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# How should the EU respond to the financial crisis?

## About ACCA

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We have 71,000 members across Europe. Globally, we support our 122,000 members and 325,000 students throughout their careers, providing services through a network of 80 offices and centres around the world.

## Introduction

Data released in January 2009 confirmed that the eurozone officially slipped into recession in the third quarter of 2008[1] and the EU as a whole now faces a prolonged period of little or no economic growth. Consequently, confidence in the EU economy sank to a record low in December 2008, according to the European Commission's Economic Sentiment Indicator[2].

Implications of the financial crisis are likely to be prolonged and far-reaching. In the short-term, with tax revenues diminishing, unemployment rising and many governments having to bail out ailing banks, public budgets across the EU will come under pressure. It is likely that countries will exceed the Maastricht budget deficit limit of 3 per cent of GDP, in some cases, by a significant margin. All of this will provide the first real test of the eurozone's sustainability.

In the medium to longer term, it is inevitable that 2009 and beyond will see greater regulation of the financial services industry in the EU and globally, with the implementation of further steps to enhance transparency and stability of financial markets being an important goal. Germany's Chancellor, Angela Merkel, has gone further, outlining the need for better regulated financial markets across the world, saying that she would 'react very strongly' if attempts were made to block tighter regulation and calling for the creation of an economy body at the United Nations, similar to the Security Council, to judge government economic policy[3].

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[1] Eurostat, 8 January 2009
[2] European Commission, http://ec.europa.eu/economy_finance/indicators/business_consumer_surveys/2008/bcs_2008_12_en.pdf
[3] Speaking at the "New World, New Capitalism" symposium, Paris, 8 January 2009

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This paper explores some of the impacts of the financial crisis on the EU, recommends key areas that decision-makers need to be aware of, suggests priorities for immediate actions and suggests issues of relevance for the financial services sector.

## Summary of key points

1. The crisis has exposed weaknesses in both the EU's and wider Europe's regulatory systems. As a result, it is inevitable that the EU will adopt tighter rules for the financial sector. However, the priority should be to ensure that existing legislative and regulatory measures are implemented and enforced effectively across the EU, rather than reactively rushing through new legislation.

2. The financial crisis has reinforced the case for a serious reform of the institutions of global economic governance. The EU should take a lead here in shaping the new global governance around progressive values.

3. The financial crisis will be a test for the euro. If the currency looks to be weathering the storm convincingly, the debate may be reopened in some of the non eurozone countries regarding whether they should join. The banking crisis and a prolonged period of little or no economic growth will also provide the first real test of the eurozone's sustainability.

4. If the Recovery Plan is to be successful, member states will need to ensure that banks, especially those receiving support, make lending available and ensure that interest rate cuts are passed onto borrowers.

5. Although the option of a single European regulator is being discussed, we should avoid any option that creates too much centralisation and bureaucracy, or that risks a one-size-fits-all approach.

6. The bail out of Europe's banking sector will make it harder to resist state support for other industries, while weaker economic growth may lead to greater calls for protectionism.

7. There will be a debate around the push to get banks lending to business again. Some businesses will have become "bad" as a result of the lack of credit and are now a greater risk than they might otherwise have been. It will be come more difficult to provide "good banking".

## The EU's role

In 2008, Europe's central banks, led by the European Central Bank (ECB), injected large amounts of liquidity into money markets and encouraged banks to borrow against an increased range of collateral, in order to thaw the frozen markets and shore up confidence in the financial system. This tactic had little impact after the initial bounce where share prices rebounded around the world and

frozen interbank lending markets showed some signs of thawing. Banks remained reluctant to lend to each other and confidence remained low.

This began to improve, however, towards the end of the year, after various EU governments, including Germany, France, Italy and a further 12 countries, adopted the main points of the 13-point action plan outlined by Gordon Brown.

Although the EU did not have a direct role in the bank bail-outs and the small upturn in confidence in the money markets, the coherent response and unity of the EU Heads of State or Government to the financial crisis has been a key factor for responsiveness and effectiveness, with the Summit of the euro area countries resulting in a declaration on a concerted European action plan of the euro area countries[4] confirming their commitment to act together in a decisive way to restore confidence and proper functioning of the financial system.

It is vital that governments increase cooperation and that they work together at EU and global levels to devise ways of bringing the financial crisis to a conclusion.

## The Economic Recovery Plan

The two-year recovery plan, which is equivalent to 1.5 per cent of the EU GDP, is made up of a fiscal stimulus of €170 billion from national stimulus budgets and €30 billion from the EU budget and the European Investment Bank. European Commission President José Manuel Barroso has not ruled out raising the amount if the crisis escalates.

The programme is aimed at breaking the vicious circle of loss of jobs, the economic slowdown and bringing back confidence in consumers and in the business sector.

The thinking behind the co-ordinated approach is that the fiscal measures will be much greater if they are part of a co-ordinated European response that will create multiplier effects. A co-ordinated approach will also avoid the effect of individual countries going it alone and running into problems, such as getting punished by capital outflows and seeing some of their stimulus leaking into imports from other countries.

If it is implemented fully across the EU, the Recovery Plan will shore up the real economy, help increase consumer confidence and restore stability to the financial markets, thus boosting lending to businesses and individuals.

However, if the Recovery Plan is to be successful, member states will need to ensure that banks, especially those receiving support, make lending available and ensure that interest rate cuts are passed onto borrowers. Community policy, structural reform, monetary policy and budget reform also need to be addressed to immediately stimulate economic growth in a co-ordinated manner.

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[4] EU Presidency, http://www.ue2008.fr/PFUE/lang/en/accueil/PFUE-10_2008/PFUE 12.10.2008/sommet_pays_zone_euro_declaration_plan_action_concertee, 12 October 2008

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## The Euro

The effect of the financial crisis on the euro has been twofold. Firstly, as smaller European currencies have suffered at the hands of investors during the financial crisis, several of them have become more supportive of joining the currency.

For example, polls in Denmark, a country which has already rejected the euro twice, now show a majority of people in favour of joining, and polls in Iceland show that up to 70 per cent of Icelanders favour joining the EU and adopting the euro. Hungary has also said that it may speed up entry to the euro following the damaging run on the Forint, although the fall in the pound against the euro over the past six months has not led to an upsurge in British support for the currency, in spite of media speculation. As and when this happens, the EU will have to consider the impact of weaker currencies joining the eurozone, including such considerations as: will they drag the euro down? Will they be able to meet the economic criteria, and if they do, what will be the overall impact on their economies?

However, even as the euro enjoys unexpected popularity, it is facing its greatest test. Over the next few months, as the economic conditions and economic policies of the 16 eurozone countries begin to diverge, the banking crisis and a prolonged period of little or no economic growth will put the currency under pressure it has not yet experienced, as job losses increase and businesses go under.

Whilst the Commission may hope the effect of this may focus attention of governments with the worst records of reform, control of public finances and competitiveness, it is not immediately apparent who or how the necessary regulations will be implemented.

There is no precedent in economic history of one currency being used by so many distinct economies without a single government or single economic policy. Predictions from eurosceptics that the euro would collapse have so far proven wrong, and it is fair to say that some of the smaller economies especially would have been even more badly damaged had they not been in the eurozone. The next year will be the real test.

## Regulation

After the initial crisis, thoughts are now inevitably turning to the regulatory response, especially as leading banks in several EU member states have been part nationalised and the overall bill for the various national schemes across the EU could reach as much as €2000, 000, 000, 000.

The risk in situations such as this is that politicians will be tempted to bring in ‘knee jerk’ regulation in reaction to calls for action to prevent a recurrence of the situation. However, we caution against reform of the regulatory regime being seen as the only solution, as the inadequacy of the regulatory regime far from being the only cause of the crisis.

Regulation brought in in this manner is rarely well designed and has often not had the benefit of rigorous and transparent impact assessment. This can result in legislation having unintended consequences and actually damaging the businesses it aims to protect. ACCA, as a representative of many SMEs across the EU, is extremely concerned at this possibility.

The better regulation principles and the Commission's aim to cut down on unnecessary legislation by 25% by 2012 are both good steps. However, the financial services industry has been subject to far-reaching regulatory reform in the past five years and we now await the comprehensive overhaul of the Accountancy Directives, with Barosso having put pressure on the Commission to introduce liberalisation of the 4th and 7th Accounting Directives by October 2009.

The priority now should be to ensure that existing legislative and regulatory measures are implemented and enforced effectively across the EU, rather than reactively rushing through new legislation. The body of EU financial services regulation must also be reviewed to ensure that it is appropriate and enforceable, before its transposition into national legislation.

## A single European Regulator?

Financial services is becoming increasingly pan-European, and cross-border activity continues to grow. In the light of the current turmoil, calls for greater cross-border supervision are likely to increase. This may take the form of a single, pan-European regulator, (which would involve changing the treaty to create a single regulator or system of European regulation, replacing the 27 individual regulators); a single regulator for the eurozone only; a European system of financial supervisors; a common rule book, whereby all national financial regulators would have to enforce a single set of rules; or a central European authority to supervise pan-European financial institutions.

In October 2008, the European Commission appointed a committee led by Jacques de Larosière, to establish what this cross-border supervision might look like. Individual member states have submitted views and an option is likely to be chosen in spring 2009.

Before any decision is taken however, a number of questions need to be addressed, including: what type of fiscal resources should any pan-European regulator or system of financial supervisors have access to? How effective would group supervision be in creating a unified system of supervision across the single market? Would group supervision assert the primacy of large supervisors to the detriment of the supervising bodies of smaller Member States? Do we need a rethink of the home-host country divide with regard to EU supervision and crisis management?

Whatever is decided, we should avoid any option that creates too much centralisation and bureaucracy, or that risks a one-size-fits-all approach.

What might be a more palatable option to some member states rather than the establishment of a single European regulator would be to strengthen the powers of the three 'Lamfalussy' committees[5]. This would increase harmonisation, although not as much as the creation of a single, EU regulator, would avoid the costly creation of a new body, and would improve communication between regulators.

## Accountancy

In response to political criticisms that fair value accounting rules caused some of the of the market volatility, the International Accounting Standards Board (IASB) has revised its rules on fair value accounting. Some countries now want the EU to seek exemptions from the international standards. This would be a serious step backwards.

The EU decision to use IASB standards (IFRS) as the basis for EU accounting standards, together with the Securities and Exchange Commission's (SEC) decision to allow foreign SEC-registered companies listed in the US to use IFRS without reconciling to US GAAP, were major milestones for EU listed companies and more generally for the development of IFRS as the global accounting language.

Rather than reverting to disparate sets of regional rules, the focus should now be on ensuring that IFRS continues to be a high quality, largely principles-based accounting language. An essential requirement for this is that the governance and process arrangements for the IASB (as the standard setting body), and its parent foundation, the IASCF, are in proportion to the global reach of its standards.

The EU authorities should engage from the beginning of the standard setting process to ensure that the IASB is aware of their views on accounting issues. The EU should also encourage EU companies and others to contribute to that process. As more and more countries adopt IFRS, it becomes ever more important that those with IFRS experience share their views and knowledge.

If this can be achieved through the consultative process, it should be possible for EU public and private sector parties to contribute to the evolution of individual standards, from the initial standard setting phase. In most cases, the EU authorities should then be in a position to give their support to new standards, as they are issued by the IASB.

## The Lisbon Agenda

The full impact of the financial crisis in terms of unemployment is of course not yet known, although the European Commission has released figures confirming that growth and jobs are being badly affected across the EU[6], a situation which is

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[5] The Committee of European Banking Supervisors (CEBS), the Commitee of European Insurance and Occupational Pensions Supvisors (CEIOPS), and the Committee of European Securities Regulators (CESR)

[6] European Commission, http://ec.europa.eu/growthandjobs/index_en.htm, 7 January 2009

only likely to worsen. This demonstrates the importance of the Lisbon Strategy, the set of reforms focusing on market liberalisation, innovation, job creation and social inclusion, and sustainable development and the environment.

Although some member states have shown encouraging results and a strong performance with regard to the Lisbon objectives, it is clear that many EU countries will miss key targets on employment, climate change and education.

Consequently, on 14 March 2008 a new three-year cycle of the Lisbon Agenda was brought in, which sets out reforms aimed at keeping the member states on the reform path. Reforms seen as being essential to shore up Europe's economy in the face of global economic turmoil.

The Lisbon Agenda should be promoted, with sharper, more realistic goals linked to action plans which commit the EU Member States to implementing reforms in the labour markets and financial services sector should be a key priority.

## The Environment

It is clear that the impact of the financial crisis will extend far beyond economics. Many fear that the downturn is likely to have an adverse impact on environmental policy, by distracting leaders from dealing with climate chance and making European businesses and government more reluctant to work towards cutting emissions of greenhouse gases.

The concern is not just that the trillions devoted to rescuing the global financial system mean less cash for the climate-change agenda, but also that a prolonged recession will mean that the public reject green options and that there is a reduction in the amount available from both government and the private sector for research and development into green technology.

However, until the recent financial crisis, the accepted thinking has been that the necessary investment will need to come from private investors and carbon markets such as the EU Emissions Trading Scheme (ETS). In fact, climate change may well become the way many governments are looking for to ‘spend themselves’ out of recession. Many now argue that the only way to reverse the current economic spiral is through investment in green technologies and jobs.

Indeed, we should expect climate change to progressively become the area to which government spending will be directed, across the EU, including investment in renewable energy and the low-carbon sector, leading to the creation of thousands of new ‘green collar’ jobs. This is timely, both due to the need to reconsider the EU’s dependence on Russian gas and because the EU, along with the rest of the world, needs to ensure that it is prepared for a future where oil will be both more expensive and scarcer. The EU needs to actively look for alternatives now and create investment and jobs in this area.

## Global Governance

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The financial crisis and other issues such as climate change, are too big for individual nations to tackle on their own. Governments are looking more and more to global agreements and solutions. However, while the problems are global, financial regulation is national. Moreover, the so-called Bretton Woods institutions, the World Bank and the International Monetary Fund, have proved insufficient at spotting, preventing or controlling global financial crises, especially the current one.

The financial crisis in particular has raised issues of global governance which need to be addressed. These include, for example, the need to improve co-ordination at global level and to review the role of international financial institutions such as the World Bank and the International Monetary Fund.

The Commission has already outlined its support for international efforts to provide a consistent framework for addressing investment issues at global level, including on the IMF General Agreed Principles and Practices on Sovereign Wealth Funds.

However, in areas such as accounting, being too prescriptive with global measures could backfire. Issuing guidance that results in mechanical rule-following would be a recipe for disaster. Principles-based standard setting and professional judgement have a vital role to play and should not stifle recovery.

While the crisis has revealed some flaws in Europe's own regulatory system, the EU is still well placed to play an active role in designing new global structures and ensuring that they are transparent and accountable and that developing countries as well as others are represented, in order to increase the legitimacy of the decision-making process.

Europe should make sure that it plays an active part in shaping the new global governance around progressive values.

## For further Information, please contact:


Veena Hudson
Public Affairs Manager
Email: Veena.Hudson@accaglobal.com
Tel: +44 (0) 20 7059 5615
Mob: +44 (0)7736 800 393

Clive Booth
Director Public Affairs and Media Relations
Email: clive.booth@accaglobal.com
Tel: +44 (0) 20 7059 5511
Mob: + 44 (0)7913774053