Reshaping the international financial system

Non Paper by the Netherlands

Introduction

Financial stability is a global public good. The financial crisis has exposed a number of fundamental weaknesses in our international financial system. Reform is needed. We suggest the following steps.

1. Gearing the objectives and incentives of financial institutions towards stability

The financial sector is not an ordinary sector. It is the backbone of our economic system. Information failures are pervasive and the risks of financial strategies are difficult to assess from the outside, and sometimes even from the inside. Due to the sheer size of the capital flows, a loss of confidence can cause serious damage to the real economy almost instantly. Public oversight and public resources cannot be a substitute for an effective functioning of the market. It is therefore essential that the incentives and transparency within the financial sector are improved. To this end we propose an international agreement on legislative reform covering amongst other things the following elements:

- First, the governance structure of large financial institutions should be adjusted to reflect the broader economic relevance of these institutions and to ensure that public interests are adequately safeguarded. For example, countervailing powers within the financial institutions against excessive risk taking, such as risk management and non-executive boards, should be enhanced. Supervisors could monitor this.
- Second, perverse elements (incentive structure, pay for failure) in the remuneration policy of financial institutions (in the Board as well as in strategic positions) should be eliminated. Salary structures and bonuses should be geared towards long term stability and continuity of the company and should not interfere with the institution's duty of care towards its customers. These elements should be made subject to scrutiny by the prudential supervisor. If this proves to be insufficient, governments should consider possibilities for corrective actions.
- Third, credit rating agencies must take measures to ensure that their rating activities are truly independent and not driven by commercial considerations. The scope of their activities should be well defined and there should be more transparency and effective oversight.
- Fourth, originators of structured products should bear financial consequences for their role in credit provision in order to ensure a proper risk evaluation. Assets transferred to special investment vehicles that still fall within the realm of the originator should be included in its risk management framework.
- Fifth, financial institutions need to provide real-time complete data to supervisors about their exposure and financial positions, with special attention to risk and liquidity management (including excessive leverage). Supervisors should also pay attention to market abuse. In addition, we need to take the final steps towards common internationally accepted valuation standards and their uniform application in practice.

2. Strengthening cross-border supervision and crisis management capacity in the EU

Financial conglomerates have outgrown their national borders and the integration of financial markets has progressed at an incredible speed. Supervisory structures in Europe need to catch up with these economic realities, particularly with regard to financial infrastructure. Progress is needed towards a more integrated European approach to financial sector supervision and crisis management, building on the recommendations of the FSF, the Ecofin road map and the recent European experience with crisis management.

- First, member states should treat their arrangements for financial supervision (both prudential and conduct of business) and crisis resolution as a matter of common concern. Such arrangements should be subject to peer review (in a manner comparable to budgetary policies) and be part of the IMF's surveillance activities. This would allow detection of shortcomings in financial supervision at an early stage. The results of these consultations should be published.
- Second, as the lines between the insurance and banking sectors are becoming more blurred due to growing integration and increasingly complex structures, supervision in Europe should converge towards an approach along functional lines (prudential versus conduct) rather than sectoral lines (banking versus insurance), thereby further stimulating cross-border cooperation.
- Third, colleges of supervisors should be in place for all cross-border groups (banks, insurance companies, investment firms) and include legally binding agreements on information sharing and cooperation. In its decisions, the lead supervisor should take careful consideration of the interests and input of all other supervisors involved. The Memorandum of Understanding of June 2008 on cooperation between the financial supervisory authorities, central banks and finance ministries needs to be implemented vigorously. In addition, there should be an institutionalized procedure for arbitration or appeal, preferably with the help of an independent body which can take into account global macro-economic and spillover effects.
- Fourth, in the area of prudential supervision, close cooperation with the competent central banks is an increasing necessity. In their policies, national supervisors should be mindful of possible negative spillovers to other member states. To this end and as agreed in the Ecofin roadmap, the mandates of national supervisors should be broadened to include a European dimension. To stimulate further progress, an EU directive could be instrumental.
- Fifth, the role of the existing level 3 committees in the institutional framework should be strengthened. They should be given the authority to issue binding guidelines and be endowed with instruments to ensure consistency and a level playing field in international supervisory practices (including colleges of supervisors with a lead supervisor). The increased cooperation between the Committee of European Banking Supervisors and the Banking Supervision Committee is a step in the right direction.
- Sixth, Europe's capacity for crisis management should be strengthened, building on recent experience. Public action should have a catalytic role in promoting a proper functioning of the

market. Crisis management tools should include flexible arrangements for sharing information, building on a framework of conditions for public interventions. In times of stress, a single decision-making responsibility is needed on issues which are relevant for all EU countries. To this end, the Presidency or an independent institution (to be determined) could have a leading role in coordinating public action. If possible, countries should not engage in individual action without having consulted their European partners.

- Seventh, in order to secure effective crisis management and minimize disturbances to the international financial sector, adequate bankruptcy legislation needs to be in place to ensure a proper winding down of insolvent financial institutions.
- Eighth, in the longer term we should consider progressing towards a European system of prudential supervision with a strong central body.

3. Strengthening the global institutions

Financial markets have become truly global. Financial instability in one part of the world may rapidly spread to other parts. Whereas financial crises are of all times. the principal sources of instability seem to have changed. Traditionally, the focus has been on the negative impacts of expansionary fiscal and monetary policies. More recently, financial sector instability has emerged as an additional important source of macro-economic disturbances. The IMF should adapt to these changing realities.

- First, the IMF should be transformed into the prime organization responsible for world financial stability. To this end, its mandate should be broadened to include financial sector stability as an additional area of responsibility. Its Articles of Agreement should be amended to reflect its role in capital account crises.
- Second, the IMF should assess the stability impact of the work of the Financial Stability Forum, Bank for International Settlements, Basel Committee, the International Organization of Securities Commissions and the International Accounting Standards Board. It should also have the authority to issue recommendations to countries and relevant fora. The FSF membership should be enlarged with representatives of systemically important emerging market economies. The work of the FSF and IASB should formally be brought under the IMF umbrella.
- Third, the IMF needs to engage in regular discussions with existing consultation groups within the financial sector, such as the Institute for International Finance and the Counterparty Risk Management Policy Group, to discuss policy requirements and stimulate best practices within the sector.
- Fourth, the IMF should strengthen its financial sector surveillance. In concrete terms, the Financial Sector Assessment Programs (FSAPs) should be made obligatory. Assessments of the financial sector should be integrated in the Article IV consultations, including an assessment of the implementation of FSF recommendations, an examination of prudential supervision and the institutional set-up compared to a set of internationally accepted standards. Obligatory publication of Article IV consultations will enhance the leverage of the IMF.

- Fifth, the IMF should provide a platform for its members to discuss the impact of national spill-overs, global standards, and regulations, incentive systems and supervision standards on global financial stability. The IMF should assess the impact of regulation and formulate recommendations at each of these levels. In addition, the IMF Global Financial Stability Report should present an analysis of the interplay between national, regional and global financial stability.
- Sixth, the IMF should be able to act at an earlier stage and in response to a larger spectrum of problems. To prevent financial and macroeconomic crises from taking place, the IMF should enhance its efforts to support governments that are adapting their macroeconomic, financial and exchange rate policies at an earlier, pre-crisis, stage. In addition to the traditional technical advisory services, the IMF should have financing available to accompany the policy changes. In this respect, the IMF should provide assurances – e.g. through a financial stability line – to countries that have adequate policies, but run the risk of contagion or rapidly changing market sentiments.

4. Next steps

- This year, international summit(s) should lead to an agreement on principles and core issues in the following areas:
  - Strengthening the responsibility and functioning of the financial sector to promote long-term stability.
  - Strengthening financial oversight of cross-border groups.
  - Anchoring global financial sector stability through institutional reform, with special attention for the role of the IMF and its relationship with other international fora.
- These principles should then be translated into concrete proposals by the IMF and other relevant fora. During this process, the EU should maintain its pro-active role and safeguard cooperation with all member states by means of a separate EU summit. Close cooperation with the "De Larosière Group" on financial sector reform should also be maintained.