HIGH LEVEL COMMITTEE ON A NEW FINANCIAL ARCHITECTURE

FINAL REPORT

EXECUTIVE SUMMARY

16 JUNE 2009

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.

x x x

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.