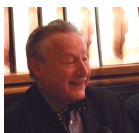


Belgian High Level Committee Report on a new Financial Architecture: Commentary

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The Report issued on the 16th of June by the Committee ("HLC") sets the question of the new architecture for financial supervision in Belgium in its appropriate global and European context (1). This is all the more welcome that quasi simultaneously, the Commission has issued its own Communication on the subject, President Obama has unveiled the most significant overhaul of US regulatory framework since the 1930's (June 17th), in the United Kingdom, the Governor of the Bank of England and the Chancellor of the Exchequer have both made public statements in this regard (June 17th) and the European Council addressed the subject at its Brussels summit (June 19th).

The two G20 meetings held in Washington and London confirmed the unanimous recognition that regulation and supervision of financial markets is an urgent "global problem". However, the proposal to confer a - so far unspecified - reinforced role at global level to the IMF is probably as far a broad consensus goes.

Implementing IMF reform in terms global stability surveillance and enforcement of appropriate remedies will prove far more difficult than the London agreement to significantly increase its financial resources.

A key point in addressing macro economic surveillance and regulatory supervision is timing: if a coherent global system is to be built, it is necessary to design the overall architecture in such a way that all levels (global - regional - national) are able to interface effectively. While the US, the EU and Belgium have published proposals which contain useful suggestions, they have been developed in relative isolation as a function of "achievable" reforms within existing - and not always compatible - frameworks. The danger of these processes moving ahead too rapidly, in the absence of any agreement (or even proposals) on the shape of "global surveillance" to be carried out by the IMF, is that it leads to the adoption of legislations that will make the G20 objectives even more difficult to implement.

One of the difficulties is that each proposal contains both measures concerning macroeconomic surveillance and micro regulatory supervision as well as their articulation. However, while macroeconomic surveillance needs, in turn, to be integrated at global level under the IMF, micro regulatory supervision is more apt to be the subject of coordination/cooperation between regional/national authorities.

One should therefore give the highest priority to designing the framework of the IMF "global surveillance mechanism". Part of the process would involve the dispassionate confrontation of the two main "regional" (i.e. USA/EU) models, which differ substantially, so as to ensure their respective compatibility with the role of the IMF in surveillance and their ability to interface effectively on regulatory matters.

Let us briefly recall the main features of the two models:

The EU proposes, in line with the de Larosière Report ("DLR"), the creation of two pillars, one dedicated to "surveillance" (the European Systemic Risk Council), chaired by the ECB President, and the other to "regulatory supervision" (the European System of Financial Supervisors). The membership of the ESRC is dominated by the 27 EU Central Banks with the participation of three new EU Regulatory Authorities forming the ESFS and a representative of the EU Commission. The ESRC will issue "recommendations" but will have no legally binding enforcement powers. The ESFS is constituted by the national regulatory authorities regrouped at EU level in three separate "Authorities" (banking, insurance, securities markets). This organisation does not reflect necessarily regulatory structures at national level. The three Authorities will have "limited" enforcement powers. The system relies heavily on "cooperation" and on the premise that each national regulator will retain substantial sovereignty over its locally based institutions.

In terms of macroeconomic surveillance, the USA intends to create an overarching "Advisory Council", consisting of all Regulatory Agencies under the Chairmanship of the Federal Reserve. The Council will have neither powers of enforcement nor responsibilities. Regulatory supervision will remain the responsibility of eight "Regulatory Agencies" – including a new "Consumer Protection Agency" - that will assume some of the powers of the Federal Reserve System which in turn will see its own powers reinforced in the areas of "resolution" and supervision of "non bank" systemic institutions.

One should note the following substantive differences:

The weakness of the US system resides in the perpetuation of the significant fragmentation of the regulatory structure (recognised as one source of the failure to identify/prevent the financial crisis), and the purely "advisory" role of the proposed overarching "surveillance" mechanism. The advantages are: availability of a wide range of competencies to the "Advisory Council", clarity in the allocation of enforcement powers and accountability and regulatory "uniformity" throughout the region.

The EU proposed system limits the number of EU Regulatory Supervisory Authorities to three but perpetuates the highly fragmented and diverse national regulatory frameworks creating a number of asymmetric relationships. The 33 Member ESRC is dominated by the 27 National Central Banks, the Eurozone Members having a built in voting majority; it has limited access to broader competencies. Cooperation between national regulators under the ESFS umbrella, on which the system is based, has shown its limits in terms of crisis prevention and management. The effectiveness of the whole system rests on further progress being made in the area of "burden sharing" and clarification of the respective powers and responsibilities between home and host regulators for institutions operating trans-nationally.

This situation raises a number of questions that are illustrated by the examples hereunder:

At global level, i.e. the IMF, how will American and European "representation" be structured in light of the fundamental differences between the make up of their respective "Risk Councils" and how will this be made compatible with the representation of other IMF constituents? How will this impact the implementation of "remedies"?

How will the direct interface/cooperation of regulatory supervision authorities be articulated between the EU and the USA, considering the profound differences between actors in terms of breadth of competencies and scope of powers? The difficulty will be increased because it will not be possible to perpetuate the very effective centralising role played by the European Commission in the "transatlantic dialogue" on financial regulation with their US counterparts, once the purely advisory status of the "level three committees" is transferred to the "Three Supervisory Authorities" endowed with legal personality and statutory obligations.

At EU level, the organisation of the ESRC is complicated by the fact that in some Member States ("MS"), banking regulation/supervision rests with Central Banks and in others with independent regulatory bodies. This creates problems of asymmetry and/or of potential conflict within Central Banks who are also Members of the ESFS through the new "European Banking Authority". Potential conflicts might also arise between simultaneous ESRC and Eurozone membership.

It is within this very complex framework that the HLC Report should be evaluated.

The mandate of the HLC was to make proposals for initiating appropriate Belgian legislation so that an obvious question relates to the desirability of drafting such detailed proposals which may prove partially incoherent with forthcoming EU legislation.

Rather, the LR should serve as a contribution to develop positions to be defended by Belgian Authorities in the forthcoming negotiations on the European Supervisory Architecture. The drafting of the Belgian legislation should be postponed until the future European Directive is due to be transposed into national law. Indeed, a pre-condition for designing an effective "national" architecture requires a greater degree of harmonisation of the supervisory structures that are in place in the different MS. For the DLR to work smoothly, it is necessary that the powers and responsibilities of the various "national authorities" which form jointly and severally the membership of the ESRC and EFSF be coherent, which is currently far from being the case. Pre-empting such a harmonisation process by implementing new legislation would appear counterproductive.

The LR specifically states that it wishes to avoid getting involved in the debate surrounding IMF reform. The sensitive questions of "representation" of emerging market countries or of EU/Eurozone participants will, nevertheless, have to be addressed if the IMF is to have "effective powers with teeth" in terms of macro economic surveillance and remedies. It is worth noting that the LR makes a very interesting proposal in this regard:

> "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."

If one can wholeheartedly welcome this suggestion, it follows that, for sake of coherence, a similar concept should be applied at ESRC and Belgian Systemic Risk Committee ("SRC") levels. Neither the de DLR nor the Commission Communication includes such a proposal, though the LR suggests the appointment of one "independent Member" to the SRC.

Turning to the SRC itself, a preliminary question needs to be addressed: Is a "Systemic Risk Committee" justified at Belgian national level? A powerful argument can be made that the usefulness of a systemic risk assessment can only be made on the scale of a given "currency" area, i.e. the Eurozone, as monetary policy is a significant component of the data and considerations relevant in macro economic surveillance. It would indeed seem odd that the SRC, whose President is on the Board of the ECB, could express recommendations impinging on Eurozone monetary policy which could lead to a conflict of interest as well as a breach of the statutory independence of the Central Bank.

Furthermore, considering that the 4 largest Belgian financial institutions account for over 500% of GNP, it is self evident that their nature, which extends far beyond the national borders, is systemic. Their effective supervision rests on the capacity of the "colleges of supervisors" to gather the appropriate information within the proposed ESFS framework. Without access to such highly specific and confidential information, would the SRC be in a position to issue soundly based "binding directives" to systemically relevant Belgian institutions? Quoting from the LR:

> "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"

and

> "In order to be effective, macro-financial supervision requires (at Belgian level) a clear mandate and full access to information, as well as adequate instruments and the authority to use them".

Furthermore, how should SRC powers - and corresponding responsibilities - to issue "binding directives" be articulated with the statutory powers and obligations of the CBFA with regard to supervision of the 4 main Belgian credit institutions? In case of conflict who prevails?

Another inconsistency is apparent between the Commission Communication on the one hand:

> "The Commission will propose that the necessary information would be passed to the European Supervisory Authorities by the national supervisory authorities in application of the rules establishing the new European Supervisory Authorities",

and the LR, which assigns to the SRC the task of collating and transmitting the relevant micro data to the ESCR on the other:

> "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."

By-passing the European Supervisory Authorities, as suggested by the LR, would render their task impossible.

Another relevant question relating to the SRC concerns the proposed voting power. While certainly more "balanced" than the system envisaged by the ESRC, where Central Banks control 29 out of the 33 votes, the SRC proposal allocates 3 votes to the representatives of the Belgian Central Bank, two to the CBFA and one to the "independent" member. The Chairman (president of the National Bank) would have a casting vote. In such a system one wonders about the ability of the SRC to issue "recommendations" to the National Bank on a "comply or explain" basis as suggested in the LR.

While the urgency with which authorities at various levels have seized the nettle of reform is to be commended, it is equally important to avoid precipitation so that global coherence is maintained in the design and implementation of the new financial market architecture.

Managing the financial crisis with existing tools should, for the time being, be the main focus of day to day politics. Addressing hastily the most emblematic – but not necessarily the most important – excesses that have contributed to the crisis, such as excessive remunerations, may prove politically rewarding but entails the risk of making the profound indispensable reforms concerning responsibility, accountability, enforcement, qualifications, etc. far more difficult to implement. These necessitate the political courage implied in the transfer further elements of national sovereignty to shared institutions.

Financial market reform will undoubtedly prove to be a touch stone for the capacity of the European Union to demonstrate to its citizens its considerable added value in providing credible answers towards future crisis prevention. Indeed, the nature of the challenge is such that it is only at EU level that significant progress can be made in this regard. Member States, including Belgium, should therefore take an active part in the European legislative process that the Commission will initiate this autumn and postpone the reforms of their respective national frameworks so that they are fully compatible with the future EU architecture.

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(1) The comments herein after should be considered in connexion with two previous analytical papers on the de Larosière Report (issued on the 25th of February) and on the Commission Communication (issued on May 27th), both of which are available on www.institut-thomas-more.org.
