HIGH LEVEL COMMITTEE ON A NEW FINANCIAL ARCHITECTURE

INTERIM REPORT

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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.*

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

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.

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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**