

# Open Strategic Autonomy in the economic and financial areas

## Introduction

The Chair noted that open strategic autonomy (OSA) has been discussed at many of the previous Eurofi conferences, but a different approach might be required to make progress on this issue. The key question for discussion is whether there is a need for OSA in the EU financial sector in the context of rapidly increasing geopolitical tensions and the associated implications for globalisation. The financial sector might have less need for OSA compared to sectors such as critical raw materials. This is a question to be inserted in the context of the European Market Infrastructure Regulation 3 (EMIR 3.0) debate, where concern about additional cost outweighed concern about excessive reliance..

It also remains to be seen whether the EU financial system will be able to deliver the necessary industrial transformation. Given the current political focus on capital markets union (CMU), it will be important to develop the EU capital markets and strike the right balance between top down EU approaches and bottom up national ones.

## 1. Open strategic autonomy: what does it mean and what is at stake?

### 1.1 Balancing openness and autonomy

A public representative agreed that it is not clear whether autonomy is needed in the finance sector. In the Critical Raw Materials Act, the decision was made that autonomy was needed. The finance sector has not yet reached this conclusion. It is important to remember that liquidity always chooses the path of least resistance. It can be transferred across the globe in milliseconds. This is very different to a machine or a raw material, which has to be explored, produced and transported. However, the export industry relies on financial services to do business around the world. This means there are two conflicting priorities. There is a need to strengthen the European financial system and the CMU to create greater possibilities for the EU and a requirement for a degree of openness. There is global competition, and Europe must be successful in this global competition. Finally, there is also a question of scale. In a fragmented market, it will not be possible to deliver the scale effects delivered by other markets. Therefore, Europe needs to find a balance between autonomy and dependence on the market.

The Chair agreed on the need to find a balance between openness and autonomy, adding that openness seems to be implicit in the word 'strategic'. Indeed, it is not strategic to be closed.

An official emphasised that OSA is a slightly contradictory concept. The only way it makes sense is by recognising that the financial system is global. There will only be a strong European financial sector if it is well connected to deep global capital pools. Autonomy will emerge when people choose to do business in Europe. If this is the definition of autonomy, it is indeed necessary. However, the discussion must be broader than CMU and EMIR. It must involve a wider discussion about economic policy and obstacles to foreign direct investment.

The Chair observed that this is not just about the financial sector. The need for autonomy in critical raw materials is unambiguous, but it is not clear whether the financial sector is willing to make the same trade offs. As the US and the UK are the only other providers, onshoring will be needed to create the requisite level of diversification. This might look like protectionism, but it is in fact diversification. This is part of the contradiction.

### 1.2 Thinking about OSA in the current geopolitical context

An official stated that any discussion of OSA must consider the broader context: geopolitical landscape, global economic fragmentation and economic challenges in Europe. The concept of OSA encompasses many different policy fields, such as technology, trade and defence. If there were deep and liquid capital markets or even a single capital market within the EU, it would be much easier for Europe to create a more competitive and innovative economy and to mobilise funds for the green and digital transitions. Without the ability to access Europe's currently fragmented financial resources, it will be very difficult to achieve these goals. It will not be possible to achieve OSA without a functioning CMU. The CMU and the banking union cannot be separated from OSA.

The Chair considered that there are geopolitical concerns about over reliance on external partners. Any reliance on a single infrastructure, even in a friendly country, carries operational risk e.g. the potential impact of a cyberattack.

An IFI representative suggested that, in the current geopolitical context, it is logical to evaluate whether Europe's financial sector is over dependent – however given the current development of Europe's capital markets the region currently remains reliant on global investment flows to help fund its green energy transition. The issue of critical raw materials is different: there is a much greater need for autonomy in raw materials because the resources are scarce and in high demand for the green transition.

### 1.3 Creating a globally competitive market in Europe

An official emphasised the importance of creating a globally competitive capital market. In the current era

of de globalisation, competitiveness is the key issue. The capital markets finance around 30% of the European economy; in the US, they finance around 70% of the economy. The European economy is faced with unprecedented challenges, such as the energy transition. This transition will require an additional €700 billion, although €300 billion of savings flow out of Europe every year. Europe must create a globally competitive capital market.

#### 1.4 Balancing EU interests with the need for open and international financial markets

An industry speaker noted that this is probably the seventh or eighth discussion of strategic autonomy at a Eurofi conference. There is now much greater convergence on how to interpret the idea of strategic autonomy and its key components. The term 'open strategy autonomy' is indeed slightly contradictory. A more appropriate term might be 'strategic resilience'. 'Autonomy' implies isolation or protectionism, which is the wrong approach to take. Indeed, the participation of global firms in the EU system brings competition and market depth, which is to the benefit of EU clients. Specifically, the involvement of US financial institutions in the EU capital markets supports the EU's aspiration to diversify the sources of funding in the economy. Financial markets gain resilience and quality by strengthening their networks. The strength of a financial market consists in how deep and geographically diverse it is. The strategic resilience of the European financial market will come from being deep and globally super connected. To achieve that, it must be attractive to the global financial community.

The Chair observed that there are many definitions of the word 'autonomy' but, in his view, autonomy is really about the ability to make decisions without being controlled by others. It is not about openness but having the ability to choose to be open. In this way, excessive reliance can be seen as sacrificing a degree of autonomy.

#### 1.5 Financing the green and digital transitions while remaining strong and resilient

An official considered the key question regarding OSA is whether the financial system has the capacity to finance the green and digital transitions. If the profits from green projects were guaranteed, these projects would attract financing from outside the EU. This is not necessarily a negative outcome. If American investment finances a hydrogen power plant in the EU, it is not possible to shut down the plant and move it to America. To some extent, it does not matter whether the financing comes from inside or outside the union.

An industry representative noted that OSA is relevant to defence, energy, food and some parts of the supply chain. In all these fields, the US is much more self-sustaining than Europe. In view of the huge levels of public debt, achieving the desired level of autonomy will require a huge amount of additional funding. The financial sector will have to 'fire on all cylinders'. Capital markets and the banking sector both have to play a role. It will not be enough to rely on European internal funding; the EU will also have to attract funding from the 'new wealth' parts of the world. An open, diverse,

competitive, accessible and easy to consume financial sector will be critical to achieving OSA in all sectors.

## 2. The need to boost capital markets in Europe

### 2.1 Tackling the obstacles to investment

#### 2.1.1 The development of funded pension systems is a prerequisite for CMU

An IFI representative opined that the EU has not completed its work on the financial capital markets. There is a continued over-reliance on banking. Europe lags behind the United States and Asia in terms of capital market development. In 2023, Europe represented 10% of the global capital market; in 2006, it was 18%. Europe accounts for 14% of the world economy. There is clearly a gap here. There is a question about should be done and at what level.

One of the big issues is the use of savings and the incentives to move into long term products. This is largely in the hands of national governments because it is contingent on the organisation of the pension system. Pensions are the most important vehicle for long term investment. The countries with strong pension systems have a greater long term investment capacity. In other words, insufficient long-term capital is a critical issue. The average ratio of pension assets to GDP in Europe is 32%; in the US, it is 173%. This is further distorted by the concentration of 62% of all EU pension assets in the Netherlands, Denmark and Sweden. The systemic development of funded pension systems is a prerequisite for capital market development. The EU can help, but this is a national issue.

#### 2.1.2 Addressing fragmentation in the capital markets: the consolidation of the Baltic market might provide a template for CMU

An IFI representative considered that there is also huge fragmentation in the post trading infrastructure in Europe. There are nearly 18 central clearing counterparties (CCPs) and 22 central securities depositories (CSDs). This is contributing to increased costs and a lack of competitiveness in Europe. The rationalisation of CCPs and CSDs is a key priority. The Giovannini report identified 15 barriers, but after 20 years only five of them have been solved. This is a long term issue, but this seems like an excessively long time for reform implementation.

The EBRD has sought to help countries join and aggregate, particularly in Central and Eastern Europe and the Baltics. This type of consolidation can happen on a regional basis. The development that took place in the Baltics has been a big success and shows that the goals of capital market union are achievable. Index providers now evaluate the Baltic region under a single index, largely because there is one trading platform, a common CSD and reasonably aligned laws and regulations. This has improved liquidity and been beneficial for the region. But it also required the willingness and strong cooperation and commitment of the political leadership.

### 2.1.3 Making a difference for issuers and investors

An industry representative emphasised the importance of taking a disciplined approach as there is much to do. The key focus should be making a real positive difference to end-users who make the market: issuers and investors, rather than infrastructures. Supply does not create demand. Strong prioritisation and an outcomes-driven approach is needed in order to define what is truly needed and what is only desired. First, there must be a targeted approach to turn companies that today are borrowers into issuers. This will require a consideration of listing rules, governance rules and insolvency law.

Secondly, savers today should be encouraged to become investors. Financial literacy and culture will be very important in this effort. Capital markets in Europe should be seen as a force for good. Tax coherence is another key priority. It will be difficult to foster the capital markets when savings products receive a more favourable tax treatment than investments.

It is important that the analysis of Europe's markets is fact driven. By way of example, the five largest national CSDs in the EU account for 83% of assets under custody; if the two international CSDs (ICSDs) headquartered in the EU are added, they represent over 90% of assets under custody. So references to fragmentation in the CSD sector, which some commentators have noted, need to be considered in this context.

The Chair noted that discussions about progress over the last 20 years raises the question of whether the glass is half full or half empty. However, it might be more useful to think about the quality of the glass. While the EU has made good progress, some of it might not be robust and may not be as effective as hoped.

### 2.2 There cannot be a fully integrated CMU with a fragmented banking union

An industry speaker stated that the primary requirement for strategic resilience is a single and deep financial market. To attract investors and investment in the financial sector, there must be a CMU. There is a new impetus to speed up the CMU project, but there cannot be a true CMU without a banking union. 10 years ago, banking union was the low hanging fruit; it is now much further away. The capital markets are complementary to banking. There cannot be a fragmented banking union and a fully integrated CMU.

An official agreed on the importance of discussing the connection between banking union and CMU. Banking union appears to be low hanging fruit because it could be regulated into existence; this is not the case for the CMU. The three pillars of banking union were established very early on, but there are no pillars for capital markets union. There are action plans and expert reports with many different components. There is no obvious endpoint to the CMU project.

### 2.3 Relaunching securitisation is an essential bridge between banking union and CMU

An industry speaker highlighted the importance of securitisation. Securitisation is one of the routes of transmission between banking and capital markets.

Nobody wants to return to the old products that contributed to the global financial crisis (GFC), but securitised products are a necessary part of a well functioning capital market and banking union. Without progress on securitisation, the EU financial market will not be sufficiently attractive to institutional investors. Securitisation is one of the main instruments through which risk can be efficiently distributed and diversified across many agents in the economy. The CMU needs both banking union and well engineered securitisation

### 2.4 European banks face many supervisory constraints

#### 2.4.1 Incentivising banks to finance investment

An industry speaker agreed that the financial sector's contribution to OSA will require a very large amount of money. Indeed, bank lending, securitisation and the capital markets will need to 'fire on all cylinders'. The banks will play a crucial role in providing this additional investment. Banks must be incentivised to lend in order to finance investment; they need to be able to securitise what they have originated and create a securitisation market; and they play a key role in the capital market. In the US, banks are originating and distributing products to meet investors' needs. They are ensuring liquidity by offering market making services, warehousing products, derivatives and securities lending and borrowing.

#### 2.4.2 Defining the optimal level of bank capital: balancing financial stability and banks' ability to finance the economy

An industry speaker noted that the European banks are hampered by a number of capital and supervisory constraints. This goes back to the traditional question about the optimal level of bank capital. Capital requirements increase financial stability but limit banks' ability to lend and participate in the capital markets. There is a balance to strike here.

In 2008, the Common Equity Tier 1 (CET1) of banks in both the EU and the US was 6% to 7%. This was clearly not enough. In 2014, CET1 in both the EU and the US was around 12%. A 2016 study by the Bank of International Settlement (BIS) concluded that a capital requirement of around 10% provided the optimal balance between limiting annual growth and avoiding financial crises. Currently, the average CET1 of the large US banks has stabilised around 12%. The average for the Single Supervisory Mechanism (SSM) banks in Europe is currently 15.6%. This 3% gap equates to €250 billion of capital, which is the equivalent of €2 trillion of risk weighted assets and €5 trillion of loans. Over 10 years, this roughly equates to the €500 billion of investment that is needed over the coming years.

The growing capital requirements have produced greater financial stability, but there is a question about whether requirement increases should continue. As the European Banking Authority's (EBA) stress test exercises have shown, European banks are now extremely resilient. If the EU banks are above the optimal level of capital, it might be appropriate to prioritise funding for growth and for the green, defence and digital

transformations over further capital requirements. The EU financial sector has all the necessary ingredients. Europe has an extremely high level of savings. The level of excess savings is also very high. These savings must be channelled into investment. The banks can facilitate this, if they are allowed to do so.

The Chair observed that it is legitimate for policy discussions to pivot towards growth and competitiveness, but it is important to remember that the financial system only benefits the economy if it is stable. If it is unstable, it has a negative effect on the economy.

## 2.5 Rethinking the CMU approach

A public representative emphasised that good progress has been made on banking union. The SSM and the Single Resolution Board (SRB) are functioning properly. National deposit guarantee schemes (DGS) are working well. With crisis management and deposit insurance (CMDI), the Commission has outlined a way to overcome the problems in the third pillar. Hopefully, it will soon be possible to complete the project.

However, there are many goals to achieve on CMU. It might be necessary to rethink the approach to the project. Until now, there have been several small pieces of legislation, such as the Listing Act or the European Single Access Point. This might not be the right way to complete the CMU. The experience with EMIR 3.0 was disappointing. The Parliament tried to find a way forward. In the next legislative term, there should be more engagement to develop a comprehensive roadmap or way forward to overcome the problems with EMIR 3.0. This is nitty gritty legislation; there seems to be a lack of real engagement and commitment.

An official noted that the Eurogroup's four workstreams on banking union were an attempt to be smart and comprehensive, but it proved politically impossible to overcome the issues. Hopefully, this issue will be picked up in the next institutional cycle, perhaps by addressing it in smaller pieces. That might be the right strategy for CMU too: it might be more useful to find specific measures that will have an effect on the ground instead of producing broad plans with a lot of smaller measures. Indeed, the top down and bottom up elements could be combined. In some areas it is preferable for measures to be taken at EU level, such as the harmonisation of insolvency frameworks or tax incentives. In other areas, national authorities can react to and reflect the specific bottlenecks that exist on the ground. Ultimately, there are still 27 separate capital markets in the EU.

An official described how he had previously considered CMU to be the low hanging fruit. After entering government, however, it became clear that this was more difficult. There is no alternative to creating a globally competitive CMU. There is a need to finance the green and digital transitions and the defence sector. Currently, the European defence market is very fragmented. Given the present and geopolitical challenges that might emerge after the next US election, there is little time to address the issue. It is important to look more closely at the defence sector. There are good defence companies in many member states, but there is a need to create the right environment and to support

the creation of value claims in Europe that will be globally competitive. The EU needs to engage the defence sector in the right way. The financial markets seem willing to make these investments, but this will require a well functioning CMU and a well-functioning defence market in Europe.

The Chair stated that he had three concluding comments to make. First, while the need for strategic autonomy may seem to be more urgent in food, energy and defence than the financial sector, any reliance on a supplier involves reliance on the regulatory and supervisory decisions taken in that supplier's jurisdiction. This is acceptable in finance if the international rules based system holds but this cannot be simply taken for granted.

Secondly, it is not possible to legislate banking union into existence. It is possible to put in place the third pillar of banking union, but the objective of banking union was not simply to create a Single Resolution Board or a European Deposit Insurance Scheme (EDIS); it was to create a properly integrated banking system. Even if EDIS were put in place, it would not necessarily have that effect. Too often, banking union and CMU are seen as vanity projects of Brussels. However, this is not the case and the real aim of these projects is to drive the direct and indirect financing of the economy and to strike the correct balance between those forms of financing as the economy transforms for the 21st century.

Finally, there is a trade off between openness and autonomy and a trade off between the EU level and the national level. If the wrong balance is found, there will be 27 well developed but separate markets, none of which are able to compete globally. The EU will not be able to be strategic if that occurs. In thinking about being open or autonomous and being EU or national, it will be important to think strategically about how to find the right balance. It seems probable that there will be a panel on OSA at the next Eurofi conference because the topic is not likely to go away any time soon.