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**COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN
PARLIAMENT AND THE COUNCIL**

Europe's financial system: adapting to change

Contribution of the Commission to the European Council

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(Text with EEA relevance)

INTRODUCTION

The Spring European Council meets at a time when difficulties in the international financial sector are still working their way through the system. With globalisation and real time inter connections between financial markets, problems in one part of the world quickly have an impact on others. Recent events have had an impact on international banks, multinational companies and individuals who are beginning to face tightening credit conditions, with consequences ranging from companies' ability to invest and grow, to home ownership and the disposable income of households. Many Europeans are worried about what this will mean for the economies of their country and for their own financial and employment security. These concerns call for an explanation of what is being done at national, EU and international level to reassure Europeans that they can have confidence in the way financial markets operate and in the EU's economic framework. Recent experience has shown that there are important weaknesses in the international financial system which need to be remedied, particularly improving the quality of information available to all investors, whilst strengthening prudential control and risk management. Discussions at the Spring European Council should be used to determine the next steps in the EU's response to these challenges.

THE CURRENT ECONOMIC CLIMATE

The global economic situation and outlook remain unusually uncertain at the start of 2008, with turmoil in financial markets, a US slowdown and soaring commodity prices all key factors. In these circumstances, the high degree of stability offered by the euro is particularly welcome.

So far, the European economy has responded relatively well to this challenge. Key indicators such as savings rates and the current account offered real protection against the consequences of financial turmoil. However, confidence peaked last summer, and as expected, GDP growth slowed in the last quarter of 2007.

The latest forecasts from the Commission saw annual GDP growth revised downwards, to a GDP projection of 2.0% for the EU and 1.8% for the euro area. At the same time, high commodity prices have fed into rising inflation, up to 2.9% in the EU and 2.6% in the euro area. But with the fundamentals looking sound in the EU and governments taking care over public finances, growth in 2008 can still be expected to stay reasonably close to the EU's potential.

REFORMS WHICH PROTECT CITIZENS

Overall, the way for the EU to cope with the current shocks facing the global economy is to maintain sound and stable macro-economic policies supporting a balanced policy-mix and continue the course of structural reforms. With the Lisbon strategy for growth and jobs, the EU has the right policies and instruments to help it weather the current storms and continue to deliver growth and jobs. A strategy targeted on growth for the long-term is the best way to limit the effects of a temporary slowdown. Past efforts to achieve budgetary balance or surpluses in line with the preventive part of the Stability and Growth Pact are paying off as automatic stabilisers and can now play their full role in most cases. For a number of Member States the 2008 budgets foresee also tax cuts. A fundamentally sound growth-orientated economy is the best platform to resist a downturn. All Member States have national reform programmes that are peer reviewed at EU level. Member States have agreed country specific recommendations that are not yet fully implemented. At EU level there is strong convergence on the areas where further reforms are needed. The Commission has grouped them into four priority areas and set out actions that need to be taken at EU level in the Community Lisbon Programme:

- investing in people and modernising labour markets;
- unlocking business potential;
- investing in knowledge and innovation ;
- helping the EU to become a low carbon economy.

A concerted effort to accelerate the pace of reform and fully implement these policies will show citizens that policy makers are neither powerless nor inactive. The Spring European Council is scheduled to adopt the next three year cycle of the Lisbon strategy, ensuring that the process of reform and modernisation will continue to deliver results in the EU, providing additional security against turbulence in international markets.

REGULATING EUROPE'S FINANCIAL MARKETS

Financial markets are well regulated in the EU. Long before the current turmoil in financial markets, the EU has been working to promote financial stability, proposing rules to strengthen the prudential mechanisms of the EU financial system through a mix of regulation, soft law and industry-led self regulation initiatives. Whilst day to day supervision and regulation of financial markets is done at national level, the development of the EU's framework rules for a single capital market has led to new cross border financial products and services coming on stream, requiring in consequence a more coherent supervisory framework at EU level.

The European capital market is now the biggest in the world, and has grown strongly over the last decade, with the added stimulus of the euro. The European framework is composed of a series of comprehensive rules covering the securities, banks, insurance company law, auditing and accounting sectors. These rules set high standards of prudential control and investor protection, whilst encouraging competition and innovation. The rules require regulators and supervisors to cooperate across sectors and Member States. Thanks to the development of these policies, Member State supervisory authorities are working closely to reinforce further

co-operation on crisis prevention management and resolution¹. Such cooperation is also active at the global level, where regulatory dialogue and co-operation, for example in the Basle Committee, and between the EU and the US authorities, demonstrate successful ways of identifying and responding to challenges in financial markets.

EUROPE'S INITIAL RESPONSE

However, global financial markets are constantly innovating and evolving; policy makers need to be vigilant if regulation is to do its job effectively. In the immediate aftermath of the US sub-prime crisis the ECB and other central banks reacted effectively to deal with the liquidity pressures coming from disruption in many key financial markets. The recent financial turmoil has revealed gaps in the framework of regulations that govern the international financial system, in particular in respect of transparency of operation, predictability of rules and quality of risk management. Therefore, in October 2007 the ECOFIN Council adopted an action plan setting out very precise measures which need to be taken in the coming months to reinforce that regulatory framework. The plan is focused on four key areas of work: improving transparency; valuation of financial products; strengthening prudential requirements; and making markets function better (e.g. through better credit rating policy). These policy priorities remain fully valid. Work has been proceeding apace in the different fora. ECOFIN Ministers will consider at their meeting in March an interim report to the European Council setting out the progress made on the various issues.

SOVEREIGN WEALTH FUNDS

The current international financial situation has illustrated how sovereign wealth funds can help to stabilise markets by providing much needed sources of liquidity and investment. However, concerns have also been expressed about the motivation and lack of transparency of certain of these funds. In the accompanying Communication, the Commission sets out its analysis of sovereign wealth funds, proposes principles for a common EU approach and sets out guidelines which could be reflected in an internationally-agreed code of conduct to be adopted by the operators of the Funds.

STATE AIDS

When companies or banks find themselves in financial difficulties, this is usually the result of excessive risk-taking or management error. Unchecked subsidies to companies or banks in this situation distort the market, undermining the reward and sanction system which makes it work. Such subsidies can also put the burden of structural adjustment to those managing without aid. That is why state aid control is needed, to ensure that aid to undertakings in difficulties and the ensuing distortions of competition are limited to the minimum.

There is a particular need for vigilance in the case of banks, where problems in a particular bank can quickly spill over to the banking sector in particular, and the financial system as a whole. In these situations, decisive action and close co-operation between the Member State concerned and the European Commission is essential to achieve the goal of contributing to

¹ This work takes place in the Lamfalussy L3 Committees.

financial stability. State aid procedures have shown themselves equal to the task of intervening effectively.

THE NEXT STEPS FOR THE EUROPEAN UNION

Despite its size and the importance of its financial markets, the EU cannot resolve all of the problems in financial markets on its own. There are steps which can be taken by the EU to strengthen and protect its own financial markets, but the EU also needs to act in tandem with other international partners to build a safer and more transparent international environment for investors, both big and small. The important role for the EU in contributing to a co-ordinated global response also reflects the emergence of the euro as a major currency. The weight of the euro in the international financial system implies a particular responsibility for the EU, and more particularly the euro-area Member States, in playing a leading role in efforts to address weaknesses exposed by the recent turmoil.

Against a background of intensifying globalisation, the EU and its partners need a framework which offers the right incentives for long term financial efficiency and stability. This must be an open framework in which investment decisions can be taken with confidence in regulatory systems. This confidence requires that these systems are equipped to perform their supervisory roles, working in close co-operation with each other, reflecting the truly international nature of financial markets, and capable of preventing and/or managing future cross border crises.

The ECOFIN action plan identifies a set of concrete steps for the EU to take. The Spring European Council can build on this and go one step further. It offers an opportunity for all Member States to confirm the principles which will guide the EU in its internal work and in international fora such as the G8, the OECD and the Financial Stability Forum. These principles should include:

- primary responsibility for managing risks rests with individual financial institutions and investors;
- national regulatory and supervisory frameworks must be equal to the task in increasingly complex and innovative financial systems;
- co-operation between regulatory authorities in the EU and internationally to prevent and manage risks must match the needs of a progressively globalised financial system.

The EU should agree to work together with other international partners to:

- improve information provided by credit ratings agencies to ensure that investors can understand the risks associated with complex financial products and that ratings are provided on a solid basis. Credit ratings agencies need to improve their governance to show that they can guard against conflicts of interest. If these agencies prove unable or unwilling to act to address their weaknesses then the EU and others will come forward with regulatory measures.
- Update accounting and valuation rules to obtain consistent information on banks and other financial institutions' exposure to off balance sheet vehicles, and ensure

that clear and consistent guidance on valuation and disclosure of such risks is made available.

- Encourage prompt and full disclosure of losses by financial institutions.
- Improve EU early warning systems on financial stability through regular reporting from the Level 3 Committees.
- Foster the effectiveness of EU networks of financial supervisors and ensure strong and effective supervision of cross border groups.
- Work on a common practical framework for the assessment of the systemic implications of a potential crisis, including common guidelines for crisis management, and improved information exchange.
- Seek a political agreement between the Commission, the Council of Ministers and the European Parliament to deliver the necessary legislative changes (e.g. amendment of the Capital Requirements Directive) before April 2009 – and agree on rapid implementation.

Current economic pressures pose a challenge to growth and jobs – in Europe, and worldwide. Policymakers and regulators need to remain alive to changing circumstances, to be ready to adapt and to choose the right response at the right moment. The European Union has proved its ability to develop the prudential rules needed and to oversee a vibrant financial market in Europe. It has strengthened the fundamentals of the economy and is better placed to withstand the financial turmoil and limit the effect on growth. It can best retain the confidence of market operators and consumers alike by remaining vigilant and determined at times of added stress in the financial markets, working with international partners to identify weaknesses and to address these swiftly and effectively. The Commission will continue to play its role in promoting financial stability by coming forward with proposals as needed.