BUSINESSEUROPE

European Banking Federation

EFRP European Federation for Retirement Provision

EVCA European Private Equity & Venture Capital Association

FEE Federation of European Accountants
Fédération des Experts comptables Européens

FESE Federation of European Securities Exchanges

Business perspective on financial market reforms: Towards financial stability and sustainable growth

Executive Summary

Financial stability and growth can and should be achieved at the same time.

BUSINESSEUROPE and the key financial market players firmly support the introduction of appropriate financial market reforms and are working together to rebuild confidence and restore sustainable growth.

Appropriate regulation must be:

- Proportionate to the size of the risk involved
- Tailored to specific financial instruments
- Mindful of the financing needs of the economy
- Targeted at achieving objectives at the lowest necessary costs
- Aimed at lowering competitive distortions and maintaining a level playing field

Key messages:

- Maintain financial market integration as a core objective and avoid segmentation of financial services along national borders
- Better coordinate macro- and micro-prudential supervision and develop criteria for early cross-border intervention
- Elaborate an international resolution regime for large cross-border financial firms
- Uphold better regulation principles to ensure that regulation is proportionate and does not undermine innovation, market integration and competitiveness
- Avoid unilateral approaches and protectionism and eliminate harmful differences between regulatory regimes and regulatory arbitrage
- Develop counter-cyclical prudential rules without stifling access to finance

I. Business vision for post-crisis financial markets

BUSINESSEUROPE together with the European Banking Federation (EBF), the European Federation for Retirement Provision (EFRP), the European Private Equity and Venture Capital Association (EVCA), the Federation of European Accountants (FEE) and the Federation of European Securities Exchanges (FESE) present in this paper their vision of the guiding principles for financial reforms in order to reinforce financial stability, underpin growth and job creation and enable change towards a sustainable economy.

The crisis has highlighted the tight interdependence between the financial sector and the functioning of the broader economy. A sudden breakdown in the credit supply chain has led to major disruptions to trade, investment and business activity worldwide. The negative impact on the corporate sector, labour markets and public finances is significant and will be long-lasting. The private sector's initiatives will be essential complements to an adequate policy response addressing market, regulatory and supervisory failures.

Confidence must be restored. BUSINESSEUROPE and the key financial market players are working together to rebuild this trust. We call to use ***the crisis as a catalyst for change***.

As responsible stakeholders we are also committed to accelerate the recovery of the EU economy and speed up the transition towards a low-carbon, knowledge-based and skills-oriented society.

We are convinced that financial stability and growth can be achieved at the same time. This requires ***a paradigm shift in policy-making, regulation and market incentives***, as well as and, at the same time, finding ways to ***better reward sound risk-taking inherent to entrepreneurial activities***, innovation, long-term investment and human capital development.

A well functioning financial sector will play a major role in this regard. The financial services industry provides an essential infrastructure for the market economy by ensuring financial intermediation and an effective payment system, by diversifying risks and by allocating resources efficiently. ***Financial services must meet the demand of business life*** in an increasingly global economy.

The financial services industry is well aware of its responsibility to develop sustainable business models, improve incentive structures and risk management, and is prepared to support companies' access to finance for the recovery.

Financial market integration must remain a core objective in the EU. Deeper and more liquid markets would act as a buffer in the face of global financial turmoil, would help to reduce the cost of financing and encourage cross-border trade and investment.

Past progress achieved through the introduction of the euro, the implementation of the EU's financial services action plan and EU competition policy must be preserved and further developed.

First, it is of outmost importance that the far-reaching public interventions required in recent months to limit the impact of the banking crisis do not unduly distort competition and are unwound on the basis of coordinated criteria. ***The segmentation of the European banking sector along national borders would inflict long-lasting damage*** to financial and economic integration.

Large cross-border financial companies should be able to exit the market in an orderly manner. In that respect, international, European and national authorities should seek to ***remove barriers to cross-border crisis management and develop common crisis resolution tools***, among them an internationally agreed legal framework for winding down financial firms.

Second, ***effective rule-making must be complemented with better enforcement mechanisms*** in order to reinforce compliance with and implementation of existing EU internal market legislation at the national level.

II. Guiding principles for financial market reforms

We firmly support the introduction of appropriate measures in order to prevent or better manage systemic risks, improve transparency and investor protection and ensure confidence in the financial system as a condition for economic recovery.

In this context, financial activity should be subject to effective and appropriate ***regulation that is targeted at clearly defined objectives***. Appropriate regulation is proportionate to the size of the risk involved, tailored according to the specifics of the financial instrument and the parties trading / investing in it, takes into account the financial needs of the economy, achieves its objectives at the lowest necessary costs, and maintains a level playing field between instruments used for comparable purposes.

Policy-makers should be particularly ***mindful of any unintended consequences*** of financial market reforms on the foundations of economic growth. Growth relies on free competition, open markets allowing the free movement of capital, goods, services and people as well as an appropriate reward for sound risk-taking.

If regulation has an important part to play, experience shows that markets are the most powerful drivers of change. For that reason, new regulation should concentrate in setting the right incentives to allow healthy market behaviours.

Better regulation principles should be upheld. Thorough and independent impact assessments should ensure that the revised regulatory framework is proportionate and does not unduly undermine innovation, market integration and the competiveness of the European economy. As a general rule, public interventions to correct distortions and other market failures should be proportionate and targeted directly at the identified shortcomings.

Reforms should be realistic and effective; therefore rushed solutions to change legislation or standards should be avoided. ***A more inclusive consultation process must be put in place*** with a stronger representation of key business stakeholders, including objective feedback statements on their contributions. Re-assessing the effectiveness of proposed rules ex-post is also important to avoid over-regulation.

The following principles must be respected to ensure that financial market reforms strike a proper balance and foster a sustainable development of the European and global economy:

1. More effective supervision of all financial markets

In the European context, the proposal for a European Systemic Risk Board and a European System of Financial Supervisors represents an improvement from the current institutional set-up. ***Better coordination of macro- and micro-prudential supervision*** at the global level will be crucial to ensure comprehensive and consistent oversight and to avoid inefficient duplication of efforts.

Criteria for early cross-border intervention, common burden-sharing and lender of last resort situations in the event of a new crisis, and possibly an ***international resolution regime for large cross-border institutions***, must be developed to bolster the supervisory framework. It is of utmost importance that the new supervisory structure is effective in enforcing regulation.

An appropriate consultation process with the relevant stakeholders is important to ensure that the views of both providers and users of financial services in supervisory bodies are duly taken into account.

2. More coordination and less regulatory arbitrage

Unilateral approaches and ***protectionism need to be prevented***. Rule-making should be improved in a co-ordinated manner, eliminating harmful differences between regulatory regimes and ***reducing scope for regulatory arbitrage***, recognising at the same time that countries can take different routes to achieve the same regulatory objectives.

In a post-crisis environment, efficient financial markets subject to open and free competition are key to economic growth. Regulation should therefore not create, but rather ***reduce barriers to entry for market participants***.

3. Adequate transparency and risk management

Investor confidence and protection should be at the core of institutional initiatives. Adequate transparency requirements will be vital to restore trust in unregulated markets and complex products. Enhanced disclosure standards, such as in the area of securitisation, are instrumental in rebuilding investor confidence and, consequently, in revitalising key funding

markets. In order to ensure the effectiveness of new rules, information should be readily available and easily accessible.

Relevant, proportionate and appropriate reporting is essential to transparency. ***Financial reporting must express the real economic value of financial instruments traded and held for trading***. The IASB should clarify the scope of application of fair value, giving consideration to both listed and unlisted financial instruments. Its guidance on the application of this measurement method should be rapidly adopted, while allowing time for an appropriate process to consult stakeholders.

The crisis has highlighted the need for ***improved standards and practices of corporate governance and risk management***. Investors should receive relevant information on how companies manage risks. This is a condition for them to take good decisions and to cope with risks that are also inherent to their investment, two areas where supervision plays a key promotional role. Supervisors should ensure that liquidity risk is properly managed within a sensible framework and that banks' level of leverage remains within sustainable parameters.

4. More resilience and less pro-cyclicality

Financial markets regulation - and, more specifically, regulation of banks' capital structure - should be approached bearing in mind that such regulation should help to absorb and moderate rather than amplify macroeconomic cycles.

Strengthening capital buffers in good times appears a practical way of improving prudential rules in the future but should not create additional credit constraints; especially during a fragile economic recovery. To reduce pro-cyclical effects of the Basel II framework, the existing rules should be modified within the scope of the underlying principles and be more mindful of its impact on companies' access to finance - in particular for SMEs.

Remuneration policies should appropriately reward talent and be aligned with sound risk management. Incentives should be closely linked to the long-term and sustainable success of the enterprise as a whole. Business has a key role to play through the adoption of transparent procedures and by complying with corporate governance codes.

III. Role of the financial industry in promoting growth[1]

- **Banking sector (EBF)**

To retain their central role in the economy and society, banks are rebuilding trust. Banks are reinforcing their balance sheets by means of capital increases and the disposal of instruments implicated in the financial turmoil. By doing so, banks are reducing their leverage whilst putting themselves in a more solid position to carry on providing credit to the real economy. In addition, banks have agreed and are implementing a number of industry-led initiatives to address market deficiencies that the financial turmoil has highlighted, in particular in the area of credit derivatives and securitisation.

Banks have acknowledged that pre-crisis capital levels were not adequate and that regulation and supervision will be addressing that shortcoming (in complement to the banks' own reaction to strengthen their balance sheets). However, as recognised by political leaders, policy actions need to be put in a broader, macro-economic context. In this regard, the liquidity position of corporates and households is increasingly uncertain, and their funding base thinner. It is therefore important to introduce any new capital increases for banks until the economic situation has improved and both the real economy and the financial markets have stabilised and are on a sustained path to recovery.

The same can be said about banking sector restructuring. Whilst banks are mindful of the need to put the sector on a healthier footing, attention is needed so as not to reverse the process of financial market integration in the EU and to ensure that banks can compete over the matching of the needs of their extensive array of clients, both wholesale and retail, professional and non-sophisticated.

As the interaction between financial markets and the real economy evolves, banks are ready to learn from past mistakes and adapt to remain successful intermediaries between savings and lending and hence, contribute to financial, social and business needs.

- **Operators of Regulated Markets and MTFs (FESE)**

The crisis has revealed the importance of the market structure and infrastructure surrounding any financial instrument to the safety and stability of the system as a whole. The Regulated Market (RM) model displays a market structure based on neutrality, independence, transparent price discovery (through high levels of pre- and post-trade transparency), the ability to provide liquidity for assets admitted to trading on RMs and sound and efficient post-trading arrangements. Exchanges offer firms the opportunity to benefit from improved access to capital and to liquidity. Moreover, they dedicate tailor-made market segments for SMEs,

[1] The views expressed in this chapter are the responsibility of each individual organisation and do not necessarily reflect a common position.

specifically designed for their needs. Investors in turn are able to rely on a fast, efficient and safe trading and post-trading environment for a wide array of financial instruments.

In order to improve the functioning of the financial system as a whole, reduce future systemic risks, ensure sustainable growth and restore the confidence of investors, the following three broad actions should be considered in relation to EU regulation: (i) providing the market with proper incentives to use safer instruments and venues; (ii) limiting the risks of the unregulated space to professional investors only and (iii) placing investor confidence and protection at the core of reforms.

- **Private equity and venture capital (EVCA)**

Private equity firms are devoting substantial resources to ensure their companies are best placed to operate through the downturn and thrive as the economy recovers. In addition, many private equity firms have raised long-term funds, and are in a position to selectively provide capital to businesses. The current financial crisis has been marked by a lack of liquidity and finance for companies. Private equity and venture capital firms therefore have a crucial role to play in ensuring that Europe's businesses have the investment and support necessary to prosper.

Private equity firms raise long-term, fixed-life funds (typically ten years) outside public markets to support companies through the provision of finance as well as intellectual capital. They participate in the company's governance, and operational and strategic performance, in order to increase its value, which is realised at the point of a sale.

In practice, private equity comes in different forms. Venture capital investors normally invest smaller amounts for minority stakes in young businesses with high growth potential. Buyout investors usually invest in larger, more mature businesses.

Venture and growth capital funds in particular have the ability to boost growth and innovation in the European economy by partnering with company managers where alternative sources of finance are extremely scarce.

- **Pension funds (EFRP)**

Institutions for occupational retirement provision (IORPs) – commonly referred to as pension funds – administer retirement plans that are part of an employee compensation package or collective labour agreement. Their primary role is to provide retirement income security to senior citizens. Since pension funds accumulate capital, they are sizeable investors on international capital markets with assets under management representing 10 percent of EU bond and equity markets.

Europe faces a major challenge of providing adequate and sustainable pensions to future generations. Population ageing renders it hard for pay-as-you-go schemes to deliver as promised. Many governments have responded by reforming public pension provision, which results in a decline in net retirement income. The European Commission projects that public

pension replacement rates are to fall on average by 20 percent in EU member states by 2060. The financial crisis has triggered a stark deterioration of public finances, which will exert additional pressure on state pension provision.

There is a need for retirement income diversification to prevent or minimise the risk of old-age poverty. Capital-funded – occupational and individual – pensions need to be further developed to cover more people and to make them save more than is the case today. Higher retirement savings will provide European industry with a steady flow of long-term capital reducing the cost of capital for companies. This stimulates investments and consequently increases economic growth and employment creation.

The development of occupational pensions cannot be successful without an institutional setting that reflects their long-term nature. Prudential regulations of pension fund and international accounting standards for post-employment benefits should aim to be sufficiently counter-cyclical. This is necessary to maintain the confidence and support of both employers and plan members in workplace-provided pensions.

- **Accountancy sector (FEE)**

Professional accountants play an instrumental role in responding to today's needs for transparency, trust and integrity and in making markets function properly. They serve the economy from two main and different perspectives:

(i) As providers of accountancy and professional services: through the maintenance of reliable financial statements, preparation of financial and non-financial information, and other business consulting services, professional accountants, in public practice or employed in enterprises, assist managers, business partners, bankers, creditors, investors, employees and public administrations in making sound and informed decisions.

(ii) As providers of statutory audit services: professional accountants act under strict independence rules in the public interest to enhance investors' and stakeholders' confidence in financial and non-financial information and consequently sound market functioning.

Beyond the scope of statutory audit, auditors can also contribute to greater confidence: in the financial sector, by providing independent opinions on the information reported to supervisors, in the reliability of SMEs' financial information, or in sustainability reporting.

Proportionate disclosure of relevant information is essential to a well functioning market economy. Regarding financial stability, accounting requirements best serve the goals of stability if they provide a transparent and faithful representation of corporate performance; this fundamental objective must be preserved, however inconvenient the message about economic reality may be in the short term, and should not be biased by attempts to counter perceived pro-cyclical effects.