POSITION PAPER

8 June 2009

FINANCIAL REGULATION AND SUPERVISION

Executive Summary

BUSINESSEUROPE supports a new regulatory agenda to reduce risks and improve risk management, to improve systemic risk absorbers, to address pro-cyclical amplifiers, to strengthen transparency and to set the right incentives. Financial markets should be regulated in a smart way considering that well-functioning and properly regulated financial markets are crucial for companies' access to finance.

Basel II

- The pro-cyclical effects of the Basel II framework must be reduced. Adjusting capital adequacy rules for banks within an internationally agreed range is crucial for limiting liquidity risk and new rules for structured loan and securities transactions are needed.

Financial Reporting and fair value measurement

- There is a need to harmonise and differentiate financial reporting and fair value measurement. Financial reporting must express the real economic value of financial instruments held for trading and the IASB guidance on fair value measurement should be rapidly adopted, whilst allowing time for an appropriate process to consult stakeholders.

Parallel banking system

- The regulatory net should extend to all operators conducting financial activities that have a systemic impact by enhancing transparency in core businesses, strategies, risk structures and leverages but a balance must be struck between regulatory needs and ongoing innovation in financial instruments.

Remuneration

- Remuneration policy should be aligned with sound risk management and long-term objectives and there should be no reward for failure.

Reform of the supervisory framework

- There should be strengthened coordinated oversight of cross-border groups, both macro- and micro-prudential, which respects national supervisory structures.
- EU countries outside the Eurozone and insurance and security supervisors should be involved.
- There should be more coordination and convergence of supervisory rules to eliminate harmful national differences and regulatory arbitrage through peer group review of national supervisors.

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1. INTRODUCTION

BUSINESSEUROPE supports a new regulatory agenda to reduce risks and improve risk management, to improve systemic risk absorbers, to address pro-cyclical amplifiers, to strengthen transparency and to set the right incentives. The need to durably reinforce financial stability requires proper financial market reforms ensuring a suitable balance between better regulation and risk prevention. It is also essential that regulators align their initiatives with those undertaken at the international level to ensure international convergence and co-operation.

Financial markets should be regulated in a smart way considering that well-functioning and properly regulated financial markets are crucial for companies' access to finance. There is a need for more regulation for previously unregulated markets as well as improved cooperation between regulators at international level. The clearing process for over-the-counter markets at international level should be improved and securitisation markets should be re-established. It is vital to restore confidence in these unregulated markets which play a key role in defining the cost and access to financing for companies.

Financial market reforms will have to allow room for financial innovation and for the appropriate reward of entrepreneurship. Investors who are willing to take risk against an appropriate remuneration should be allowed to do so ensuring the access to finance of emerging and innovative firms which hold the key to a sustained recovery.

In addition, there should be strengthened coordinated oversight of cross-border groups, both macro- and micro-prudential. There is a need for effective crisis management procedures to increase confidence between countries. Public interventions to reduce systemic risks in the financial sector should be proportionate, transparent, sufficiently coordinated and conducive to a rapid return to self-supported activities by commercial banks and capital markets. A level playing field at the international level should be maintained and financial protectionism strongly combated.

2. NEW REGULATORY AGENDA

Basel II

The pro-cyclical effects of the Basel II framework must be reduced. Building up anti-cyclical buffers appears as a practical way of dealing with this issue. Adjusting

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capital adequacy rules for banks within an internationally agreed range is crucial for limiting liquidity risk and new rules for structured loan and securities transactions are needed.

Any revision of the Basel II conditions should translate into an effective and tangible easing of the conditions for granting credit to companies. Basel II highly depends on past performance of companies and does not take proper account of the long term strategy of a company. This greatly affects access to credit also once the economic situation improves delaying the ability of companies to benefit from an up-swing.

Financial reporting and fair value measurement

There is a need to harmonise and differentiate financial reporting and fair value measurement. The impact analysis of new reporting rules must take into account different stakeholder interests, types of financial instruments and relevance of the accounting measurement model for the users of the financial statements. This will help to balance the costs of new accounting and control procedures and the benefits of disclosure.

Financial reporting must express the real economic value of financial instruments held for trading and the standard-setters must consider to what instruments "fair value measurement" must apply and in particular whether it should apply to unlisted financial instruments.

In view of a single set of high quality global accounting standards, the IASB guidance on fair value measurement should be rapidly adopted, whilst allowing time for an appropriate process to consult stakeholders.

Credit rating agencies

Investor confidence in credit rating agencies and the ratings which they produce should be restored through a robust and efficient regulatory framework which should not disrupt the use of ratings, which are an intrinsic part of global finance.

National and regional authorities of countries where rating agencies operate in should be able to carry out the necessary oversight and there should be globally consistent and non-protectionist regulation to manage conflicts of interest and assure transparency and quality to the rating process.

There should also be reinforced international cooperation between regulators and competition in the credit rating industry, which is a very concentrated and oligopolistic market, should be encouraged.

Any registration process for credit rating agencies should take account of the need for those responsible for registration decisions to liaise with and make consistent decisions with each other.

Parallel banking system

The regulatory net should extend to all operators conducting financial activities that have a systemic impact by enhancing transparency in core businesses, strategies, risk structures and leverages. However, a balance must be struck between regulatory needs and ongoing innovation in financial instruments that enable companies to borrow and/or price risks on financial markets.

Enhanced public disclosure for market operators is key to the orderly functioning of financial markets, including short-selling transactions above a certain threshold. In addition, there should be disclosure standards for off-balance sheet transactions.

Confidence in credit default swap markets should be restored by the use of central clearing systems. The netting of all positions against the clearing house would eliminate counterparty risk which in the long term would lead to better pricing. To facilitate the organised trading and clearing of these products, regulators, in consultation with market participants, should also work towards standardised contracts, margin payments and settlement of daily profits/losses.

The functioning of securitisation markets should also be restored. Securitisation is a vital component of bank's business models and strengthened the supply of credit. In recent years, securitised products have become increasingly complex. To reactivate securitisation markets, issuers must simplify structures and offer detailed information about the underlying claims and collaterals. Furthermore, it is essential that originators retain some liability in order to regain market confidence. Investors must be able to assume that the originator of the securitised product has an ongoing interest in verifying the solvency of the borrower.

Remuneration

Remuneration policy should be aligned with sound risk management and long-term objectives. There should be no reward for failure and a reasonable relationship between a company's performance and the remuneration of the people who are responsible for that performance. The remuneration process should be based on self-regulatory principles, such as transparency and businesses complying with codes of corporate governance.

Harmonisation of regulations and sanctioning regimes

Businesses should comply with financial services regulation. In this context, BUSINESSEUROPE supports the principle of improved harmonisation of sanctions as this will ensure the proper functioning of the single market.

Consumer and investor confidence

The role of consumers as a contributory factor to the financial crisis has been limited to date as much of the crisis has unfolded in wholesale markets but the crisis is rapidly reaching into the real economy and the retail financial sector with the result that depositors, policy holders and consumers are increasingly affected.

There should therefore be more transparency and disclosure to help consumers make informed and empowered decisions. Focus must be on restoring consumer confidence in financial markets and long-term savings and investment, such as measures to reinforce depositor, investor and insurance policy holders together with measures on responsible borrowing and lending although we are concerned about regulatory overload at the current time. Policy-makers should also be conscious of the usefulness of self-regulation.

Reform of the supervisory framework

There should be strengthened coordinated oversight of cross-border groups, both macro- and micro-prudential.

Regarding macro-prudential supervision, there is a need for a body which oversees financial stability and acts in a macro-prudential capacity to capture and analyse data across the financial services industry and to point out issues to key participants. Such a body would have to pay sufficient attention to non-banking bodies to ensure an international capital markets perspective. A pan-European macro-prudential supervision body would also have to include countries outside the Eurozone.

There should be a robust mechanism of reaction from Member States to ensure that warning signals are properly considered and acted upon. This mechanism needs to be balanced in order to provide an appropriate degree of flexibility and a 'comply or explain' approach may be one way to achieve this.

The interaction with the International Financial Institutions such as the revised Financial Board, the International Monetary Fund (IMF), the Basel Committee and IOSCO is also key. Financial stability surveillance should flow from global to regional to national (and back the other way where necessary). These institutions need to be able to analyse, alert and consider required actions, and appropriate connections and communication is essential to achieve this. In this context, the IMF's role and capacities must be further enhanced to improve its functions by providing early warnings and rapid intervention in the most critical situations and to work closely with the private sector.

Regarding micro-prudential supervision, moving towards stronger cross-border oversight should leave intact national supervisory structures. Oversight should be extended to all unregulated actors and final responsibility should be clearly attributed. The regulatory philosophy of new bodies and structures should be clear from the outset and it must be made explicitly clear that the responsibility for supervision of individual firms is left with national supervisors. In this context, there should be a clear definition of the operational relationship between macro-prudential oversight and day-to-day supervision considering that the risk assessment flows directly from the hands-on experience in day-to-day supervision.

The role of new micro-prudential supervision bodies should confine itself to oversight of the system of European colleges of supervisors to improve co-ordination and ensure the convergence of supervisory opinions through peer group

review of national supervisors and assistance with developing consistency to technical rule-making across Europe. Rule-making should be improved in a co-ordinated manner, eliminating harmful national differences between regulatory regimes and regulatory arbitrage and providing oversight and best practice peer review of national supervisory operations whilst leaving some degree of flexibility at national level with respect to rule-making for conduct of business regulation which needs to be appropriate for the national marketplace.

New micro-prudential supervision bodies should also be compatible and/or integrated with the colleges of supervisors for large cross-border financial groups that are being set up at the international level to avoid inefficient duplication of efforts and decrease risks.

Better Regulation

It is important that better regulation principles are fully respected when reviewing financial regulation and enhancing supervision. Thorough impact assessments should be carried out in accordance with the EU's Impact Assessment Guidelines and regulators should refrain from imposing unnecessary burdens. In the area of financial regulation, the costs and dangers of unintended consequences can be very significant and given the long lasting effects of changes it is crucial to take the right and proportionate approach. Timing of new measures should therefore be realistic to avoid rushed solutions that entail unnecessary burdens, disrupt the quality of supervision, or delay a sustainable recovery. Timing should also be co-ordinated with other international developments to avoid opportunities for regulatory arbitrage.

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