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THE STABILITY OF FINANCIAL MARKETS

The European Council will discuss the economic situation and progress in ongoing work on financial market stability, on the basis of an interim report from the Economic and Financial Affairs (Ecofin) Council, and in the light of the sustained volatility on global financial markets since last August.

The Ecofin Council's interim report, approved at its meeting on 4 March, can be found in document *6784/08*.

The Commission has also submitted its contribution, a communication entitled "*Europe's financial system: adapting to change*" (*6930/08*).

The economic situation

The global economic outlook has deteriorated with the turbulence on financial markets, and also as a result of a slowdown of economic activity in the United States as well as higher oil and commodity prices.

The Ecofin Council's interim report notes that growth in the EU economy is expected to moderate this year, although the extent of the slowdown should remain limited in Europe because of strong fundamentals, and because of the absence of significant macroeconomic and financial imbalances.

In an interim forecast issued in February, the Commission revised growth prospects for 2008 downwards to 1.8% of gross domestic product (GDP) for the euro area and 2% of GDP for the EU as a whole. While this represents growth only a little below potential, the outlook remains subject to a number of risks, notably from the external economic environment.

In the current context, the Council's report states, economic and financial policies in the EU should be geared towards ensuring macroeconomic stability and pursuing structural reforms.

The European Council will highlight the need to avoid complacency and to sustain reform efforts. In order ensure greater stability of financial markets, action is required to strengthen their transparency and functioning and to further improve the supervisory and regulatory environment at national, EU and global level.

The European Council will acknowledge that recent significant increases in food and energy prices have contributed to inflationary pressures. It will recall the need to avoid distortionary policies that prevent the necessary adjustments by economic agents. It will invite the Council to identify the driving forces behind developments of commodity and food prices, and to pursue policies which remove possible supply limitations.

Ongoing work on financial stability

The European Council will review work on a series of initiatives launched by the Ecofin Council at its meeting on 9 October in response to weaknesses identified in the financial system.

These combine actions of both a regulatory and non-regulatory nature around four main objectives:

- improving transparency in the market, notably as concerns banks' exposures relating to securitisation and off-balance sheet items;
- upgrading valuation standards to respond in particular to problems arising from the valuation of illiquid assets;
- strengthening the EU's prudential framework for the banking sector, e.g. with respect to the treatment of large exposures, banks' exposures to securitisation as well as liquidity risk management; and
- investigating issues such as the role played by credit rating agencies.

The European Council will underscore the need for prompt and full disclosure of exposures to distressed assets and off-balance sheet vehicles and/or of losses by banks and other financial institutions. Improvements are needed to the prudential framework and the risk management of individual institutions.

Policy action will focus on the four areas identified by the Ecofin Council. The European Council will call on the Council, the European Parliament and the Commission strive for agreement by April 2009 on amendments to the directive on the capital requirements of financial institutions. As regards market functioning and incentive structures, including the role of credit rating agencies, it will confirm the readiness of the EU to consider regulatory alternatives if market participants do not rapidly address the issues.

Financial services regulation and financial supervision

At its meeting on 4 December, the Ecofin Council assessed the work of the so-called Lamfalussy process for financial services regulation and supervision[1], reviewing developments and identifying potential challenges.

[1] Developed in 2001 and named after Alexandre Lamfalussy, chairman of the EU advisory committee that helped develop it, the Lamfalussy process is aimed at providing increased flexibility in legislative process so as to allow it to better respond to technological change and market developments, and to allow convergence in national supervisory practices. Introduced initially for the securities sector, it was later extended to the banking and insurance sectors.

Whereas the Lamfalussy process is generally viewed as working well, the Council examined ways of improving the overall functioning of its structure and procedures, and of intensifying convergence and cooperation amongst national supervisory committees.

It agreed on a detailed timetable for further actions to be undertaken at all levels of the Lamfalussy structure.

The European Council will call on the Ecofin Council to swiftly implement its work programme, making further progress during the spring. Main issues include improvements to and the convergence of key supervisory rules and standards, convergence of regulatory/financial reporting clarification of the relationship between home-host authorities, the role of colleges of supervisors, and improvements to the functioning of supervisory committees, as well as consideration on inclusion of an EU dimension in the mandates of national supervisors.

Arrangements in the event of a financial crisis

At its 9 October meeting, the Ecofin Council also reviewed management arrangements to be followed in the event of a financial crisis with cross-border implications.

Financial integration in Europe has resulted in an increase in the number of cross-border banking groups, and the trend is set to increase. There are now 46 cross-border banking groups, of which 21 have significant operations outside their home country. As a result, a crisis involving a bank is more likely to have cross-border implications.

An EU crisis-management simulation exercise held in Frankfurt in April 2006 revealed broad variations in national approaches to processes such as information sharing and cooperation, the assessment of systemic implications and decision-making, as well as to the sharing of potential costs.

At an informal meeting in Porto on 13 and 14 September 2007, ministers and central bank governors agreed that further actions should be taken to ensure that EU financial stability arrangements are in line with evolving financial markets. The Council in October accordingly approved common principles for cross-border financial crisis management and a detailed timetable for strengthening financial stability arrangements.

A further crisis simulation exercise is scheduled for the spring of 2009.

The European Council will call on the Ecofin Council to swiftly implement the work programme it agreed in October, making further progress during the spring. Tools and procedures should be enhanced and, as a first step, a new memorandum of understanding on cross-border cooperation between the relevant authorities is expected to be signed in the spring[2]*. On the basis of further work by mid-2008, the Council should also scrutinise the functioning of deposit guarantee schemes.*

In addition, early warning systems at EU and international level should be enhanced, including by strengthening the role of the IMF in oversight of macro-financial stability. On financial stability issues, the EU should work in close cooperation with its international partners in the relevant fora.

Sovereign wealth funds

[2] The current memorandum of understanding dates from May 2005.

The European Council's discussion on the stability of financial markets is expected to also cover the role of sovereign wealth funds.
These are state-owned investment vehicles funded by foreign exchange assets, the biggest of which are sponsored by China, Kuwait, Norway, Saudi Arabia, Singapore and the United Arab Emirates. More than 30 countries have established sovereign wealth funds since the early 1950s, most of those in the last eight years.

They are estimated to control assets of between EUR 1.5 and 2.5 trillion – more than all the world's hedge funds together – up from several hundreds of billions a few years ago.

At its meeting on 4 March, the Ecofin Council discussed the issues raised by sovereign wealth funds, on the basis of a communication from the Commission, entitled "*A common European approach to Sovereign Wealth Funds*" (*6944/08*).
The Commission suggests promoting the definition at international level of a code of conduct – involving the sponsor countries – in order to ensure greater transparency, predictability and accountability in sovereign wealth funds.

The European Council will emphasise the useful role played by sovereign wealth funds as capital and liquidity providers with a long-term investment perspective. However, it will acknowledge concerns related to the potential non-commercial practices of new players with limited transparency regarding their investment strategy and objectives.

The European Council will confirm the need for a common European approach, taking into account national prerogatives, in line with five principles proposed by the Commission, namely:
- *commitment to an open investment environment;*
- *support to ongoing work in the IMF and the OECD;*
- *use of national and EU instruments if necessary;*
- *respect of EC treaty obligations and international commitments;*
- *proportionality and transparency.*

The European Council will endorse the aim of agreeing on a code of conduct for sovereign wealth funds and defining principles for recipient countries at international level.

Delegations agreed on the need for the EU to forge a common position, so as to help ensure that their shared objectives are met through the work of international fora.

Follow-up

Ministers and central bank governors will take work forward on the various issues at an informal meeting at Brdo, near Ljubljana, on 4 and 5 April. The meeting will focus on the economic situation, market developments and financial stability.

The European Council will invite the Ecofin Council to continue to give high priority to these issues in the coming months, with a major review of progress in April, and to monitor closely the situation so as to react swiftly to any possible adverse developments. The European Council will come back to these issues as appropriate and at the latest in autumn 2008.