Open strategic autonomy and EU economic security

Introduction

The objectives of strategic autonomy in the financial sector are clear, but implementation remains challenging. Deepening banking union (BU) and the capital markets union (CMU) is the right way forward, but it is difficult to make progress on those shared priorities.

The EU banking sector remains fragmented in part due to a sub-optimal capital and liquidity allocation between the parents and subsidiaries of pan-European banking groups, low profitability levels, different legal systems and so on. A key challenge going forward will be to balance financial stability concerns at national level with the need for a more integrated and efficient internal market for banking, within a well-regulated prudential and resolution framework with single supervision and resolution in the BU.

For a CMU to emerge, it seems necessary to set up a bottom-up approach by meeting the needs expressed by many countries, where the economy is financed almost exclusively by banks, to develop local capital markets and share equity financing. At the same time, it is essential to establish a single European rulebook and single supervision for cross-border activities and pan-European financing players to eliminate undue complexity, level the playing field with foreign third-parties and facilitate European consolidation of financial players. Combining these two approaches remains challenging and all the more so as many member states often favour national strategic autonomy at the expense of European autonomy.

The Chair stated that the objective of 'open strategic autonomy' in financial services is to avoid excessive reliance on any single external service provider or jurisdiction. By developing an adequate domestic capacity and diversifying exposures externally, it should be possible to increase the EU's resilience in a world of growing uncertainty, while remaining integrated in a global financial system. For him, two questions arise in this regard. The first question is whether it is more feasible to to be open, strategic and autonomous as an integrated EU market than it is as 27 national markets. The next question is whether being open, being strategic and being autonomous are complements or substitutes.

1. Objectives and ways forward

1.1 The objectives are well defined

1.1.1 Strategic autonomy's increased significance

An official highlighted that ambitious conclusions on European financial strategic autonomy were adopted in April 2022. These conclusions remain valid in front of the Covid pandemic and the war in Ukraine, which were wake-up calls on the need to work further towards strategic autonomy of the EU. In the field of financial services, Strategic autonomy relies on three main aspects: a strong and internationally recognised currency, a resilient and competitive financial sector, and autonomous rule-making with respect to setting new standards and norms.

On the first aspect, there has been progress on the international role of the euro and 20% of international reserves are now labelled in euro but there is a need to be mindful of the impact of fragmentation on the international role of the euro. On the second topic, the financial sector has shown its resiliency despite turmoil in the US and in Switzerland. However, there is still some work to do to deepen the capital markets and have an integrated single market for banking and financial services.

On the last aspect and the creation of norms, Europeans have played a key role, in particular, on sustainable finance. There is now a framework that brings more clarity and transparency over the environmental, social and governance (ESG) characteristics of companies and financial products, though it can be improved. Building on this work, there is also a proposal on the regulation, transparency and integrity of ESG rating agencies currently under discussion.

1.1.2 Defining autonomy

An official stated that strategic autonomy is neither protectionism nor separatism. It is about making own decisions and own alliances. It is about working together with like-minded partners that share the same values and want to protect those common values. It is mainly about increasing the EU's capacity to act strategically on the global stage or in the global market. It is also about increasing competitiveness and building resilience.

The concept of strategic autonomy includes financial autonomy. The financial sector is a key area where open strategic autonomy (OSA) can be ensured. Brexit raised the question and highlighted a key dilemma about whether the EU's economy can be satisfied by being mainly an importer of financial services developed in third countries. The financial sector and the real economic sector go hand-in-hand, and without fostering autonomy, resilience and strengthening macroeconomic stability the resilience of the EU cannot be ensured.

The EU has great ambitions for the green transition, climate change investment and new technologies. They all need a great deal of fresh money, which should come from capital markets. The financial sector should not be seen solely as a bundle of risks that have to be regulated and supervised. Its core function is to intermediate financing from private people to investors and thereby enable growth.

1.1.3 The openness of the EU financial system

An industry representative remarked that Europe is the most open bloc in the planet. The question is whether to be more open. BRICS want to challenge Europe and the economic equilibrium. They have a plan to fundamentally transform the way the rest of the world operates. Before the competitiveness test, there should be an evaluation of what the unintended consequences could be. It should be asked whether it makes European producers and makers stronger or weaker.

The EU consists of 450 million people and has $16,000 billion of economic output, which is third in the world after the US and China. It had $1,450 billion of foreign direct investment between 2019 and 2022. Europe is as strong as its single market is. The only reason the rest of the world respects it is because of the strength of the single market.

1.1.4 Stability, competitiveness and customer confidence are three key aspects of strategic autonomy

An official indicated that strategic autonomy in finance means being stable, competitive and having the complete confidence of customers. OSA should be centred on those three aspects. Financial services are the backbone of the economy and economic security. The vulnerabilities should be mapped to interdependencies, for example, which could be handled either through diversification or cooperation, even with third countries.

One good definition of OSA is the ability to cope alone but to cooperate whenever possible. The financial sector can only support the economy if it is competitive. A substantial share of the knowledge and technology necessary for a successful digital and green transition resides outside of the EU, so there should be caution about placing unnecessary barriers that can slow down the EU's green transition.

The confidence of all consumers should be kept, while ensuring that banking groups are strong on all levels, and that supervisors know the entities and the market specificities. Customer protection is crucial, and even more so when it comes to digitalisation. As electronic payments gain momentum, new types of fraud are increasing. Customer awareness should be strengthened, and attention paid to managing cyber risks.

1.1.5 Europe 's competitiveness and growth needs competitive banks

An industry representative remarked that in 2008 the EU's economy was larger than the US's, but now the US economy is a third larger than the EU plus UK. At the beginning of 2008, the market cap of the top eurozone bank was very similar to that of the top American bank. At the beginning of this year, the top American bank represented more than the first 10 eurozone banks combined. European banking sector's competitiveness has eroded to be much lower than the other international players. Since 2008, EU banks have been weakened by poor growth, lasting negative interest rates, market fragmentation and lack of scale.

1.1.6 The participation of global firms in the EU system adds competition and market depth to the benefits of EU citizens

An industry representative suggested that strategic autonomy is about being competitive, resilient and globally relevant. That means having a financial sector that is able to provide a complete set of services to the economy under any circumstances.

In Europe, perhaps because of the trauma of the great financial crisis, much of the focus has been on being prudentially resilient, which has been achieved very well. The worry that foreign banks – US ones in particular – just want to take advantage of their effective internal market and then leave Europe in case of a crisis is no longer accurate. During Covid, for example, the foreign banks' share of the market did not change from 33%. Financial market resilience is not about how strong a single institution is. It is about the financial network. The financial network cannot be autonomous and has to be global.

1.2 Ways forward are well known

1.2.1 Completion of the CMU is crucial

An official emphasised that when creating the CMU there should be focus on local initiatives to build the depth of the market from the bottom up. The diversity of member states should not be seen as an obstacle, but as an opportunity for safety and increasing the competitiveness and resilience of the EU.

An official highlighted that some concrete legislative proposals and topics should be prioritised in order to make additional progress on the CMU agenda. First, the Listing Act should be a priority in order to reverse the trend of decline in public markets in Europe. Second, there is the need to increase investor culture with better information and further market transparency, including through the review of MiFIR. Third priority should be securitisation, which needs to be revitalised. Fourth key topic is credible and manageable sustainable finance requirements. Finally, Europe should increase financing opportunities for start-ups and scale-up companies.

1.2.2 Making the EU banking sector more competitive and resilient

An industry representative remarked that there is a need for a strong, competitive financial system that can finance the economy to achieve the goals of security, social equity and transition. However, it is difficult to see the light at the end of the tunnel in terms of the single market and the service passport due to the wide array of national rules on insolvency, consumer protection and deposit insurance. The lack of a BU is one of Europe's biggest missed opportunities. A European Parliament study estimated that the completed economic and monetary union can add €320 billion a year to the economy until 2032.

An official reminded the audience that size matters: all foreign or non- European banks are welcome on the single market but there is a need to ensure the rise of bigger actors and further consolidation of the banking sector. A great deal of progress has been made towards a more resilient and better supervised banking sector, but we are still far away from a true single market for banking. There has to be consideration of what is preventing cross-border exposure and integration. To find the right solutions, there is a need to re-engage the industry to better understand the impediments to more cross-border exposure and to look at the different ring-fencing practices to determine which distort the most and try to lift them.

An industry representative stated that good progress has been achieved on BU, especially the creation of the single supervisory and resolution mechanisms. The recent proposal to strengthen rules for bank crisis management and deposit insurance (CMDI) is welcome. CMU and BU are the fundamental drivers of financial resilience in the EU.

2. Priorities for progressing towards open strategic autonomy

The Chair summarised that strategic autonomy is a relatively new concept to finance, being more familiar in political science. So, a question is whether it is a natural concept for finance. It is about building and using domestic capacity but also being willing to cooperate where possible. The question then is whether to build that domestic capacity as a complement to the rest of the world or if there are substitution effects between building domestic capacity and the willingness to interact with the rest of the world.

'Open', 'Strategic' and 'Autonomy' have to be balanced, but the question is which to stress more, and whether the balance is the same in the financial sector, given the network effects, as in the real economy where there is greater traction for the concerts such as strategic autonomy.

2.1 Combining bottom-up and top-down approaches

2.1.1 Identical rules, single supervision and European equity

An industry representative commented that a single rulebook is necessary. When rules are only similar, they are different. Identical rules are needed. The Listing Act is a unique opportunity to create a proper S1 with the EU flag on it and a European Securities and Markets Agency (ESMA) logo so the rest of the world understands that it is the output of European regulation.

There is a need to move radically to single supervision for pan European players. There are plenty of pros and cons to single supervision, but there is too much asymmetry between local supervisors and too much unpredictability around gold-plating. Single supervision is needed for harmonisation purposes.

Fragmentation of producers and makers is never going to be the right tool to compete against giant companies. Consolidation has to be facilitated and creative ways found to ensure competition. Size is a prerequisite to being able to buy other assets and to influence other's decisions.

The world has changed, as more people in Europe will be voting for populist and nationalist right-wing parties. Those votes must be respected, but they do not provide a mandate to continue with the narrative of the happy globalisation days of the CMU. There is a need to find a way to reconnect with the fundamental values of the European project. The way to continue integration while resonating with citizens' expectations is to make sure a set of measures is delivered so European money is going to owning European assets, and where equitization is an avenue to provide the migration of the pool of European savings towards ownership of European companies.

2.1.2 Strengthening the securitisation to connect capital markets to the real economy

An industry representative stated that the EU's CMU is underdeveloped, limiting financing choices for large companies and small and medium-sized enterprises. A weak securitisation market and market fragmentation hampers investment within the EU and also dampens funding from outside. One of the priorities should be strengthening Europe's securitization market.

2.1.3 A competitiveness test in order o to assess systematically unwanted consequences of any piece of EU financial regulation

An industry representative noted that if Europe does not own assets, and Europeans do not manage European players, it is not autonomous. Europe has to not just be a continent of consumers of finance but also of makers of finance. There should be a pause to try to realise, when it comes to competitiveness tests, that there are two types of players in the industry. There are those who sell services in Europe, who benefit from all of the money injected into the system for stability purposes, and those who treat this part of the world as a division called Europe, Middle East and Africa (EMEA).

2.1.4 The use of domestic resources to preserve diversity

An official remarked that the CMU under consideration is multi-centred and should take into consideration market and corporate specificities. The main opportunity of CMU is its diversity. Accelerating the green and digital transitions plays a key role, and with the CMU the right direction is being taken. There should be a move toward strengthening the resilience of the non-banking sector, while also ensuring the cooperation of regional centres. ESG is also a critical aspect. ESG ratings, for example, will have an important impact on capital markets in trying to strengthen investors' confidence in sustainable products.

2.1.5 CMU does not mean centralisation

An official emphasised that there should be learnings from the approach taken so far on CMU. There has been a focus on creating a pan-European capital market with unified regulations and centralised institutions large enough to serve all member states and to compete on a global scale. Over the past 15 years much of local capital market capacity has been lost due to this approach and due to regulatory and technological changes that have favoured centralisation. Instead, the CMU should be based on the best practices from the regions that have successfully developed their markets and be closer to medium-sized companies. The CMU should consist of closely interconnected international, regional and local EU financial hubs.

Local ecosystems should be rebuilt through regulation that is better adapted to the size of companies and markets. Private capital markets and alternative ways of financing should be developed. An equity culture should be built in Europe. Prudential regulation should be reviewed to prevent it from handicapping the sector's capacity to finance the economy.

2.2 Improving the BU remains difficult

2.2.1 Integrating bank supervision in Europe vertically and horizontally

An industry representative noted that bank supervision is carried out in a much fairer way compared to the US. It is vertically integrated, independently of the size of the bank. There are the same criteria, although there might be a different supervisor. The biggest enemy is market fragmentation. There is no single market to talk about for financial services. The culprit is not yet achieving a true BU. Supervision is vertically integrated, but horizontally, geographically, it is not, so European institutions cannot capitalise with the huge economies of scale there are in Europe. That is one of the most important improvements that can be introduced to the market.

2.2.2 The home-host issue is difficult to solve

An official stated that fragmentation of the EU banking sector should be avoided by ensure that consumers can be confident in the resilience of local subsidiaries of banking groups. The home-host question is very difficult. Banks use different business models in different countries. As long as there are various financial cultures and market situations, local supervisors are needed. The supervisors know the local entity and its environment, with sensitivity to local and regional trends, and can act quickly and efficiently.

An official noted that the home-host issue is also due to the banking systems and the differing levels of development of European countries. It is not possible to think that host countries will have a sufficient level of prudential regulation requirements and will allow the banking groups to transfer meaningful financial resources from the subsidiaries to the parent entity, with of all the costs that will arise. The costs associated with bank failure are still largely assumed at the national level. There can be discussion of how to create a mechanism that will provide an outflow of capital to the home countries and not affect negatively the depositors and clients in smaller countries, and how to make the market more unified and open. All member states should be considered.

An industry representative called for dispensing of home-hosting because it is politically loaded. Even if there is the European Deposit Insurance Scheme (EDIS), if the system still has the home-host situation there will not be a BU, and there cannot be a CMU without a BU or a fully developed securitisation market.

An official noted that when creating new concepts, like the CMU or BU, there is a focus on the regulation but, rather than looking for new rules, the existing rules should be evaluated to identify how they could be simplified.

The Chair summarised that OSA is not an obvious concept in an international financial system that has been characterised by globalisation. It is a question of balance between the O, S and A, and it has to be decided whether they are complementary, or partially substitutable or not. As a collection of 27 national financial systems, they cannot be complementary because there will always be a feeling of threat from the outside. There is a better chance as an EU 27 single financial system which would be large enough to compete globally and so less likely to be about openness. Supporters of globalisation must accept that the world has changed and that the commitment to openness has weakened. One concern is that if the emphasis on openness is reduced, the pressure for integration of national markets within the EU will be reduced and the EU will stay fragmented and never become strategically autonomous. Openness is part of what delivers a strategically autonomous Europe.