapid availability of funds and thus payout.**
- **Only institutions with a significant cross-border deposit base would be required to participate (and would of course receive corresponding relief from their national schemes).**
- **The scheme should be managed by a new agency, the European Deposit Insurance Company, which would also administer the funds.**
- **Contributions to the scheme would have a risk-based component.**

The Committee estimates that a period of five to ten years would be sufficient to put in place a European fund which would be able to deal with all but the very largest institutions.

3 POLICY IMPLICATIONS OF THE FINANCIAL CRISIS FOR THE STRUCTURE AND FUNCTIONING OF THE BELGIAN SUPERVISORY FRAMEWORK: TOWARDS A CLEARLY REINFORCED COOPERATIVE MODEL

3.1 THE BELGIAN FINANCIAL LANDSCAPE HAS CHANGED

The Belgian banking system is highly concentrated. The four largest banking groups account for approximately 80 % of all deposits, assets and loans in Belgium. The degree of concentration has increased slightly over the last ten years as can be seen from Table 3:

Table 3: concentration of the Belgian banking sector

		Big banks	Other local banks	Foreign branches	Total
		%	%	%	in bn. euros
Balance sheet	1999	77.1	15.6	7.3	767
	2007	82.7	10.9	6.4	1 400
Deposits	1999	74.4	21.6	4.0	390
	2007	77.4	16.6	6.0	660
Loans	1999	77.3	19.4	3.3	490
	2007	82.1	14.1	3.8	763

Source: Febelfin

As the table suggests, the "small" local banks have continuously lost market share – about 5 percentage points or, in relative terms, one third of their 1999 market share. At present these "local non-systemic banks" account for approximately 17 % of deposits and 14 % of loan. It remains to be seen whether the current crisis will reverse this trend decline. Local banks have a loan/deposit ratio equal to one, whereas the large banks have extended significantly more loans (630 billion € in 2007) than they have received in deposits (510 billion € in 2007).

The market share of the branches of foreign banks has also increased but remains marginal at around 6 % of deposits and slightly below 4 % of loans. Branches of foreign banks have thus used Belgium as a funding base, but the overall net amount has been modest (approximately 11 billion € resulting from a deposit base of around 39 billion € and local loans of only 28 billion €). Again, it remains to be seen whether the current crisis will reverse this trend.

Belgium does not appear to be an outlier in terms of the concentration ratio, but it is the only member country where all systemically important banks have had to receive state aid during the crisis.

Two of the four local giants, including the largest, are in process of becoming fully owned subsidiaries of foreign banking groups. The situation of the fourth is still evolving. This implies that for only one large, internationally active bank is it reasonably certain that the bank's headquarters will remain in Belgium.

It is thus clear that, with respect to two thirds of the banking system — but with the notable exception of well-known international institutions active in payments and settlement networks and headquartered in Belgium — the Belgian supervisory authorities will now be "hosts". This share is also likely to increase in the future. As a result, the situation in Belgium has begun to resemble that of most of the new EU member countries, whose banking systems are also dominated by foreign banks.

3.2 TOWARDS A CLEARLY REINFORCED COOPERATIVE MODEL

3.2.1 Preliminary considerations

The preceding analysis of the recent developments in the Belgian financial sector suggests two important consequences.

First, as discussed earlier in this report, the establishment of a European supervisory framework along the lines of the DLR is crucial, and the enforcement of information

rights within this framework and provisions for emergency action for host country authorities is more important than ever.

Second, the Belgian supervisory framework will need to be adapted to introduce a proper macro-prudential supervision, an element that is strikingly deficient in the present framework. Moreover, the functioning of the Belgian micro-prudential supervisor, the CBFA, will need to be considerably reformed. In terms of macro stability, the main objective is to put in place a system that:

- **has the legal power to collect all the relevant information it deems necessary;**

- **has the expertise to conduct an independent analysis of the information;**

- **can take clear decisions, has the power to have them implemented, and can follow up on them;**

- **can make adjustments to its own functioning in response to outside monitoring of its performance.**

The mandate of the HLC is to make proposals to the Belgian government of reforms that would reduce the probability that Belgium will be hit by a future financial crisis as severe as the one we are currently experiencing. The core of the requested reform proposals concerns the structure and functioning of the Belgian supervisory framework.

It should of course be realised that no reform carried out in Belgium could fully protect the financial sector from a crisis originating beyond the borders. Nevertheless, a serious effort should be made to avoid a situation in which Belgian financial institutions are highly vulnerable to a shock from abroad, or in which Belgian financial institutions actually play a role in aggravating a global crisis.

As was discussed in our interim report, the current crisis has multiple, interdependent origins, and all of the main actors share responsibility. Apart from the excess global liquidity mentioned above, the most obvious proximate cause of the crisis was the gradual erosion, followed by the virtual disappearance of risk awareness among market participants, which manifested itself in a vanishing risk premium. This led to the

generalised mispricing of real and financial assets and to similarly widespread over-leveraging. Adding to this was a widely shared belief by market participants that while the authorities would do precious little to try to prevent bubbles from developing, they would bail out the market participants, directly or indirectly, once the bubbles burst.

As far as the role of the authorities in the present financial crisis is concerned, it is fair to say that two facts clearly stand out, both in Belgium and in most other developed countries. First, while there were warnings by organisations such as the BIS and the ECB regarding potential dangers, no authorities (and, admittedly very few individual experts) foresaw the violence of the crisis, the astronomic figures involved, or the speed of contagion, both geographically and across financial industry segments. Second – and perhaps more importantly - while a number of discussions took place at the European level concerning potential policy reactions to an emerging crisis, no significant policy measures were taken to enhance the crisis resistance capability of our financial systems.

The proposals which are put forth in this report therefore aim at institutional changes which should enhance the ability of the authorities to detect signs of emerging dangers of a systemic nature and dimension, as well as their capacity to undertake preventive policy actions.

In this regard, the proper functioning of "traditional" micro-prudential regulation and supervision is key to enhancing the crisis resistance of individual financial institutions. But this is not enough: micro-prudential supervision should be complemented by a well organised, forward looking, macro-prudential supervision. This calls for close cooperation between those undertaking the two types of supervision. On the one hand, macro-prudential supervisors should have at their disposal all the relevant information which micro-prudential supervisors possess. Conversely, macro-prudential supervisors should keep their micro-prudential colleagues well informed of their own findings.

The proposed reforms are intended to be fully compatible with the supervisory reforms proposed at the European level by the DLR, and at the same time should enable the Belgian authorities to feed the European Systemic Risk Council with all the relevant information concerning systemically important Belgian institutions.

While we hope, and expect, that the DLR's proposals (at least the most essential components) will be effectively implemented, our own proposals should enhance the stability of the Belgian financial system even in the case of a delay or rejection of reforms at the European level .

Introducing a fully fledged macro-prudential supervision in the Belgian financial supervisory framework raises not only the question of a recalibration of Belgian financial supervision but also the question of the ideal institutional structure of the supervisory system. To properly assess the institutional aspect, one needs to take account of four interconnected functions at play: monetary policy, micro-prudential policy, macro-prudential policy, and market integrity and consumer protection.

The question has recently been raised on several occasions, inter alia in the federal parliament, whether the supervisory system should not be organised on the basis of a so-called "integrated model" (often called the "twin peaks" model) or a so-called "cooperative model". In the integrated model the central bank would be competent for monetary policy, micro-prudential supervision and macro-prudential supervision (micro and macro supervision would be located within the same institution, giving the model its name), while an independent institution outside the central bank would deal with the oversight of market integrity and investor protection.

In the cooperative model the central bank would be responsible for monetary policy, while micro-prudential supervision and market integrity and investor protection would be the remit of an institution outside the central bank; macro prudential surveillance would be entrusted either to the central bank or an independent institution, closely linked to the central bank. In Belgium the supervisory framework is clearly based on a cooperative model.

However it must be acknowledged that the integrated model has theoretical attractions. If one could start from scratch, the starting point would probably be the questions: how to structure and assign a mandate for preserving financial stability to complement the mandate for monetary stability? Which specific competence should the financial stability regulator receive? And who should be the financial regulator?

IMF studies suggest that an expanded role in financial regulation can enhance the effectiveness of central banks, for several reasons: because of their expanded role they would have additional incentives to mitigate systemic risk; their expertise in macro-financial analysis would contain considerable added value for the design and use of macro-prudential tools; they would have specific incentives to collect information that is needed for the implementation of a policy to reduce systemic risk.

When assigning the central bank an explicit mandate to mitigate systemic risk, the integrated model may be more effective than having a single integrated regulator outside the central bank. Under the former approach the central bank, as the systemic risk regulator, becomes the prudential regulator for all systemically important financial institutions. However, in order to limit the number of prudential regulators and to avoid coordination problems, particularly in smaller jurisdictions, it would seem that the authority of the systemic risk supervisor should be expanded to enable supervision of all deposit-taking institutions, life insurance companies and pension funds. A separate authority would then function mainly as a "conduct-of-business" regulator for the protection of consumers and investors and as the authority in charge of ensuring the proper functioning of securities and derivatives markets.

It is therefore arguable that if the Belgian financial supervisory system were to be designed from scratch, micro-prudential supervision would unlikely be entrusted to an independent institution, outside the central bank. However, in the context where the latter situation already exists, the changeover to an integrated model would present several important drawbacks. First, recent experience with the financial crisis does not corroborate the hypothesis that countries with an integrated model were more successful in crisis prevention and management than countries which did not have this model. One of the main explanations for the similarity of outcomes seems to be that the problem of compartmentalisation of information flows and assessments affects both models: the problem is simply shifted from one institution to another when moving from one model to the other. In other words, even if the central bank were also responsible for micro-prudential supervision, there would be no guarantee that "Chinese walls" would not exist within the central bank as, unfortunately, the experience in some member states has recently demonstrated.

A second problem in moving toward an integrated model is that with the increasing involvement of banks in securities trading, part of their activities (mainly lending) would be supervised by the central bank while another part (securities trading) would be supervised by the CBFA. This could make micro-prudential supervision rather cumbersome.

Another problem is that in an integrated model the central bank would be even more likely to be confronted with conflicts of interest between its roles in monetary policy and financial stability, if only because it would inevitably be involved in the preservation of the competitiveness of the national banks vis-à-vis foreign competitors.

Finally, and most importantly, in the Belgian political and social context a switchover to an integrated model would undoubtedly require lengthy and burdensome debates, with only an uncertain outcome. Moreover, the transition would require enormous organisational and operational resources and would distract decision makers whose attention should be focused on resolving the ongoing financial crisis.

Consequently, the Committee has come to the conclusion that the precondition for any model should be that macro-prudential concerns are granted a clear priority over micro-prudential issues. A priori, both supervisory models could deliver this outcome. Since the cooperative model already exists in Belgium, and considering the arguments outlined above, the Committee believes that it is advisable, at this stage, not to switch to an integrated model, provided that effective macro-prudential supervision, with a clear priority over micro-prudential supervision, can be built into the present system and that the investor protection role of the CBFA is addressed and strengthened, with a clearer focus. This implies that the present system must be clearly reinforced, and with revised legal and institutional underpinnings.

Though the Committee feels that effective macro-prudential supervision can be built into the present model, the success of this type of supervision will depend on how it is implemented. One cannot rule out the possibility that, as a result of implementation problems, the new framework does not function properly and that, if other appropriate corrective measures cannot be found, a switchover to an integrated model would become worthwhile. For this reason the Committee proposes that a group of independent

experts (GIE) be established to assess at regular intervals the practical functioning of the supervisory framework. This group could put a switchover to an integrated model on the table if it were to judge that the framework proposed by the Committee is not functioning properly and that a switchover to an integrated model is desirable.

These independent experts should have a thorough knowledge of financial markets and be well versed in regulatory issues; they would typically be academics with a strong feel for practical issues, or persons in senior positions who have recently halted their career in the private financial sector or in supervisory or international financial institutions. Not all the experts would need to be Belgian nationals. The GIE would report periodically, with its report being published.

Starting from the institutional precondition of priority for macro-prudential supervision, the Committee considered the strategic adjustments that should be undertaken with respect to the Belgian supervisory framework along three dimensions: macro-prudential supervision, micro-prudential supervision, and market integrity and consumer protection. Since from the outset the Committee was convinced that an efficient macro-prudential framework would be key in preventing a crisis, the Committee also considered the complementary question as to how macro-prudential supervision could work in practice.

3.2.2 Strategic adjustments to the Belgian supervisory framework

3.2.2.1 Macro-prudential framework

Since one of the main innovations of the DLR is the creation of a separate macro-prudential framework, much of the Committee's attention has been devoted to the possibility setting up a similar structure at the Belgian level. The law of 2 August 2002, on the surveillance of the financial sector and financial services, provided for inter alia the founding of a Financial Stability Committee (FSC), for which one of the main objectives was the analysis and assessment of the stability of the Belgian financial system. The FSC consists of the joint executive committees of the National Bank of Belgium and the Commission for Banking, Finance and Insurance, with an observer from the finance ministry. Though its role is an advisory one, there was clearly an

expectation that the outcome of its deliberations would lead to practical decisions to be taken by both institutions.

It has to be admitted, however, that the FSC has not lived up to that expectation. First of all, and in part because of the legal limits of its mandate, the FSC's remit was not sufficiently focused on systemic risk issues and had a tendency to examine financial stability in rather general terms, without considering behaviour and risks created by individual financial institutions. Nor was there a holistic approach towards risk analysis for the financial system. Moreover, the rather large composition of the committee was not conducive to in-depth treatment of financial stability issues, while the lack of clarity on the legal provisions concerning confidentiality issues contributed to the reluctance to share confidential information on individual firms, especially listed ones. It is therefore not surprising that the FSC was not able to identify a forthcoming crisis, nor to effectively coordinate the management of the crisis once it erupted.

In the crisis of September 2008 the latter role was very soon taken over by the so-called "monitoring group", set up by the federal government. This group should, however, have a temporary existence, if only for the reason that members of this group are experiencing increasing problems relating to compatibility with the roles and tasks they perform in other entities.

The HLC therefore believes that the FSC should be profoundly recalibrated. Namely, in order to arrive at quicker decisions, more efficient deliberations and less reluctance to share confidential information, the composition of the FSC should be strongly focused on systemic risk issues and hence the number of members should be sharply reduced, notably to six. In this scenario the new FSC, which could be renamed the Systemic Risk Committee or SRC, would be chaired by the governor of the National Bank, who would have the casting vote. Of the other five members, who should be closely involved with systemically relevant issues, two would belong to the executive committee of the National Bank while the other two members would be the chairman of the executive committee of the CBFA and another member of the executive committee of the CBFA (where the latter is not also a central bank director). The fifth member would be an outsider, belonging neither to the CBFA nor the central bank, with recognized experience and standing in the financial world and with no conflicts of interest; this person would not

necessarily be a Belgian national. The fifth member should be the "fresh eye" in the Committee, while at the same time a "whip", making sure that the members coming from CBFA and National Bank do not slide into a cosy relationship, and reminding the Committee of the necessity to follow up on its decisions. Given that public funds are at risk in the case of systemic problems, it would also be advisable that a representative of the Finance Ministry attend the SRC meetings as an observer.

The mission statement of the SRC would focus on crisis prevention. To implement this mission, the activity of the SRC should relate exclusively to the macro-prudential supervision of the financial system, meaning a contrario that it would have no role to play in micro-prudential policy or practice.

The SRC would be operationally independent, but because of the nature of its mandate, it should have intimate links with the National Bank. This is justified by the fact that the NBB will always be in the first line of defence when there are signs of a potentially systemic crisis. For this reason, the possibility that the SRC could be part of the NBB should not be ruled out, as long as the SRC remains operationally independent. It is vital to ensure that the information collected by the secretariat of the SRC is promptly transmitted through the National Bank, which then could make proper use of the information in its communication with the European Systemic Risk Council or ─ when there is urgent need for direct liquidity assistance to one of the large Belgian institutions ─ with the ECB itself. At the same time, the SRC secretariat would be in contact with the ESRC secretariat.

As implied in the previous paragraph, the SRC should have a secretariat with a staff of highly qualified people who, typically, would have a deep understanding of the way financial markets and institutions operate. In this context it would be strongly advisable to attract people who have already had broad experience in the private financial sector. These people would above all have a good feel of the market and an excellent capacity to analyse and assess the implications of changes in the financial market place on individual financial institutions and on financial stability as a whole.

It is the opinion of the Committee that the SRC should have its own distinct secretariat and information flows because, in the present context, this would likely provide the

strongest guarantee that the macro-prudential supervision function would operate on an independent and autonomous basis, acquiring in the process the indispensable stature to make sure its voice is heard inside and outside the central bank.

Since the activity of the SRC secretariat must be focused on systemic risk, it should be clear from the outset that the SRC would waste its resources if it were to follow the more than two hundred financial institutions active in Belgium. On the contrary, the SRC should focus on institutions which, because of their size or their activity, can be considered to be of systemic relevance. An important additional reason for concentrating on systemically important institutions is that, with their wide range of activities, these institutions are a precious source of information concerning what is going on in the markets in general. At the present juncture this would comprise five banks (including Euroclear Bank), one insurance company and one financial services provider. However, systemic relevance is not necessarily a stable notion; the secretariat, by its feel of the market pulse, could very well determine that new firms and/or practices of systemic importance are emerging.

The SRC-secretariat would be entitled to obtain from the individual financial institutions directly, and under conditions of strict confidentiality, all detailed information it deems of systemic relevance. This information would then be transferred by the secretariat to the SRC with an accompanying analysis. In this context, the development of a systemic risk scale might also be contemplated. The secretariat would be entitled to contact financial institutions directly, to request any information they consider necessary. It would be crucial that the information gathering by the members of the secretariat would not be confined to the processing of data flows but that these members would pay regular visits to and have in-depth discussions with relevant officials of all the banks or financial institutions which are judged to be of systemic importance on a Belgian or/and European scale. It would also be crucial for the members of the secretariat to participate as observers in meetings between the micro-prudential supervisors and the staff of the supervised institutions whenever they find it appropriate.

Indeed, the purpose of these new working methods would be to develop an excellent, almost continuous feel of the activities and trends in financial markets and in the main

financial institutions. With hindsight, for instance, these people should have detected a couple of years ago that the trend decline of the gross intermediation margins of banks on their traditional lending activities had become a powerful driving force pushing them towards the higher yielding structured products that became the epicentre of the present financial crisis. This development was entirely logical from a micro-prudential point of view and would not have, as it turned out, raised too many eyebrows from the supervisors; only a holistic approach at a macro-prudential level could have signalled that some very powerful, unsavoury forces were at work.

The SRC would be entitled to formulate recommendations to prevent, limit or redress macro-prudential risks. These recommendations could be formulated towards the NBB, the CBFA or the federal government. They could take the form of general micro-prudential guidelines, such as introduction of capital buffers or provisioning requirements. In fact, in the context of these macro-prudential recommendations the SRC may soon be faced with two pressing issues. The first is the formulation of a maximum leverage ratio for financial institutions, a subject that for reasons of relative competitiveness will have to be taken up at EU level. The second is the question of whether, awaiting a European arrangement on burden sharing in the case of bank rescues, it would be appropriate or not to impose limits on the size of financial institutions or at least some of their activities, with these limits being determined by the national government's ability to come to the rescue if a crisis were to re-emerge. Indeed, the impression has been that at certain times since the start of the present financial crisis the adage "too big to fail" has threatened to become a "too big to save".

The SRC's recommendations could also concern the behaviour of individual institutions, markets or instruments which are judged to create unacceptable risks for financial stability. More generally, all factors directly affecting banks and financial institutions and that may have systemic consequences should be included in the remit of the SRC, such as certain aspects of the tax system or of financial consumer protection legislation if specific provisions — or the lack of such provisions — were to generate considerable systemic risks.

3.2.2.2 Micro-prudential policy framework

Since, one way or another, the CBFA has to oversee more than 200 financial institutions, the work overload is so severe that controls and verifications tend to be implemented in very much of a "ticking-box" style. Consequently, supervision needs to become more focused on core issues and risks of specific importance. More specifically, the HLC believes that the daily functioning of the CBFA could be improved in the following areas[2]:

- there should be a better, i.e. a more transparent and competitive, system of appointments to the executive committee, ensuring the required technical expertise; it would be advisable that members of the executive committee be appointed to one, non-renewable eight-year term;

- the powers of the supervisory board should be strengthened, and the composition of its membership should better reflect the need for technical expertise of financial supervisors;

- the status of CBFA staff should be changed in order to foster greater mobility of staff within the organisation between the NBB and the CBFA, and between these institutions and the private sector;

- present staff tend to come disproportionately from the legal profession, which sometimes means that they are not adequately acquainted with new products and risks; sufficient staff with a "good feel of the market" should be employed; contrary to today's practice, staff should not be hired for life-time employment, and they should be able to retrain in the financial sector; they should have more international exposure and preferably have been previously employed by one of the larger international financial institutions, international audit firms or credit rating agencies;

[2] In addition to these general remarks, a specific item – consumer protection – is analysed in the next section.

One may also ask whether the executive board could not be relieved from many dossiers that are either routine or of minor importance and which, via a delegation of powers, could be entrusted to so-called chambers within the CBFA. This would allow management to concentrate more on dossiers which are of greater systemic importance.

3.2.2.3 Market integrity and consumer protection framework

Apart from micro-prudential supervision, the CBFA also has also an important role to play in the area of market integrity and consumer protection. In this regard, the Committee is of the opinion that there is ample room for the CBFA to strengthen its role in consumer protection. The current deficiency in this area results from two factors.

First, no legal underpinning exists for the role of the CBFA in consumer protection, and this is odd. The financial crisis has demonstrated that legal aspects of investor protection are extremely important, and the Committee urges the government to provide a solid legal foundation for the role of the CBFA in consumer protection.

The second explanation for the inadequacy in consumer protection is that the double role of CBFA (i.e. micro-prudential supervision on the one hand and market integrity and consumer protection on the other hand) can give rise to conflicts of interest within the organisation itself. A typical case would be one where certain, disturbing information concerning a bank is of direct interest for consumer protection or market integrity but where making public such information (or action on the basis of that information) could further weaken the bank.

The present structure of the CBFA does not allow for effective identification of such conflicts of interest or for adequate communication of the relevant issues to the top management. The Committee believes that when conflicts arise between micro-prudential supervision and consumer protection, the organisational modalities of the CBFA lead to a bias of the final decision in favour of the former. Consequently, the Committee considers that the organisation of the CBFA should be reformed in such a way as to achieve a true level playing field between the concerns of micro-prudential supervision and consumer protection. This should contribute to better articulation of

conflicts of interest and clearer communication of the potential problems to the management, who can then make the necessary arbitrage.

3.2.3 The Systemic Risk Committee: operating modalities

It should be absolutely clear that the SRC, in contrast to the present FSC, would not be a paper tiger but one that can bite. Indeed, as described above, the SRC will have:

- **the power to gather confidential information**
- **the power to take decisions**
- **the power to impose action on the two other pillars of the supervisory framework, namely the NBB and the CBFA**

The following paragraphs elaborate on these powers. Indeed, once the principle of a Systemic Risk Committee was accepted, the Committee considered how the SRC should or could work in practice. Although the Committee naturally avoided venturing into all of the nuts and bolts of the daily functioning of the SRC, it is nevertheless aware the operational details will determine to a large extent whether the SRC ultimately succeeds or fails.

3.2.3.1 Legal Powers of the SRC

❖ ***Mandate***

As discussed above, the mission statement of the SRC is reflected in two words: crisis prevention. Consequently, its legal mandate should reflect this mission statement. The mission will have to be translated into a legal list of tasks that the SRC must perform. While the HLC feels that it would be overstretching its mandate to identify a detailed list, it is clear that the list should derive from the underlying principles of the SRC as sketched above. In other words, the legal mandate would be based on three fundamental powers:

- **the power to gather, process and analyse (often confidential) information. Examples here would include:**

- **assessment of the resilience of financial firms whose financial distress may create disruptions in the Belgian or European financial system or economy;**

- **researching and analysing developments, in Belgium and abroad, which may have a significant impact on financial stability in Belgium and in Europe;**

- **analysis of regulatory proposals that are likely to affect financial stability or have an impact on systemic risk;**

- **delivering information to and analysis and follow-up of the recommendations of the European Systemic Risk Council;**

- **coordination of crisis preparation and management;**

- **the power, on the basis of these analyses, to take decisions regarding necessary policy measures**

- **the power, on the basis of decisions, to impose actions on the two other pillars of the supervisory framework, namely the NBB and the CBFA, and to advise action in other instances**

It should also be noted that, given that the SRC is mandated with the prevention and management of systemic risk, the SRC itself should be the ultimate judge of what is meant by systemic risk.

❖ ***Legal status***

As noted earlier, the SRC should be operationally independent but have intimate links with the National Bank. Consideration of the powers attributed to the SRC (see below) raises the question as to whether it should or could have a legal personality. Providing an answer to this question will require further investigation.

❖ ***Decision making process***

As far as the decision making process is concerned, the SRC should not be an entity where decisions are based on consensus. This would indeed imply too significant a risk that decisions would be based on the lowest common denominator of the positions taken in the Committee or that one member could "hold the rest of the Committee hostage". Hence, voting should be explicitly envisaged, with the casting vote given to the chairman.

❖ ***Decisions***

It was stated earlier in this report that the SRC would act via "recommendations" with the legal status of this term deliberately left vague and therefore, somewhat misleading. It is thus appropriate to provide a more accurate description of the legal status of the SRC's decisions.

In order for the SRC to be effective, its deliberations must have "real teeth" while, at the same time, its actions must be pragmatic and flexible. These considerations should be reflected in the legal implications of the SRC's decisions. It will be opportune in this regard, and indeed unavoidable, to foresee a certain "scale" in the legal status of its decisions. The form of this scale will depend upon both the type of results the SRC wants to achieve and the type of economic actors to which the decisions are applied.

Indeed, in a number of cases the decisions of the SRC will have to take the form of recommendations sensu stricto, which are of a non-binding nature. This will be inevitable when recommendations are addressed to public authorities over which the SRC has no power, such as the Belgian federal government, the regional governments, the European Commission or the ESRC. In this case the SRC will have recourse only to moral suasion with respect to its recommendations; nevertheless, one may expect that the authorities concerned will feel compelled to take the recommendations seriously.

When addressing entities that fall within the direct action perimeter of the SRC (i.e., the NBB, CBFA or the institutions supervised by them), the SRC may issue recommendations sensu stricto in cases where it feels that it should stimulate actions without being heavy handed. In this case the recommendations would have to be issued on a "comply or explain" basis.

In other cases, however, the SRC will need to take decisions of a binding nature. One could call these decisions "directives", since they would not be imposed by the SRC on financial institutions. Rather, these directives would be addressed to the CBFA and/or the NBB. They would be legally binding for both institutions but they would be implemented by these institutions using the gamut of legal powers which they have at their disposal. According to whether the directives are intended for a group of institutions or to particular individual institutions, the SRC would issue general or specific directives.

In the case of failure by the implementing institution to act, the SRC would be entitled to impose a regulation with direct legal force.

Attributing the legal powers described above to the SRC would require a series of amendments to existing legislation. In particular, a new formulation of the role and position of the existing FSC would be necessary, as would introduction into the banking law and into the NBB basic law of provisions allowing measures to be taken vis à vis systemic firms.

❖ ***Follow-up process***

Finally, there should be a strong follow-up process. This could be enhanced by the requirement that the SRC address a quarterly report to the finance minister and that the chairman of the SRC present a yearly report to the council of ministers. In this regard, the presence of an outside member of the SRC with a specific role description should be useful.

3.2.3.2 Working arrangements between SRC, CBFA and NBB

Since the secretariat of the SRC would operate independently but would work under the auspices of the NBB, it would be desirable to establish a protocol between these two entities regarding their respective responsibilities, powers, external representation, personnel and logistics. A protocol could also be signed between the secretariat and the CBFA, i.a. to avoid double reporting by the supervised banks and financial institutions.

It should be stressed that, although the founding of the SRC secretariat will inevitably give rise to several outside recruits, the majority of the secretariat's staff should come from a shift of personnel presently working at the NBB and the CBFA. In this respect it will be critical that differences in the personnel statutes of the two institutions do not constitute an impediment to attracting the brightest minds.

Annex 1: Interim Report

HIGH LEVEL COMMITTEE ON A NEW FINANCIAL ARCHITECTURE

INTERIM REPORT

23 FEBRUARY 2009

LIST OF THE MEMBERS OF THE HIGH LEVEL COMMITTEE ON A NEW FINANCIAL ARCHITECTURE

Mr LAMFALUSSY Alexandre, Chairman

Mr CATS Jean-François

Mr GROS Daniel

Mr KIEKENS Willy

Mr LEFEBVRE Olivier

Mr NOELS Geert

Mr PRAET Peter

Mr WYMEERSCH Eddy

Secretariat

Mr KORTLEVEN Jozef, secretary
Mr GUIOT Bruno, deputy secretary
Ms DIDDEREN Delphine
Ms MITCHELL Janet

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INTRODUCTION

The mandate of the Committee was defined as follows: *"The Belgian High Level Committee for a New Financial Architecture ("The Committee") will advise the Belgian Government on proposals to strengthen the financial system in order to prevent future problems of the same kind as the international financial crisis of 2008. Advice will be provided for the improvement of the governance of the financial system at three levels: the Belgian level, the European level, and the international level. The Committee will prepare an interim report before February 2009 and will present its final report to the Belgian Government before mid 2009". (For the full text of the terms of reference see Annex I.)*

The purpose of this interim report is to offer advice to the Belgian Government on some specific, but necessarily partial reform initiatives which are already at a more or less advanced stage of discussion both at the European and the wider international levels. The Belgian Government will be called upon to take positions on these initiatives in the course of the coming months. It is on the following topics that the Committee proposes its advice to the Belgian Government in the present interim report:

1. Originate and distribute model
2. Credit default swap market
3. Credit rating agencies
4. Risk management
5. Compensation schemes
6. Procyclicality

The reform proposals on these topics, while undoubtedly useful and necessary, are however unlikely to bring a decisive contribution to preventing the repetition of a crisis with potentially systemic implications. Such contribution requires tackling some fundamental problems relating to the lack of efficiency of crisis prevention arrangements at all three levels mentioned above – which will have to imply deep institutional changes. The discussion on these issues is still in a state of flux, and this leads the Committee to consider its future work in two steps.

The starting point is to acknowledge that no sensible and realistic proposals can be made for the improvement of the governance and the supervision of the Belgian financial system without taking into account the reform proposals and potential decisions at the European and international levels. As a result the Committee proposes to give advice during the coming months to the Belgian Government on what sort of institutional reforms it should support during the ongoing discussions at both levels. (Depending on how these discussions progress, this may lead to a second formal interim report.)

As a second step, the Committee will consider the topic of institutional reform in Belgium. Its conclusions, in this respect, will be part of its final report.

Given the importance, and the political sensitivity, of the institutional issues at the European and international levels, the Committee has decided to signal the nature of its concerns already in the concluding section of the present interim report.

1. Originate and Distribute Model

1.1 Analysis

Securitization, and the related "originate and distribute" (O&D) model, offers opportunities for improving risk diversification and for lowering financial institutions' funding costs. It also allows for a better matching of asset risk characteristics with investors' risk preferences, including duration, which is important for the financing of long-term mortgage loans.

Compared to the traditional bank intermediation model, securitization and the O&D model unbundle the various functions to be performed, creating a “chain” of participants including (among others) originators, servicers, arrangers, rating agencies, and investors. The impact of the securitization process and the O&D model on financial stability depends crucially on whether the relationships between the participants along the securitization chain preserve discipline and maintain adequate information flows. Over the last decade, the securitization process in the US and the UK created increasingly complex, structured products, through multiple restructuring of the same underlying pools of securitized loans and mixing with credit derivatives. This product complexity increased opacity and reduced the accountability of the participants.

Originators of subprime mortgages who intended to securitize most or all of their loans had weak incentives to apply strict underwriting standards. Their business models placed a premium on volume rather than quality of originated assets.

Arrangers – investment banks or brokers who bundle the assets into pools, structure the *tranched* cash flows, and market the tranches to investors – appear to have faced similar pressures from business models or compensation schemes that were focused on volume and on up-front recording of profit, independently of the ultimate risk or long-term performance of the transactions. These forces resulted in weakened incentives for arrangers to perform due diligence on the originators or to collect and disseminate information to investors relating to the risk of the underlying assets.

Products. The sequential restructuring of securitized risks, by which the mezzanine tranches of subprime mortgage-backed securitizations have often been recycled into new structured products, contributed further to hiding the true underlying credit risk.

The advantages of securitization suggest that the O&D model can be preserved. The structuring and the better matching of risk is useful, in particular, for facilitating the funding of long-term fixed-rate loans including mortgages. However, structural changes are necessary to re-start activity while removing the risk of renewed instability. These changes should be driven by a combination of principle-based regulation and market standards.

1.2 Policy Recommendations

a) Strict market standards and, possibly, regulatory restrictions should be applied to achieve:

(1) a radical simplification of products, including increasing the homogeneity of assets in order to facilitate the risk assessment and prohibiting sequential restructuring of already structured assets;

(2) better and more timely information, relating both to the riskiness of the underlying asset pools and to their performance over time, together with standardized reporting of this information[1]*.*

b) *The responsibility of all participants in the securitization chain should be enhanced. In particular, the originators and arrangers should be required to remain sufficiently exposed to the credit risk, in order to foster effective credit screening, monitoring, and management.*

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1 Examples of efforts to improve the information flow include the project RESTART by the American Securitization Forum, which aims to develop guidelines for standardized information disclosure and performance reporting for residential mortgage backed securities.

2. Credit default swap market

2.1 Analysis

The market for credit default swaps (CDSs) – insurance-type contracts in which one party pays a periodic fee (the "spread") to another party in return for a payment if default occurs on a referenced financial instrument – has played a significant role during some of the crucial episodes of the current crisis. The unregulated, bilateral, over-the-counter (OTC) market for CDSs serves as one of the main channels through which credit risk is transferred through the financial system. Counterparty risk in the CDS market became a source of major concern following the fall of Lehman Brothers and the rescue of AIG, two of its largest participants. In addition, the volatility of banks' CDS spreads has played a critical role in the (in-) ability of the banks to refinance themselves, raising more fundamental questions concerning the instrument itself. Moreover, it was the explosion of the CDS market which made the exponential development of the market for collateralised debt obligations (CDOs) possible. Adding more fuel to these developments was the fact that margin requirements on CDSs are comparatively low.

In order to reduce systemic risk, CDS contracts between counterparties should be netted. To that effect, there is now general support for the creation of a central clearing counterparty (CCP), since it would considerably reduce counterparty risk and improve risk control and margining. Through an automated contract confirmation procedure, the CCP would also reduce operational risk and the number of failed trades, which have become a source of concern as the market has burgeoned. Finally, a CCP would provide an "exchange" model for transparency and disclosure, although not necessarily for price discovery. There are solid legal grounds for arguing that standardisation of CDS contracts and the creation of one or several CCPs together with the underlying registrar or ''warehouse'' should be organized under EU legislation.

Creation of a CCP, however, does not address the more fundamental questions raised by CDS markets. The problem is not the trading of CDS indices, which represent roughly 70 % of the market. Rather, the main issue is that of single-name CDSs, which provide a useful tool for disconnecting the financing of a specific issuer from the issuer's default risk. However, as this market has developed, CDSs can be signed and bought by counterparties who have no exposure to the underlying default risk. Indeed, the combination of cash settlement and low margin requirements helps to make CDSs a cheap, speculative instrument, which may help to explain why the total value of CDS contracts for a given firm is often a multiple of the total value of the outstanding bonds for that firm.

The CDS spread, or premium, is normally linked to the probability of a binary event: the default of the underlying issuer. Indeed, the CDS spread is used by market participants (including the rating agencies) as a creditworthiness indicator for a firm, thereby heavily influencing the firm's refinancing conditions. Under normal market conditions CDS markets should not be expected to generate extraordinary problems. However, under stressed conditions and highly asymmetric information, CDS markets, which are exposed to manipulation, can be the source of self-fulfilling, value-destroying feedback loops.

As for all insurance contracts, in normal times the premium of the CDS will be higher the higher is the probability of occurrence of the damage (default in this case). In crisis times, when the market becomes more one-sided, the *sense of causality* between the insurance premium and the probability of damage can be reversed, with a high CDS premium inhibiting the refinancing of the underlying borrower and provoking its default. This is a very awkward effect for an insurance contract.

This reverse causality can be exploited for the purposes of market manipulation, at the expense of the underlying firm and its shareholders. This can be achieved, for example, by combining a short position on the equity of the firm with an increase in demand for default protection through CDS contracts, thereby pushing up the CDS premium, and doing this ideally just before a refinancing period. Inquiries by regulators regarding possible manipulation through such combined positions are made difficult by the absence of centralised data on CDS exposures and by the fact that CDS fall outside the scope of the Market Abuse Directive.

The CDS market raises additional sources of concern which have led many observers to question its overall economic benefit. For example, the high correlation of default risk in case of a recession makes it a "high beta" instrument, providing little possibility of diversification. The off balance-sheet accounting of CDSs, as for all swaps, also reduces the ability to assess the credit exposure of sellers of credit (default) protection through CDSs.

2.2 Policy Recommendations

The Committee recommends the following actions to mitigate the destabilizing effects of the CDS-market:

a) *CDS contracts should be cleared within a CCP framework. The Committee welcomes the initiative by the European Commission to support the organisation of a central depository and a central counterparty for CDSs under European law.*

b) *Although creation of a CCP should reduce systemic risk created by the CDS market and improve transparency and the reporting of exposures, it does not cure the intrinsic flaws of this market. Therefore the Committee recommends regulation of CDS markets in order to restrict the purchase of credit protection to the hedging of effective exposure to credit risk. This might be accomplished by requesting physical settlement on new single-name CDSs.*

c) *Financial market regulation should be modified to bring the CDS market within the scope of the Market Abuse Directive.*

d) Past experience suggests that a rule strengthening margin requirements on CDS seems to be warranted.

e) The CDS exposures should be better disclosed, including on a nominative basis for large exposures.

3. Credit rating agencies

3.1 Analysis

Credit rating agencies (CRAs) have traditionally played an important role in the functioning of financial markets. This role has been officially recognized and reinforced over time through incorporation of references to ratings in market and banking regulation and, more recently, in the regulation of insurance firms and pension funds. Ratings have been considered as reliable assessments of credit quality.

Over the past decade the role of rating agencies was further enhanced by the development of structured products. These products consist of different classes of securities, representing the "tranched" cash flows from an underlying pool of assets, and a key objective underlying their creation is to obtain at least one class of securities whose rating is higher than the average rating of the underlying asset pool. Acceptance of structured products by market participants was thus contingent on these products receiving a rating. Revenues from structured product ratings eventually overtook the revenues from traditional bond ratings.

Problems with the performance and ratings of structured products based on U.S. subprime mortgages and the ensuing turmoil in financial markets are now well known. Ratings of many structured products were systematically downgraded, leading to extensive losses in the accounts of many financial institutions.

As a result, the CRAs have been severely criticised. The most often heard criticisms include:

- failure to gauge the impact of the decline in underwriting standards for U.S. subprime mortgages, leading to sudden and massive downgrades at a very late stage

- use of flawed rating methodologies and lack of transparency in the rating process
- failure to maintain adequate resources and personnel to keep up with the growth of structured product markets
- failure to appropriately manage potential conflicts of interest.

In November 2008 the European Commission issued a proposal for regulation of CRAs, and the proposal is currently being discussed among member states. This proposal has four main objectives:

- avoiding conflicts of interest;
- improving the quality of rating methodologies and of the ratings;
- increasing transparency by setting disclosure obligations;
- ensuring an efficient registration (single entry point) and surveillance framework, avoiding “forum shopping” and regulatory arbitrage between EU jurisdictions.

The draft regulation aims in general at providing better protection of investors. To that end, it includes the obligation for CRAs to disclose conflicts of interest, and it also deals with compensation arrangements for CRA employees. Of particular relevance are the requirements to disclose methodologies, models and key assumptions used in ratings and the obligation to use a different rating category for structured products than for traditional bond ratings. The proposed single entry point for registration should also facilitate the monitoring process. Therefore, if the basic provisions of the proposed regulation are approved and implemented, the quality of the rating processes is likely to improve. For this reason the Committee welcomes the Commission’s initiative.

At the same time, the Committee wishes to express its concern that the regulated status of the CRAs might further encourage investors and asset managers to rely excessively on ratings, even more than in the past, for their investment decisions. This might have unwelcome effects, even for standard debt instruments: a rating represents a single assessment, which by definition involves a certain degree of arbitrariness and, therefore, must be complemented by the investor's own due diligence. This is especially important, given that the oligopolistic nature of the ratings market may not be conducive to an improvement in the quality of ratings through increased competition. Finally, the rating of highly complex products is itself complex and is subject to a number of serious limitations.

3.2 Policy Recommendations

The Committee recommends supporting the European Commission's proposal for regulation of CRAs, provided that additional measures are taken:

a) The use of a single synthetic indicator is insufficient to provide an adequate assessment of the risk of a financial asset, and especially a structured product. Financial regulation should stress the responsibility of asset managers and professional investors to undertake their own due diligence and not outsource risk management to the rating agencies. For that reason, financial regulation should be revisited, with the objective of removing all prescriptive references to ratings.

b) The development of alternative risk assessment instruments should be encouraged. Competition between the CRAs should be promoted and barriers to entry in the market for ratings reduced.

4. Risk management

4.1 Analysis

Risk is inherently difficult to measure and control. Indeed, the crisis has demonstrated that risk management in many financial institutions was woefully inadequate. Risk management failed, in the pre-crisis period, to prevent institutions from building up excessive leverage and risk and from accumulating concentrated exposures in complex, overvalued assets. Once the crisis hit, risk management at several institutions was also unable to halt a collapse at an unexpectedly high speed.

Part of the explanation for the inadequacies of risk management in many institutions lies in an over-reliance on quantitative risk models, which suffer from numerous shortcomings. In addition, the reliance on models may have been exacerbated by insufficient communication between risk modellers and senior management concerning the limitations of the models. Yet, other deficiencies have also been revealed in institutions severely affected by the crisis. These include, among others, low status of risk managers and/or risk controllers compared with risk takers, and lack of communication and aggregation of risks across business lines or functions, reflecting a "silo" mentality. All of these factors are likely to have contributed to creating a situation where senior managers were unable to fully identify or understand the emerging risks for the institution or to take appropriate actions to mitigate the risks once they materialised. At the same time, management at some institutions may have authorised expansion of certain new activities and businesses without a commensurate focus on the capacity of the control infrastructure to keep pace with the developments.

Effective risk management calls for adopting a firm-wide perspective, with information flowing both horizontally and vertically. It also requires fully understanding the limitations of any given method of risk measurement, employing a variety of risk measures and achieving an appropriate balance of quantitative and qualitative analysis.

Over the past decade advances in computing power, statistical techniques, and data availability have fostered the development of mathematical models for measuring portfolio risk. These models, of which the most widely used is value at risk (VaR), have been increasingly embraced by financial institutions and regulators alike.

While such models possess benefits – such as offering objective measures of certain aspects of risk and facilitating comparison of risk across different portfolios – they are also subject to serious limitations, which need to be recognized and taken into account in institutions' risk management. The potential weaknesses fall into five categories.

Model risk: Assumptions underlying the models can be unrealistic, and model output is often sensitive to changes in assumptions. In addition, the models are often "backward-looking", relying on recent or historical data which will fail to capture any potential future variation that exceeds the historically observed level.

Liquidity risk: Most risk models do not incorporate liquidity risk, leading to underestimates of correlations, volatility measurements, and VaR. The failure to take account of liquidity risk was a key factor leading to financial institutions' losses in the current crisis.

Self-enforcing dynamics: If many financial institutions use the same risk models, based on similar (potentially flawed) assumptions, these institutions will receive the same leveraging and deleveraging signals. This can create strong self-enforcing dynamics, leading to sudden illiquidity in particular market segments and downward price spirals.

Ignoring systemic risk: Risk models lack a focus on potential systemic risks. Although many models rely on analyses which are themselves based on thousands of hypothetical scenarios, these scenarios do not pick up possible systemic risks created by the own institution.

False sense of security: The mathematical sophistication of risk models may lead to a false sense of security. Favourable assessments from the model can create the illusion of stability, which can be particularly dangerous when the model is used mechanically.

The illusion of stability may also have been reinforced by the incorporation of VaR models in financial regulation. For years, VaR for market risk has served as the basis for computing regulatory capital requirements for banks' trading books. Over time, however, the inclusion in the trading book of assets such as structured products with significant illiquidity and credit risk has rendered market-risk VaR alone inadequate. VaR is now also used in the Basel II framework for determining regulatory capital requirements for the banking book. This regulation, however, was not yet in place when the crisis erupted.

4.2 Policy Recommendations

a) Banks should employ a wide range of risk measures, both quantitative and qualitative, which provide different views of risk. Banks should avoid relying exclusively or mechanically on any given measure, such as VaR.

b) Liquidity risk should become an integral part of risk models and supervision.

c) Serious consideration should be given by regulators and banks to supplementing sophisticated tools with simple, easily understandable measures such as leverage ratios or nominal limits.

d) *Regulation should promote a consistent reform of banks' risk management. Persons in charge of risk management should have an upgraded status, securing their independence, and decision making authority, which should also be reflected in compensation levels. Particular weight should be given to doubts expressed by risk managers in favourable periods.*

5. Compensation schemes

5.1 Analysis

The present crisis has revealed that the remuneration of management in some firms was not always commensurate with the added value represented by these managers' activities. The public has been surprised by the high levels of remuneration granted to the managers of financial institutions, and an outcry has followed the revelation of high remuneration upon termination of contracts (severance fees), especially when granted to managers of failed firms. Some observers have criticised the way that remuneration is determined, while others consider that the sheer amount of the remuneration is unacceptable.

The issue of high levels of remuneration is an international one and is not limited to the banking sector. Yet, while the remuneration of the top managers of a financial institution may be publicly disclosed, they are not necessarily the highest paid persons in the organization: traders often receive higher remuneration or consider their remuneration to be the product, of which the bank may retain a part, of their higher skills and insights. The problem of the risks created by traders whose bonuses depend on short-run profits has been recognized for many years. Recommendations have been issued concerning adequate supervision of traders' activities. However, despite these efforts, a number of high-profile cases has recently come to light.

The fundamental issue relating to remuneration is essentially one of incentives. Most of the difficulties stem from the variable portion of remuneration packages and derive mainly from the short-term focus of the compensation schemes. If the reward for risk taking is too high, managers may be driven to relax controls in the organization and to take on excessive risk. Related to the question of incentives is the issue of conflicts of interest: managers, traders and other employees may act to enhance their personal remuneration, irrespective of the interests of the institution. One of the aims of remuneration schemes should be to align the incentives of the employees with the interests of the institution.

The potential conflicts of interest arise throughout the organization: the employee offering investment products to the consumer is often motivated less by the interest of his client than by the fee he will receive from the sale of the product. The trader takes additional risks in order to increase his bonus, even if the failure of the trading strategy may bring down the bank. And finally, top management may focus on improving quarterly accounting figures, since bonuses will be calculated on that basis. This well known and often cited "short-termism" certainly lies at the root of the excessive increase in the size of the financial sector in relation to the overall economy. It may also help to understand the lack of objections to marking assets to market prior to the crisis. This accounting technique produced very favourable results in the boom that preceded the crisis, although just the opposite has occurred in the downturn that followed.

Many people argue that the structure of remuneration of top managers of financial institutions has contributed to excessive risk taking and to procyclical behaviour. This is due to the fact that remuneration schemes entail rewards on the upside but insufficient penalties on the downside, thereby creating asymmetries in incentives. This argument applies not only to the banking sector (and primarily to the investment banking side), but is probably even more relevant for hedge funds, whose managers usually receive a high percentage of the annual increase in the value of the fund (usually 20%, but in some cases up to 50%).

In principle, remuneration committees within the firm's board of directors determine the remuneration of the management, and in particular the variable portion. Prevailing wisdom, which is reflected in corporate governance codes, is that a majority of the members of the remuneration committee should be composed of independent directors, in order to avoid conflicts of interest in the design of remuneration schemes. It is often additionally specified that the remuneration committee should call on external experts, to ensure that remuneration schemes are determined in an objective manner.

These rules have failed to produce the desired results. Often independent directors are themselves managers of other firms, hence they take the case at hand as an example for their own remuneration. The reliance on remuneration experts has undoubtedly also contributed to inflation of the size of remuneration packages, as the experts are usually designated on the basis of a proposal by the firm's management, and these experts may have no interest in adopting a conservative stance with respect to the proposed remuneration scheme. Finally, remuneration schemes have often been ill conceived, linking the remuneration to factors beyond the management's control (e.g. the market price for stock options).

Several work streams at the international level are currently focusing on the issue of remuneration, following a rigorous fact-finding exercise by the Financial Stability Forum. Some proposals have already been floated, e.g., to change the basis upon which compensation is calculated or to require that results-based remuneration is vested over a sufficiently long period, once the benefits from the activity have been firmly established. Other proposals consist of varying remuneration both on the upside and on the downside, thus implying repayment of remuneration in certain circumstances. These discussions are still ongoing, and it would be useful to analyze the likely pros and cons of each of the solutions advanced.

5.2 Policy Recommendations

The main objective should be to identify and eliminate the elements of remuneration schemes that generate systemic risks and induce pro-cyclical behaviour of financial institutions.

To that end:

a) Ensure that risk managers carefully assess the incentive effects of remuneration schemes at the different levels of management and, where appropriate, report them to regulators as part of the discussion of risk factors.

b) Establish and ensure proper functioning of remuneration committees, in particular with respect to their composition and independence.

c) Consider introducing specific instruments such as claw-back or lock-up provisions, in addition to limits on golden handshakes, in order to prevent inappropriate incentives for risk taking.

6. Procyclicality

6.1 Analysis

For many different reasons, behaviour by participants in financial markets tends to fluctuate with the business cycle. In boom periods risk perceptions are low, collateral values are high, banks relax lending standards, and financial institutions expand their balance sheets. In contrast, in downturns banks suffer loan losses and tighten their lending standards, and financial institutions' balance sheets tend to contract. These responses by the financial system to the business cycle actually serve to amplify the cyclical fluctuations in the economy. This phenomenon has been labelled procyclicality.

The potentially severe consequences of procyclicality for the economy have raised questions about the extent to which financial regulation may generate or contribute to procyclicality. Two principal areas of concern relate to prudential requirements and accounting standards. For example, to the extent that regulatory capital requirements increase in downturns, banks may face additional constraints on their lending capacity. Similarly, to the extent that the value of financial institutions' assets decline in downturns, these institutions may need to undertake further asset disposals, in order to meet requirements such as margining rules.

Prudential Regulation

Several different techniques have been either applied or proposed to limit the procyclical impact of prudential requirements on bank behaviour. The underlying rationale for all of the techniques is to reduce the tendency to expand in the upturn by, for example, building up buffers of capital or loan provisions which can then be drawn down, if necessary, in the downturn.

The increase in the risk sensitivity of regulatory capital requirements in the Basel II framework has raised particular concerns about procyclicality. Although a number of features have been included in the Basel II framework to mitigate its potential procyclical effects (e.g., method for determination of obligors' probabilities of default, stress testing, etc.) the crisis has prompted consideration of the need to implement additional measures.

Current proposals involve using the Pillar 2 supervisory review process of Basel II to create time-varying buffers of capital above the minimum levels set via the formulas in Pillar 1. This could be accomplished, for instance, by multiplying the Pillar 1 capital requirements or banks' estimates of their obligors' probabilities of default (PDs) by a scaling factor whose value varies with the business cycle.

Another potential technique for reducing procyclicality is that of “dynamic provisioning” for loans, which has been employed in Spain since 1991. This technique consists of setting aside provisions against loans on the basis of an estimate of the long-term, expected losses on these loans, rather than on the actual, realised losses, which may occur several years later. The provision is "dynamic" in the sense that it increases when expected losses exceed actual losses (i.e., in upturns) and is drawn down when actual losses approach expected losses.

Finally, in the past some governments have attempted to directly affect credit availability by varying requirements such as the maximum loan amount as a percentage of the value of the collateral (e.g. in real estate). These types of discretionary government interventions have nevertheless fallen out of favour in recent years.

Accounting standards

Many observers have argued that the imposition of fair value accounting standards exacerbated the difficulties of financial institutions during the current financial crisis. According to International Financial Reporting Standards (IFRS), assets have to be valued at "fair value", which implies using market prices when active markets for assets exist[2]. When no active market exists for an asset, an estimate of fair value should be made using the best available information. As active markets do not exist for many of today's complex or illiquid assets, valuation is often based on models. This can lead to differing values being assigned for the same asset by different institutions.

The use of market valuation (or other techniques based on market prices) leads to cyclical outcomes: lower market prices lead to lower valuations in all entities holding the assets, triggering potential losses in these firms and creating pressure to sell assets to generate liquidity. A downward spiral of asset prices can result, with the effects being felt throughout the financial system.

As it has been widely understood, fair value accounting is a fairly rigid accounting system which leaves little room for institutions to make adjustments to cyclical developments. Attempts to introduce buffers in favourable times, such as dynamic provisioning for loans, have generally been judged to be contrary to fair value accounting, on the basis that such techniques leave too much discretion to firms.

Despite these concerns, it would seem very difficult to replace "fair value" as a basic accounting standard, as no viable alternative exists. Moreover, since introducing fundamental changes in the accounting system in the middle of a crisis would further undermine confidence in markets, most proposals have been limited to reviewing the existing

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2 Fair value is defined as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

accounting system. Some exceptional measures have been introduced by the International Accounting Standards Board (IASB) in light of the crisis – notably allowing institutions to reclassify assets from categories that require fair value accounting to categories that allow other valuation methods. However, the IASB is reluctant to introduce further flexibility, despite requests to do so by the European Commission.

On the political dimension, questions have been raised as to whether an accounting standards board should be allowed to act independently from the political and social environment in which it functions. Should the standard setter be fully independent and, if so, how can independence be ensured? Should a board with monitoring power over the IASB be established?

Europe should have an important say in the functioning of the IASB. The European Commission is currently pleading for stronger involvement in the governance of the IASB, while favouring independence as far as standard setting is concerned. Member states, however, are divided on this issue.

6.2 Policy Recommendations

Procyclicality is an important feature of the current financial system. Focus should be on implementing mechanisms to mitigate procyclicality.

a) *With respect to prudential regulation, the Basel II framework should be complemented by instruments designed to reduce its procyclical impact. A system of dynamic loan provisioning would also be a helpful tool, as would a more active use of traditional counter-cyclical measures, such as certain financial ratios or leverage-reducing instruments.*

b) *Tensions between prudential and accounting systems with respect to the use of instruments such as dynamic provisioning should be resolved, in order to avoid the existence of two parallel systems, which creates confusion and breeds distrust.*

c) *With respect to accounting standards, the concept of fair value should be maintained, given the absence of alternatives and the need to avoid exacerbating current instability in markets. The rules relating to implementation should, however, be clarified and refined, in order to make them less likely to accentuate the business cycle. This is especially important for assets for which liquid markets do not exist.*

d) *The Committee supports the European initiatives to improve the IASB's governance.*

CONCLUSION

Responsibility for this worldwide financial crisis should be attributed to all actors in the financial world on both sides of the Atlantic, and beyond. Mortgage brokers, mortgage banks, banks which adopted the originate-and-distribute business model, issuers of CDOs, managements of non bank financial intermediaries, credit rating agencies, auditors, regulators and supervisors, governments and central banks, economists, professional investors – they all have to bear their part of the blame. It is now up to all of them to participate in a collective effort to overcome our present predicament and to cooperate in the implementation of reforms which would make exposure to a future crisis of this severity less likely.

The specific reform topics listed in this report all share one common feature: they suggest remedies for the deficiencies that have been identified in the past working of our financial system – deficiencies which bear a shared responsibility for the gravity and the generalization of the current crisis. To the extent that these reform proposals – as well as others that have not been included in this report – are effectively implemented, one can hope that the system will have gained resilience.

But what about the future? Our globalised, interdependent, competitive and highly innovative financial system is not a static one. It produces continuous change: new financial intermediaries emerge; the business model of the existing ones undergoes gradual or abrupt alterations; new interconnections appear between various segments of the financial industry; and, most important, the flood of innovation continues unabated. To assess the potentially crisis breeding impact of such developments, those in charge of systemic crisis prevention cannot satisfy themselves with having identified specific past deficiencies. They need to have a forward looking approach, short of which they run the risk of preparing themselves for fighting the last war. To realize this very demanding objective two simultaneous lines of action have to be considered. On the one hand, in terms of analysis, we have to look into some fundamental “core” problems which go beyond the specific issues listed in this preliminary report. On the other hand, we have to envisage designing wide reaching reforms in financial regulation and supervision as well as in the conduct of early crisis prevention action that would give institutional support to the forward looking approach.

With these broad concerns in mind, the Committee intends to make proposals in five areas – at the latest in its final report.

First, both recent experience and earlier historical experiences confirm that financial euphoria, with the associated disappearance of risk awareness, breeds crisis; and the gravity of the crisis is, as a rule, positively correlated with the intensity and the degree of generalization of euphoria. It has also been demonstrated that ample liquidity combined with the belief that market participants will be bailed out by the authorities - indirectly or directly - powerfully contributes to asset price bubbles, the vanishing of risk awareness and reckless indebtedness. It is thus the duty of the authorities to prevent the development of overabundant liquidity and refrain from encouraging market participants’ belief that they will always be able to count on prompt rescue. But this is more easily said than done. What policy actions can, and should be taken – and by which authorities – to prevent the development of excessive credit expansion? Can one identify asset price bubbles or generalized overleveraging as danger signs? And how to minimize moral hazard?

Second, the structure and content of regulation must take into account macroprudential concerns. Microprudential supervision of financial intermediaries in general, and of banks in particular, is potentially a very valuable source of information for those in charge of a major macroprudential responsibility: namely, trying to detect, well ahead of the visible signs of an impending financial crisis, the emergence of a systemic danger. For this potential source to become an actual one several conditions will have to be satisfied. The facts and figures collected by the supervisors of the systemically significant institutions should be aggregated; there should be an appropriate flow of information between banking supervisors and supervisors of both other financial intermediaries and of securities markets; and, most important, the authorities in charge of macroprudential responsibility – primarily the central banks – should be associated in the collection and analysis of information and in the evaluation of its macroprudential implications. Supervisors have neither been trained, nor mandated, to assess the macroprudential significance of their findings. The Committee considers that putting in place at the European level a system of close association between micro and macroprudential supervision should be one of the major objectives of institutional reform initiatives.

Third, there is a need for reconsidering the perimeter of regulation and supervision. Should the perimeter be defined on functional grounds – that is, for instance, by regulating and supervising intermediaries not because they are called banks, but because they do what banks do? What criteria should be used to determine the perimeter? And, most important, what to do if forward looking macroprudential supervision discovers that there is a significant development of unregulated, highly leveraged market participants of systemic importance? Or that a group of unregulated financial intermediaries is beginning to play a systemically destabilizing role? What are the ways and means of speedily redefining the perimeter of regulation to ensure an adequate level of oversight? And what would be the institutional consequences of such redefinition of the scope of supervision? Is it possible to enact at the European level an “enabling” legislation that would allow the authorities to enlarge regulation and supervision to any institution or group of institutions of systemic importance?

Fourth, since the current crisis has revealed weaknesses in global organizations covering a wide range of financial services, a number of large financial market participants seem to be rediscovering the merits of specialization. Should this process of restructuring be left entirely to the market, or are there arguments in favour of mandatory specialization – especially, but not exclusively, from the angle of efficient crisis prevention? And how to avoid contagion from those firms that can still engage in a wider or different range of activities?

Fifth, we are aware that the mandate of our Committee is to give advice on crisis prevention, not on the management of the current crisis. But we cannot ignore that while the authorities, both in Europe and the world at large, must be given credit for having so far prevented a severe banking and credit crisis from turning into a full blown systemic crisis, they are beginning to yield to the temptation of using intervention methods which store up trouble for the future. These methods endanger the working of the single market in Europe, and raise the spectre of protectionism at the world level. The history of the 1930s teaches one indisputable lesson: it shows that such a trend would backfire on the "real" economy and therefore aggravate and prolong, rather than alleviate, the current crisis. What a shame, if a long period of arguably efficient crisis management were to end with a dismal failure. We feel obliged to conclude this report by expressing our deep concern.

Annex I : Mandate of the High level Committee for a new Financial Architecture

The Belgian High level Committee for a new Financial Architecture will advise the Belgian government on proposals to strengthen the financial system in order to prevent future problems of the same kind as the international financial crisis of 2008.

Advice will be provided for the improvement of the governance of the financial system at three levels: the Belgian level, the European level and the international level.

Concerning proposals for the improvements of the governance of the Belgian financial system, the Committee will reflect on the functioning of the Financial Stability Committee and the Financial Services Authority Supervisory Board, established by the law of 2002, their organisation, functioning and performance, on the improvement of the flow of information from the private financial institutions to the supervisors and other aspects deemed necessary to improve micro prudential (done by CBFA) and macro prudential supervision (responsibility of NBB).

At the European level, the Committee shall reflect upon solutions to bridge the gap between, on the one hand the single European financial market and the increasing importance of cross border transactions by financial institutions and, on the other hand, the still insufficiently coordinated national governmental bodies in charge of the well functioning of the financial markets. The distinction between the EU level and de Eurozone level is important in this respect, taking into account the link between liquidity provision and solvency aspects.

The Committee will also support the Belgian government at the international level by submitting proposals for an improved financial architecture at world level.

There can be recommendations common to all three levels. These can refer, among others, to the need to bring the current business model of financial institutions in line with the principles underlying a well functioning free market system.

The Belgian High level Committee for a new Financial Architecture will prepare an interim report before February 2009 and will present its final report to the Belgian Government before mid 2009.

The Committee can consult other experts and representatives of relevant public and private financial institutions.

The Federal Public Service Finance will act as the secretariat of the Committee and provide the required financial and logistic means.

Annex 2 : List of abbreviations

CBFA	**Banking, Finance and Insurance Commission**
CCP	**Central Counterparty**
CDO	**Collateralized Debt Obligation**
CDS	**Credit Default Swap**
CRAs	**Credit Rating Agencies**
EU	**European Union**
IASB	**International Accounting Standards Board**
IFRS	**International Financial Reporting Standard**
NBB	**National Bank of Belgium**
O&D	**Originate and Distribute**
OTC	**Over The Counter**
PD	**Probability of Default**
VaR	**Value At Risk**

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