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NOTE

from:	The Presidency
to:	The Council (ECOFIN)
Subject:	Follow-up of the European Council on 15 and 16 October 2008: preparation of international initiatives in response to the financial crisis - Note of the Presidency on International Financial Architecture

Delegations will find attached a Presidency note on "International Financial Architecture".

Encl.:

ANNEX

International Financial Architecture

The current crisis is both a macroeconomic crisis and a crisis of the regulatory and oversight architecture.

As a macroeconomic crisis, it signals the disorderly unwinding of internal imbalances (leveraging of the financial sector) and external imbalances.

As a crisis of the financial markets regulation, it unveils a poor functioning of some of the aspects of our regulation and oversight frameworks which have failed to correctly address market failures. Recent developments have also revealed lack of market discipline and weak incentives to embrace a long term approach, notably in the field of risk management and on compensation. Moreover, the crisis emphasizes the risks associated with an excessive and uncritical reliance on market valuation and their presentation in company accounts,*)*. While *fair value* has helped increase transparency of balance sheets the need to explore the interaction between this method of accounting and regulatory capital requirements, and their contribution to pro-cyclicality is now obvious.

Many of these aspects are being taken care of within the framework of the road maps, and the ongoing work undertaken within the framework of the Ecofin, alongside the contribution of the European Commission, European Central Bank and national central banks, and of supervisors.

Thanks to this work, the European Union displayed decisive leadership. It should remain pro-active and ambitious so as to enhance the present financial architecture, in international fora and dialogues, as well as in the prospect of the Summit called for by our Heads of states and governments.

This note proposes some possible contributions of Ecofin ministers to the reflection in preparation of the forthcoming Leaders Summit, due to take place on 15 November in the United States.

I. VALUES

Reaffirming the fundamental values of the free market and the necessity to fight protectionism, which delayed the global macroeconomic and financial recovery after the 1929 crisis, we should review the underpinning values of the financial system in a spirit of multilateral cooperation.

In order to make markets work for the benefit of all, we propose to emphasize the following **values** for a renewed international financial and monetary system:

(i) **Ensure that our frameworks are not excessively biased towards the short-term:** changing culture in the governance of financial industry towards sustainable value creation is needed. The work undertaken on compensations in the financial sector, with results expected for next December, could contribute to such an improvement;

(ii) **Ensure increased responsibility** of all the financial actors, notably along the credit chain, at the EU level, based inter alia on the Commission's proposals on the role of banks in the securitization process (ensuring risk management and incentives are decisively improved in the originate-to distribute model)

(iii) **Work towards properly enforced and extended transparency** on all the segments of financial markets, be it financial institutions, financial products and valuations or jurisdictions;

(iv) **Ensure more consistency across standard setters and across regulatory and oversight frameworks** with a common aim to promote financial stability; avoiding regulatory arbitrage is key in that respect;

(v) **Better anticipate risks** and appropriate risk management based on an enhanced cooperation between institutions and bodies detaining financial information; the recently established working group on pro-cyclicality could usefully make recommendations in this respect.

II. ORIENTATIONS

To enforce these values, four main orientations could be proposed by the European Union:

Orientation #1. Strengthening and broadening the scope of global oversight of financial markets.

The current regulatory and oversight architecture (central banks, supervisors and standard setters, gathered in international associations of supervisors, the BIS and the Financial Stability Forum-FSF) has been efficient in addressing the crisis, but loopholes, inconsistencies and insufficient incentives remain. These are not due to the regulators themselves but to the lack of a comprehensive and sufficiently robust framework:

- In some countries, regulation and surveillance schemes do not include several financial actors and markets, which have a significant impact on financial stability: there are many jurisdictions with little or no regulation for certain lenders (mortgage lenders for instance), rating agencies and investment funds such as hedge funds. Taking stock of what is now being considered for rating agencies at the European level (registration and monitoring of the enforcement of good behaviour codes), these actors should be submitted to stricter surveillance, including enhanced registration and reporting requirements. This would not necessarily imply regulation rules. In addition, the fight against non-cooperative jurisdictions (non compliant offshore centres, tax havens) should be intensified.
- Coordination of international standards remains insufficient, leading in some instances to inconsistencies. . This is particularly the case for Basel Committee capital adequacy standards and IASB accounting standards, which do not give the same scope to the *fair value* principle and do not apply consistent rules on special purpose and special investment vehicles consolidation in banks' balance sheets. This results in less transparency and makes the supervision of these actors more complex.

- Incentives in financial markets are too much focussed on the short run, regarding both supervision and compensation policies. Supervisors can induce pro-cyclical behaviours. Similarly, compensation policies provide incorrect incentives leading to excessive risk taking in the short run; on the contrary, they do not reward strategies taking into account longer term perspectives.
- Supervisory practices failed to properly locate the risks and further to prevent the emergence of a crisis situation. Therefore, a deep analysis is needed as regard the way to improve the effectiveness of crises prevention capabilities of financial supervisors.
- The on-going financial crisis has shed new light on a number of risks and challenges to the sound functioning of the post-trading infrastructure in this environment. Building a safer, more stable and efficient financial system will require addressing these risks and challenges more vigorously and therefore step up the ambitions for secured post-trade infrastructures

The authorities and bodies making up the Financial Stability Forum have provided an important contribution over the last year. The independence of supervisors is essential for their credibility of supervision. Yet theses authorities alone cannot remedy to the financial markets malfunctioning without any input from authorities that have a broader scope of analyses and interventions as well as a proper level of political accountability. Besides, the working horizon of all financial actors needs to be widened notably through reinforced coordination between central bankers, supervisors and relevant industry bodies.

A reflection could be initiated aiming at better incorporating financial stability and consistency between standards into the mandate of these authorities. This is particularly relevant for self-regulated bodies such as IASB.

<u>Orientation #2. Promoting a global approach of risks.</u>

Beyond failures of the financial sector itself, the crisis highlighted the <u>lack of a global approach</u> to better understand interactions between economic and financial mechanisms, as well as the <u>lack of information</u> that would have helped anticipate triggering factors and the intensity of the current unwinding. These shortfalls call for a global and comprehensive approach for financial stability, integrating:

- macroeconomic risks (such as global imbalances and the design of macroeconomic policies),
- systemic risks originating from the financial sector including their spillovers between countries and sectors,
- a realignment of incentives inside the system (excessive risk taking by the traders, insufficient stock tacking by some self-regulated authorities of the consequences of their prescriptions in terms of global economic and financial stability),
- and lastly, minimising moral hazard in the future.

With regard to the first point, it is very likely that the building up of imbalances contributed to significantly increase the indebtedness of the global economy. The early identification of these imbalances including through identification of currency misalignment is of the utmost importance for a renewed global surveillance. The 2007 Decision adopted by the IMF membership should therefore be fully implemented in an even-handed manner. Clearer and more robust exchange rate analysis into the assessment of the overall policy mix is necessary.

To address challenges of systemic risks and of the structure of incentives inside the financial system, the current financial architecture may be further strengthened in the following fields:

- Settle an information network and a early warning system of risks to global macroeconomic and financial stability, which would, *inter alia*, be based on continuous work and information flows between the IMF, supervisors, central banks, regulators and standard setters, which would also be a way to ensure proper and timely communication to political authorities;
- Improve regulatory cooperation between jurisdictions. Supervisory colleges should be rapidly established for all significant cross-border firms to ensure effective oversight. More broadly, finance ministries, supervisors and central banks should work together, within cross-border stability groups, to identify and remove possible operational barriers to effective cross-border crisis-resolution.
- Propose an international framework for a fully integrated surveillance of both real and financial sectors and better analyse spillovers between them;
- Analyse pro-cyclical consequences of prudential and accounting standards, and their potential inconsistencies to be able to make proposals as needed;
- Coordinate analysis of prudential and supervisory frameworks and practices defined by the competent institutions, notably regarding rating agencies, *hedge funds* and *offshore* centres and make proposals as needed;
- Follow up the implementation of roadmaps including ECOFIN's and of FSF recommendations and their outreach to non FSF member countries;
- Undertake an in-depth impact study of innovative financial instruments to anticipate possible effects and, as needed, adapt financial regulation;
- Make the IMF Financial Sector Assessment Programs (FSAP) mandatory and, as needed, consider multilateral consultations to reinforce financial surveillance at a global level.

In order to establish political leadership in undertaking these actions, the impetus role of the IMFC could be strengthened e.g. by activating the ministerial "Council" as provided for in the Articles of Agreement.

Orientation #3. Reinforcing the legitimacy of the global financial architecture so as to better promote coordination and crisis prevention

Increased responsibility needs increase legitimacy. Therefore, the IMF and the existing relevant institutions should be more strongly legitimated. In this regard, further association of emerging and developing countries is essential.

Quota and voice reform, the approval of the first step of a similar reform at the World Bank the election of Minister Boutros-Ghali to the position of IMFC Chair, has already begun to demonstrate influence and openness to the enhanced voice of developing countries.

New steps still have to be taken. One step further could be to make the IMF Managing Director's and World Bank's President selection processes more open and transparent. Furthermore, the ongoing review of the governance of the Fund should help raise the effectiveness of this institution further. Moreover, the European Union could express its openness to the setting-up of the Council, to take over the IMFC and provide statutory political oversight of the Fund's activities. In addition, to ensure maximum effectiveness, and in recognition of the global nature of financial markets, an expansion of the FSF should be envisaged to include all relevant actors and regulatory institutions. The FSF could work within the umbrella of the IMF, so its proposals can be multilaterally discussed and endorsed. Also, further reform of the G8 should be considered to make this group more inclusive of the emerging countries.

The review of the IMF toolkit should be finalised swiftly, in particular so that the IMF is able to better provide liquidity to its members in case of a sudden stop of capital flows, while setting the right incentives and preserving the revolving nature of IMF resources Adaptations to the IMF toolkit also needs to be considered so that the Fund be better equipped to provide financial assistance to its members in case of a capital account crisis, of illiquidity situation.

Orientation #4. Addressing global challenges of the 21st century.

The crisis is also challenging our ability and will to address major issues the World is facing at the beginning of the 21st century. The crisis may lead to a durable and global slowdown. At the same time, there is still an urgent need to conclude the Doha trade round, to tackle climate change and delivering our Millennium development objectives. Both challenges – monitoring the slowdown risk and pursuing long term global objectives – must be strongly addressed. Therefore we should encourage an internationally coordinated macro-economic response, based on the promotion of environmental investments, including in developing countries.

The reform of the global financial architecture will be all the more efficient if mirrored in the improvement of the other international organizations. This may be an opportunity to improve the current framework based on a careful and comprehensive analysis of potential weaknesses in financial architecture. The following questions could be raised: 1) avoiding overlaps and duplications between international institutions acting in the economic and social fields, 2) enabling high level political coordination to ensure coherence between the programs and decisions of the different institutions.

III. PROCESS AND OUTCOME

President Bush has convened a Leaders meeting on 15 November in the United States in a broad format including emerging market economies. Other summits are likely to follow later in 2008 and in 2009 to reach decisions in the different fields which will have been identified on 15 November. The EU should thus define its common position and approach for discussion in the international fora in order to safeguard the leading role it has developed so far. It is important that the inaugural summit delivers a first set of decisions so as to initiate the right momentum around the process and build confidence in it.

At the inaugural summit on 15 November, Leaders could therefore commit to:

1. Increase transparency on financial markets and take the necessary steps not to let any financial institution, market or jurisdiction outside the scope of regulation or oversight
2. Submit rating agencies that provide public ratings to registration and to governance rules and to appropriate monitoring of their activities
3. Draw up codes of conducts to address incentives to excessive risk taking in the financial industry, including through compensation schemes
4. Reconsider accounting and prudential standards where necessary to improve their mutual consistency, facilitate coordinated supervision and control, raise the margins of safety of the system and mitigate pro-cyclical effects
5. Regarding capital adequacy standards, harmonising capital definition to ensure an homogenous quality of capital
6. Promote proper risk-magement incentives regarding securitization, including considering the impact and effectiveness of requiring originators to retain a share of their issuances
7. Reinforce cross-border cooperation between supervisors and regulatory authorities, especially to oversee activities of cross-border groups
8. Promote a change of culture in the governance of financial institutions towards sustainable value creation. Risk control mechanisms in financial institutions should be enhanced and placed under direct responsibility of senior management, notably to prevent significant operational incidents in market operations
9. Review improvements in liquidity risk management and promote a consistent approach for cross-border groups
10. Encourage an internationally coordinated response to the macroeconomic challenges to come
11. Formulate concrete solutions to improve the international economic governance