SESSION SUMMARY - BERLIN SEPTEMBER 2020

Should financial sovereignty be a key objective for the EU and what are the priorities?

1. Defining 'sovereignty'

A Central Bank official outlined that sovereignty is a complex topic with tensions between maintaining control and taking autonomous decisions on the one hand and the reality of global financial interdependence on the other.

A policymaker confirmed that one of the key objectives of the European Commission is to consider what can be done to make Europe more sovereign. In the past, there has been a great deal of reliance on the change in the rule of law between Europe's jurisdictions and other parts of the world, but the world is changing, and Europe needs to re-evaluate its role in the world. The geopolitical background is now one of competing interests and competing jurisdictions. This relates not only to financial services but also digital and security. Europe needs to consider what its role is in these things and how sovereign it wants to be. These questions are particularly pertinent in light of the supply chain issues that have arisen in the wake of the COVID crisis.

The Commission has three particular concerns: financial stability with control over Europe's financial market infrastructure; competitiveness with key financial companies in and outside Europe; and Europe's ability to conduct its own policy without outside undue influence from third countries

A Central Bank official underlined that the COVID-19 crisis, Brexit and the issues in Hong Kong have demonstrated the fragility of global economic integration. Global financial markets might not always be available. Therefore, it is an important discussion "how much" sovereignty Europe needs.

2. Improving EU financial sovereignty

2.1 Three key elements

A policymaker highlighted three elements for improving EU financial sovereignty. First, the EU financial markets need to be attractive internationally. Completing Capital markets union (CMU) and Banking Union are very important in this respect.

The second element is financial market infrastructure. There needs to be an assessment of the vulnerabilities Europe's financial market infrastructure to political pressure by third countries and an assurance that Europe will retain control of it. Equally, consideration needs to be given to what can be done to make the euro more attractive for commodities trading. In addition, one has to have a state-of-the-art digital financial infrastructure for the pan-European use of tokens, cloud solutions, blockchain technology, etc.

The third element is sanctions. Sanctions linked to financial market infrastructures and currency are increasingly used to project foreign policy. A blocking statute is in place, but it is difficult to enforce and has not always worked the way it should have. Consideration needs to be given to better enforcement of sanctions by member states and to whether the blocking statute can be improved.

2.2 Effective and fair enforcement of international agreements is essential

A Central Bank official noted that the European Parliament rejected the first SWIFT agreement in February 2010.

An official highlighted that the Commission is sometimes hesitant to apply its own rules, as seen with the European financial sector delivering data to the US despite the US not being compliant with the General Data Protection Regulations (GDPR). The Commission needs to be able to stand up to the Americans during negotiations rather than undermine its own rules out of fear.

2.3 IT sovereignty is essential

An industry representative stressed that financial sovereignty cannot be achieved without 'sovereign IT'. Sovereignty has three components: the technological component; the legal framework; and the economic core of European players.

2.4 The strength of EU financial players is essential for EU sovereignty

An industry representative stated that a strong financial sector is necessary for a sustainable economy and that that financial sector should not be at the mercy of non-European actors, which would leave it in a position of dependency.

Another industry representative stressed that the purpose of financial sovereignty is to ensure the efficient provision of financial services to the real economy.

There are two components to a financial services sector: its strength and its stability. Strength can be measured by the capital ratios of the banks and by their earnings capacity. Currently, the capital ratios are depleted, and their earnings capacity are not strong enough to invest or to absorb further shocks. Meanwhile, stability has been affected in the wake of the 2008 financial crisis with changes in the mix of international and domestic banks in particular territories.

The question for Europe is what control it has over its financial infrastructure. It is not about excluding foreigners but rather it is about governance and influence at a time of crisis to ensure stable provision.

A Central Bank official highlighted that Europe is trying to develop something new in terms of sovereignty at a non-state level.

2.5 The expectations of shareholders regarding the EU banks should factor in the positive consequences of a now stricter banking regulation

An industry representative stressed that return on equity should be linked to the interest rate level and to the risks that are borne by the equity, the bank or the issuer in question. Banking institutions can be content with relatively lower returns on equity where there are no shareholders demanding a larger percentage dividend. Regulators and the general public are calling for a less risky banking industry with lower real returns on equity and even lower nominal rates on equities. The issue is not just about the inefficiency of the banking system but also about changes in the environment and in the business models.

3. The risk of unbalanced EU sovereignty

An official highlighted that 'sovereignty' implies control over people but that this is not what the financial system is designed to do. Some jurisdictions, notably the United States, are using their currency as a weapon but this will backfire because it undermines the attractiveness of their jurisdiction as a destination for investment. Adopting such behaviour would penalise the EU even further because the euro is not as important as the US dollar in global financial and trade transactions.

In terms of financial flows, 'financial sovereignty' makes as much sense as 'trade sovereignty'. Financial flows are simply the flipside of trade flows. If Europe does not want to shut itself off from a globalised world, it does not make sense for it to talk about financial sovereignty.

It is clear that the Commission is trying to make Europe more attractive as a destination for investment and to improve the payments infrastructure. The issue here, however, is Euro currency clearing in London, which is a part of the financial infrastructure that is beyond Europe's jurisdiction. This therefore has less to do with financial infrastructure and more to do with risk management.

The other elements that will make Europe more attractive, such as CMU, banking union (BU), modernisation, the digital economy, greening and investor-friendliness, are all worth pursuing but they are an end unto themselves, not a means of reaching financial sovereignty.

An industry representative suggests that people should not be caught up in semantics over the word 'sovereignty' and acknowledges the tension between control and interdependence. What is important is that Europeans are in charge of the financing of their continent. There is nothing wrong with interdependence but, equally, dependence is a concern.

A Central Bank official acknowledges the tension between a liberal approach and the observation that the environment has changed. Sovereignty is usually attributed to states. Applying it at the European level is an interesting idea but perhaps has some flaws with regards to financial markets, as it is impossible to be completely independent and sovereign in this world.

4. The importance of a level playing field between EU and non-EU players

An industry representative stated that openness is good for the development of the financial system but only if there is a level playing field. In that regard, Europe should not be naïve when setting out its regulations and legislation. Otherwise, globalisation will turn into Americanisation.

An industry representative suggested that sovereignty does not necessarily mean being closed behind borders. It could be open, but this requires a level playing field. European values of transparency, openness, reversibility, and not having a locked-in market must be adhered to by anyone operating in the market.

There needs to be clarity on which statute or regulation applies to data and whether, for example, any Chinese or US extraterritorial regulations apply. The trade association CISPE is developing a data protection code of conduct, which will soon be approved by the European Data Protection Board. A level playing field with competitors has already been developed with certain rules, for example rules stating that European data should only be stored and processed in Europe and rules limiting access to customer data. A single code of conduct should be developed on reversibility, data protection and cybersecurity that takes account of all the rules that apply to the financial sector in Europe.

5. Cyber-risk and IT sovereignty

An industry representative stated that financial institutions take cyber-risk seriously and that they are taking necessary measures. The difficulty is that the hackers may be states rather than private individuals or private companies with access to greater means than the financial institutions. Fortunately, there is a great deal of cooperation amongst institutions under state supervision. Institutions want to ensure that control over data is maintained but this can be difficult in the current environment.

Keeping data within Europe and improving cybersecurity is more an issue of physical capacity and global standards rather than just money. Europe, in terms of data storage and IT in general, is in a situation of dependency and has lost its sovereignty, partly due to the number of skilled Europeans that have gone to work for non European providers.

An official confirmed that Europe's Finance Ministers are aware of the cybersecurity risk and the importance of proper data storage. Sovereignty, however, is not just about rules but also about political and military strength. The EU has perhaps the best data regulation framework in the world, but it is hesitant to apply it. European actors seem ready to break their own rules in order to provide American institutions with data.

6. The role of policymakers and financial players in achieving optimal sovereignty

A Central Bank official stated that a dynamic financial market in Europe cannot be constituted by politics but instead has to be built by market forces. The European Union, as a regulator and legislator, is unable to guarantee financial sovereignty but it still has a role to play because the legislative and political framework can inspire and encourage market forces that then lead to a stronger European financial market.

7. The next steps

7.1 Transparency further empowers EU citizens to make their own choices

An industry representative stated that, in order to increase financial sovereignty, greater transparency within the financial sector is required. The sector needs to be far more open about what it does and what it contributes towards the communities it exists in.

7.2 Market openness and the improvement of resilience and efficiency

A Central Bank official suggested that the shift in attitude towards financial markets should not be one of moving away from participation in global financial markets. The objective of all European financial regulation has been to open up the markets within the EU, for EU and non-EU market participants. The aim of EU financial regulation is to build a strong European financial marketplace. For building up such a strong, international, relevant financial market, progress in important projects, such as the BU, the CMU and various others, is needed.

Consideration needs to be given to the notion of financial sovereignty from the supervisors' point of view. The ability of EU regulators, supervisors and central banks to secure European financial stability on their own may be in question if relevant market operations take place outside the EU regulation. EU domestic financing should be handled on capital markets within the continent. Today, however, one third of the EU capital market activities are handled in London, for example. Trading in interest rate swaps is 85 percent conducted in London, while 37 percent of global foreign exchange trading is conducted in London and only 11 percent in the EU.

With the new digital technologies, a new means has opened up of combining all the strengths of the various European marketplaces together to function like one "digital market" with the necessary depth and product variety to be attractive to outside investors.

Another Central Bank official noted that central clearing counterparties (CCPs), while important for financial stability, are a monopoly by nature because the greater the concentration the greater the benefit for clients. London provides a great financial centre, but the United Kingdom has decided to leave the EU.

In the context of whether different EU countries are competing against each other, a Central Bank official remarked that, when people have a cake in front of them, they can either compete for the largest slice or they can work together to make the cake bigger.

7.3 Understanding what investors want

An industry representative stated that BU and CMU are both trying to achieve the same goal, which one could call 'financial sovereignty', but there is a significant difference between the two in that the BU requires a greater focus on legislation while the CMU, though it also requires legislation, cannot be ordered top-down. Investor flows and the buy side are required. The buy side in the UK has always been one of the core strengths that has been misunderstood in the Brexit discussion. This broader perception needs to be understood in terms of what the investors want and how to attract them. There is an opportunity for Europe to leapfrog others and to create the markets, particularly in the space of environmental, social and governance (ESG) in terms of climate bond initiatives. The Americans are not doing this under their current administration, and so there is a tremendous opportunity to be at the forefront.

7.4 Improving the efficiency of retail payment infrastructures and becoming closer to clients

An industry representative stated that the European Payments Initiative (EPI) is a prime example of European banks taking their destiny into their own hands and illustrates that sovereignty need not lead to inefficiency. Historically, attempts at cooperation between multiple banks have failed but the environment is different now. Coordinating the 16 banks involved in the EPI and achieving the desired goals will still be a challenge but the timing is certainly right.

Banks also have a tremendous opportunity to be closer to their clients with digital interactions across channels having increased by 7 to 10 times during the current crisis. In the last crisis, the banks were seen as the 'bad guys' but, this time, the banks are part of the solution. Banks need to leverage this opportunity to be closer to their clients and to better understand them. This will allow banks to step up and ultimately support the European economies.

An industry representative stated that their organisation is taking steps in relation to data and the EPI in order to be a better master of its future. In both cases, it is a matter of the cost benefit. The bank's main asset is the trust of its customers. A customer's data is, in a way, a customer's trust and banks should therefore be prepared to pay extra to protect that data. In addition, if European banks do not invest in the EPI, others will step in and payments will end up going through a non-European provider.

7.5 IT, data and data service providers

An industry representative the importance of knowing which regulations apply to data. For instance, where data is stored does not necessarily determine which regulations apply to it.

Most of the value of an ecosystem will come from the data. The question is how that data will be shared amongst the players of that ecosystem to generate value. The European Commission published a data strategy in February 2020, looking at how data will be used to generate value in Europe.

Value generation out of the data can be done by any financial institution but it can also be done by technology providers. A pure player in the financial sector may be reinforcing their future competitors by using their algorithms. They therefore need to think carefully about who they want to work with and who could extract value out of their data. In particular, continuously reinforcing non European organisations means that European actors could be in a weaker position when negotiating with overseas entities.

7.6 The importance of various levers alongside 'EU digital autonomy'

A policymaker outlined that the Commission wants to keep the EU open and stated that a more pertinent concept than 'financial sovereignty' is 'open strategic autonomy'. European foreign policy is being influenced by the use of secondary measures leveraging on financial market infrastructures, other financial companies and the use of the dollar. Several dimensions are at play, such as financial stability, competitiveness, the level playing field, BU, CMU and foreign policy at large. These all come together and there are different instruments that can be used to try to achieve these different goals. This must all be considered in a broader strategy that touches on, for example, security, technology and data.

The Commission is aware that not everything can be achieved through legislation; it is also up to the market.

Europe has to consider the value of the independence and the control that it has over its own infrastructure also in view of preserving financial stability in the EU versus the trade-off in relation to, for example, additional costs for setting up such infrastructure at least in the short term.

An official noted that economic strength obviously increases economic power, which relates to the importance of Europe having its own critical infrastructure. The issue is whether that infrastructure can be upscaled to the extent that the US financial system is no longer needed. This is a particular problem in relation to money transfers and the system of correspondence banks in Africa where American institutions are unavoidable because there are only two institutions left that go through the trouble of dealing with anti money laundering (AML) regulations.

An industry representative calls for more alignment along the European and international layer. Clients find it impossible to consolidate their balance sheets and achieve integrated liquidity management in European markets due to differences amongst national regulators. Though there may be competing interests at play, a more coordinated effort is required to understand what the European banking and financial sectors need and how to improve them.

A Central Bank official cautioned that the new environment of digitisation might also make it necessary to modernize “classic” projects like the BU and the CMU. When a clearer picture of the desired outcome has been reached in relation to a digital financial market, it might be necessary to identify new priorities.

8. Key success factors

A Central Bank official recognised that the concept of ‘financial sovereignty’ may not mean the same thing for everyone. It also needs to be recognised that the world is changing. Europe today, unlike its founding fathers, has perhaps been too inward-looking. Europeans could be brought together on the realisation that Europe has enemies that are building their capabilities to destroy or attack them. At the very least, this realisation will help in properly assessing the risks.

It is important to develop a legal framework and the capacity to resist some partners worldwide while at the same time building up the competitiveness and the efficiency of the system.

The consumers and the citizens have not been present during this discussion, and so the views expressed have only come from the industry and public authorities. The public opinion may be different, but the main goal remains increased efficiency and ensuring that finance is going where it is needed. In that regard, there have been some failings, particularly with regard to energy transition and population reskilling.

There are many good reasons to retain some control. It is about making the choices that the democracy wants to make at a certain moment, and the indications given by the European Commission on digital and climate are the right ones and properly reflect some of society’s main concerns.

Europe can be proud of what the euro system is doing, even if this constantly has to be proven. As compared to the financial crisis, Europe has reacted well in the face of the COVID-19 crisis by providing liquidity solutions and facilitating better coordination with respect to the independence of both the monetary and the budgetary sides. ■