

Financial reforms and the recovery

Introduction

BUSINESSEUROPE together with the European Banking Federation (EBF), the European Federation for Retirement Provision (EFRP), the European Private Equity and Venture Capital Association (EVCA) and the Federation of European Accountants (FEE) present in this paper their ideas for effective financial reform in order to reinforce financial stability and achieve sustainable economic growth.

Rebuilding trust in financial institutions and restoring investor confidence in financial markets is key for a sustained economic recovery and for the competitiveness of the European Economy.

BUSINESSEUROPE and the key financial market players reiterate their call to ***turn the crisis into a catalyst for change***. We are working together to draw the lessons from the crisis and take all necessary measures to reinforce the financial system, increase transparency, rebuild trust, and reinforce the foundations for future growth.

These have been again put to the test by renewed tensions on capital markets and concerns about fiscal sustainability. The increased need for appropriate public sector accountability has been clearly evidenced. Confidence in sovereign debt markets and the stability of the euro are critical for company investment decisions and impact in many ways the capacity of the financial sector to deliver the necessary financing to stimulate growth. It is therefore a major factor influencing economic conditions and the chances of sustained recovery in Europe.

To prevent the contagion of the sovereign debt crisis in the eurozone, the European Council, the European Commission and the ECB agreed to implement an unprecedented stabilisation programme early May. This has demonstrated commitment to the single currency and to safeguarding financial stability at a critical moment.

This will need to be backed by immediate actions at national level in order to restore confidence in the long term sustainability of public finances and to implement far-reaching reforms of product, labour, capital markets and social security systems.

In this same perspective, the robustness, transparency and comparability of public sector financial reporting will deserve more attention; the necessary improvements will have to be duly considered in light of recent experience.

Recent events also illustrate persistent vulnerabilities in the financial system and the need for prudential regimes and supervisory actions to be sufficiently counter-cyclical to absorb rather than amplify economic and financial shocks.

I. The need for reform

This crisis exposed serious regulatory shortcomings which contributed to the build-up of poor quality assets leading to a severe decline in market confidence. It also revealed the need for coordination and collaboration at European and global level underlining the importance that reforms are pursued in an internationally consistent manner. Global coordination therefore must prevail. The priority is to allow the EU's financial sector to rebuild a stronger capital base, to provide sufficient financing to the economy and to ensure a global level playing field in the sector. To meet these criteria, it is necessary to avoid unilateral actions.

Top priority must be to reinforce the regulatory and supervisory framework. The gaps in the existing regulatory and supervisory framework should be identified and resolved at both European and global level. The goal must be to establish a sustainable basis for financial markets and the economy as a whole, avoiding overregulation and preserving a favourable climate for financial innovation. In this respect, the impact on the real economy of potential new taxation mechanisms should also be carefully assessed, coordinated and agreed at global level to avoid distorting competition.

The stability of the financial system and the steady growth of the economy depend on an adequate regulatory framework. When devising an adequate regulatory framework, policy-makers have to strike the right balance between the need for stricter regulation and control on the one hand and the needs of the real economy on the other, including the need for a fair risk/reward ratio for entrepreneurs, fair return on capital for shareholders and rewarding employment opportunities.

Efficient financial reforms should take account of the following:

- Maintain financial market integration as a core objective and avoid segmentation of financial services along national borders. Respect key values and freedoms provided by the Treaties such as entrepreneurship and social inclusion, open markets, free movement of goods, people, services and capital. Ensure a level playing field, undistorted competition and sustainable development.

- The financial sector needs a robust framework to secure future stability. Regulation should cover all operators conducting financial activities while respecting the proportionality principle.
- Regulation should foster market transparency and accountability.
- Regulation should reduce risks, improve risk management, and be proportionate to the size of the risk involved. Improved risk management includes adequate rules for capital and liquidity which preserve the capacity of the financial sector to service the economy and support its financing.
- Regulation should contribute to help to absorb shocks and moderate macro-economic cycles. Pro-cyclical amplifiers in capital requirements should be mitigated.
- Macro- and micro-prudential supervision should be upgraded urgently. We need global approaches to reinforce cross-border oversight and effective early warning systems. Supervision should be coordinated at global level to ensure comprehensive and consistent oversight and avoid inefficient duplication of efforts.
- Harmful differences between regulatory regimes should be eliminated and regulatory arbitrage prevented. National divergences in supervisory practices should be removed to establish a level playing field and strengthen the application of the sectoral single rule book.
- Develop a European framework for early intervention, crisis resolution, common burden-sharing and lender of last resort situation within an international crisis management system for cross-border institutions to complement a reinforced supervisory framework and ensure better crisis management.
- Appropriate national resolution regimes should be implemented on a harmonised basis at European level – within broader internationally agreed principles – with a view to creating mechanisms to prevent escalation of financial distress or its contagion and make all market participants more responsible.
- Financial reporting must provide a transparent view on the financial position and performance of market participants and not be confused with regulatory reporting requirements and needs. At the same time, unnecessary administrative burdens on business should be minimised and duplication of requirements avoided.

II. What has been achieved already

1. Both financial institutions and investors have re-assessed their risk tolerance. Risk management has been reviewed and strengthened throughout the financial industry.
2. In many EU Member States, corporate governance codes and related legislation contain provisions aligned with G20 and EU recommendations on sound risk management. A recent study on corporate governance codes shows a positive level of application of the EU recommendations. In most Member States corporate

governance codes require disclosure of remuneration policies and the link between variable remuneration and performance.

3. In line with the agreed G20 principles and standards, many financial institutions are assessing their remuneration practices where bonus/malus factors and minimal retention periods are becoming common reference benchmarks. Consistent and equal implementation in this area remain key in order to preserve the competitiveness of the EU.
4. European and global trade associations have formally committed to improve the transparency of European securitisation markets. In conjunction with other EU representative bodies, a range of EU industry initiatives has been launched which focus on improvements to issuer disclosure and reporting of structured products, enhanced access to information by investors, increased standardization and comparability and better valuation methods.
5. Since 2000 more than €400 billion have been invested in over 70,000 companies by the European Private equity and venture capital industry, and only in 2009 more than 4,000 companies have benefited from private equity investments. Of those companies 2,000 were seed and start-up companies.
6. Dialogue between supervisors, management of enterprises and auditors has been strengthened in the past year and results in better exchange of information critical to mitigate risks.
7. Following the G-20 statements calling for a global set of high quality accounting standards, the IASB has fostered its dialogue with the US accounting standards setter (FASB); such dialogue should be supported with a view to facilitate the emergence of globally accepted accounting solutions fostering a level playing field and fair and stable financial markets.
8. Many businesses are making bold moves towards adopting longer term perspectives embedding sustainability in their strategies and business model and improving and reporting on their environmental and social performances.

III. Combining financial stability and growth

The EU2020 Strategy is putting emphasis on attracting investors to fund innovation in Europe and facilitating cross-border investments. Pension funds, insurance companies and banks are the major source of funding. For those investors, policy should ensure that their capital adequacy or solvency requirements reflect the real risk and rewards involved in each asset class (e.g. private equity and venture capital). Newly proposed regulatory measures such as Basel III, CRD II, III and IV, Solvency II and AIMFD should be conducive to financial stability and mindful of their impact on the availability of capital and growth in Europe, whilst preserving a level playing field. Strengthened capital and liquidity requirements, beyond what

is necessary to ensure a certain level of stability, will damage banks' lending capacity and therefore have negative effects on the broader economy as demonstrated by various impact assessments already conducted at sectoral level. This is especially true in Europe where companies depend highly on bank intermediation.

Smart regulation must ensure that the right solutions are found and that policies are effective and proportionate in their scope and nature which is easier to achieve if substance prevails over form, and reform is not driven by short term communication objectives but by the real needs of citizens and markets.

Coherence between new and existing regulation must be ensured, particularly in cases of regulatory overlaps. Comprehensive impact assessments must be carried out which also address the cumulative and/or systemic impact of different pieces of regulation, not only on the financial sector but on the economy as a whole. They should assess the non-linear effects i.e. not add-up separate assessments, but assess the interactions between different initiatives. These assessments should also address possible interactions with new accounting rules which also impact on capital allocation such as requirements to bring securitized loans onto banks' books and rules related to the way financial institutions account for bad loans. To achieve these objectives in a timely manner and to provide the expected level of quality and objectivity, proper resources, both in terms of quantity and competences, must be devoted to such impact assessments.

A baseline scenario must be developed which explains how the current situation would evolve without additional public intervention in the financial sector and realistic alternative policy options must be considered when designing the future course of action.

Uncertainties must be addressed such as the outcome of regulatory initiatives aimed at reviving securitization markets and the impact of raising public indebtedness on financial stability and access to finance. Final decisions on the new regulations should be taken only after these impact assessments have been considered and discussed in a transparent manner. The assessments should be carried out urgently in order not to delay the adoption of much needed reforms.

Conclusion

Rebuilding trust in financial institutions and restoring investor confidence in financial markets is key for a sustained economic recovery and for the competitiveness of the European Economy. The gaps in the existing regulatory and supervisory framework should be identified and resolved at both European and global level. The goal must be to establish a sustainable basis for financial markets and the economy as a whole, avoiding overregulation and preserving a favourable climate for financial innovation. The stability of the financial system and the steady growth of the economy depend on an adequate regulatory and supervisory framework.

Financial reforms should not have a disproportionate impact on growth. Smart regulation must ensure that the right solutions are found and that policies are effective and proportionate in their scope and nature. Comprehensive impact assessments must be carried out which address the cumulative and/or systemic impact of different pieces of regulation, not only on the financial sector but on the economy as a whole. They should be carried out urgently in order not to delay the adoption of much needed reform measures.

The debt crisis in the euro area is threatening a fragile recovery. A relapse into economic recession will be very costly in terms of higher unemployment and more severe budgetary problems. To contain the debt crisis there is a continuing need for coordinated responses that are credible to financial markets. Prudential regimes and supervisory actions should be sufficiently counter-cyclical to prevent an aggravation of the crisis. Member States should start consolidating government budget sooner rather than later. Europe's business and financial industry can contribute to achieving sound public finances, while maintaining adequate provision of health care, long-term care and pensions to our citizens.

The current circumstances call for great caution, as well as great leadership and determination to act. Today's crises are global in nature whether they affect the financial sector, the States or the environment. These increased interdependencies make uncoordinated unilateral communications and actions counterproductive and potentially detrimental to all, especially in the current climate of extreme volatility. All governments, all market players and all citizens have a common interest and that can only be met through cooperation.
