Memo to the commissioner responsible for financial services

Silvia Merler and Nicolas Véron

As a result of the extensive regulatory activity triggered by the Great Financial Crisis and the euro-area crisis, the area of financial services has seen a clear shift towards broad-based acceptance of primarily EU-level regulation and, to a lesser extent, also supervision. This shift remains unfinished, however. The two main areas in which greater EU integration is both necessary and achievable in the near term are banking crisis intervention and capital markets supervision. In the newer area of sustainable finance, where EU regulatory activity has been massive over the past five-year term, gaps exist that could limit the effectiveness of the framework in leveraging the power of finance behind the EU's climate goals.

You should address these issues forcefully, striving for consistency across the whole landscape of EU financial regulation including sustainable finance, and not giving up on completing the banking union.

Integrate capital markets supervision at EU level

Push sustainable finance in pursuit of climate goals

Don't neglect banking union

State of affairs

Financial services is one of few policy areas for which the centre of gravity of decision-making is now closer to the EU than the national level

Your portfolio, corresponding to the scope of activity of DG FISMA (labelled in the last two terms as 'financial stability, financial services and capital markets union'), is among the most impactful of the entire Commission. This is because financial services is one of few policy areas for which the centre of gravity of decision-making is by now closer to the European Union than to national level, and the political momentum points towards still greater EU-level integration.

This state of affairs is relatively new. At the close of the twentieth century, financial services policy was still overwhelmingly a national prerogative. The path towards policy integration has been punctuated by a series of developments, including the single currency and your predecessor Mario Monti's Financial Services Action Plan in 1999, the crisis-induced commitment to a single rulebook in 2009, and the watershed decision in mid-2012 to entrust the European Central Bank (ECB) with European banking supervision, soon followed by the establishment of a less solid but nevertheless significant crisis management component centred on the newly established Single Resolution Board (SRB).

Further steps included the spin-off of your portfolio from the previously sprawling DG MARKT in 2014, the Brexit vote of June 2016, which resulted in the departure from the EU of the country with the staunchest attachment to autonomous national financial services policy implementation, and the decision in 2021 to create an EU agency for anti-money laundering and countering terrorist financing (AMLA). Taken together, these milestones have created a landscape in which you have significant policy initiative, even though you must also take into account the parallel activity of EU institutions and agencies that you do not fully control. The latter include, most prominently, the ECB in Frankfurt, the SRB in Brussels, AMLA in Frankfurt and the European Securities and Markets Authority (ESMA) in Paris. Complementing this increasingly crowded landscape are the European Banking Authority (EBA) in Paris, the European Insurance and Occupational Pensions Authority (EIOPA) and European Systemic Risk Board (ESRB) in Frankfurt, and the European Stability Mechanism (ESM)

in Luxembourg, which may intervene in certain financial crisis scenarios and has accordingly developed its own capacity

To be sure, member states still have independent roles in many aspects of financial services policy. What has been pooled at EU level has largely depended on contingent circumstances, particularly during the decade-long systemic financial crisis from 2007 to 2017, which greatly accelerated the shift towards EU-level empowerment. For example, it was commonly accepted wisdom throughout the 2000s that the European integration of supervision of wholesale markets would happen, if at all, before supervision of retail banking prudential supervision – but the opposite occurred in the turmoil of the euro-area crisis.

Consequently, the current division of labour by no means reflects a rational application of the subsidiarity principle, under which the policy challenges handled at EU level would be those with most EU-level or even global significance. If that were the case, globally systemic market infrastructures based in the EU, including Clearstream and Eurex Clearing, Euroclear, LCH SA and SWIFT, would be supervised at EU level. This example is only one of several cases in which the status quo deviates from subsidiarity by erring on the side of excessive policy decentralisation. Conversely, we do not presently identify cases of excessive supervisory concentration. In other words, applying the subsidiarity principle in financial services, at this point, means further supervisory integration at EU level. A time will probably come when some financial supervisory tasks should be delegated back from the European to the national level, as happened in competition policy in the early 2000s, but in our assessment, that time has not come yet.

Brexit's early impact on financial firms' legal organisation and geographical footprint continues to unfurl

Several more recent developments also affect your portfolio. The COVID-19 pandemic, contrary to initial expectations that it might trigger a wave of bankruptcies, has not left a structural mark on the European financial system. By contrast, Brexit represented a major if orderly transformation when the United Kingdom left the internal market on 31 December 2020. Its early impact on financial firms' legal organisation and geographical footprint continues to unfurl. The EU has adopted a pioneering approach to regulating the recourse to critical technology providers such as cloud services vendors, through the Digital Operational Resilience Act (Regulation

(EU) 2022/2554), enacted in December 2022. It has initiated a project of introducing a digital euro in close partnership with the ECB.

Russia's full-scale invasion of Ukraine in February 2022 has made financial and trade sanctions more relevant than ever. While the High Representative for Foreign Affairs and Security plays a key role in preparing the Council's sanctions decisions, DG FISMA has provided much of the policy expertise in this area. More generally, the rise of geopolitical confrontation is a major development in the landscape of risks that may affect financial stability in Europe.

Meanwhile, the EU has an ambitious goal of making Europe the first climate-neutral continent by 2050, and of ensuring that all sectors are able to finance their transitions towards a net-zero economic model "*regardless of their starting point*" (European Commission, 2021). According to the Commission, additional investment of about €620 billion will be needed annually to meet the objectives of the Green Deal, of which the greatest part needs to come from private-sector funding. The EU sustainable finance framework – which is part of your remit – will play a major role in reaching these goals.

Challenges

Banks appear to be sound, at least in the euro area, where European banking supervision appears to have been effective

The current condition of the EU financial sector appears stable, more so than in 2019, 2014 or 2009. Banks appear to be generally sound, at least in the euro area, where European banking supervision appears to have been effective so far.

In that context, the dominant challenge, for you as for your immediate predecessors, is the mismatch between European-level risks and capabilities – in other words the unfinished nature of the transition from a mainly national to a mainly European financial services policy framework. The combination of EU-wide market integration with national policy responsibility often results in harmful incentives for the relevant authorities. The resulting failures, respectively in the prudential supervision of banks and in AML supervision, have been addressed with European banking supervision and AMLA. They still exist in other areas of financial sector policy.

The incompleteness of the banking union remains the major shortcoming of the EU financial services policy framework

Because the banking sector is so central in the EU financial system, the incompleteness of the banking union remains the major shortcoming of the EU financial services policy framework. That incompleteness perpetuates a structural vulnerability of the euro area and entails continued fragmentation of the banking sector along national lines, since national authorities implement ringfencing measures under the guise of their lingering authority over the banking sector. The aim of banking union, as stated at the outset, was the "*imperative to break the vicious circle between banks and sovereigns*" that came close to breaking up the euro area (Euro Area Summit Statement of 29 June 2012). European banking supervision has mitigated the bank-sovereign nexus by making bank failures less likely, but it has not broken it. Bank-sovereign linkages include, on the one hand, financial exposures of banks to national sovereigns (mostly their home country), and, on the other hand, contingent liabilities of national sovereigns in relation to banking crises, such as national deposit insurance and the possibility of other forms of national funding of bank crisis management.

Several interrelated initiatives have been identified as needed to complete the banking union: the pooling at European level of deposit insurance, liquidity in resolution and a quasi-fiscal backstop for the SRB's Single Resolution Fund (SRF); a regulatory limitation on banks' concentrated domestic sovereign exposures; and, once a credible safety net is established at European level to address systemic banking crises, effective constraints on the ability of national sovereigns to bail-out 'their' banks. While the latter component is a matter for your colleague in charge of competition policy (who will need to revise and tighten the 2013 'Banking Communication' on state aid control in the banking sector), other aspects fall within your remit and have been discussed at length but without result since 2015. Despite the Commission President's commitment in 2019 to deliver at least on European deposit insurance and SRF backstop, nothing has been achieved in that area since the historic initial round of banking union legislation in 2012-2014, championed by your predecessor Michel Barnier. EU leaders have decided to allow the European Stability Mechanism to play the role of backstop to the SRF, but this is not yet implemented because Italy has not ratified the ESM treaty.

Meanwhile, European capital markets remain underdeveloped and fragmented along national lines, despite the European Commission's proclaimed promotion of a capital markets union (CMU). To fulfil the CMU vision, public policy has a major role to play, given the extent of regulation and supervision of numerous segments of the capital markets complex. Since Jean-Claude Juncker coined the CMU term in July 2014, initiatives have been of two types: either incremental EU financial regulatory changes that have stopped well short of transformational, even when they have been well-grounded (eg the European Single Access Point for corporate financial information and the so-called consolidated tape of market transactions, both to be implemented in the coming years), or attempts to foster changes in structural areas that go beyond your portfolio – such as in taxation, insolvency law, pension finance and housing finance – which have achieved little to nothing because these areas remain the near-exclusive and jealously guarded preserve of member states.

The EU has pioneered legislation including the EU Taxonomy for Sustainable Activity (Regulation (EU) 2020/852) and the Sustainable Finance Disclosure Regulation (SFDR, Regulation (EU) 2019/2088), but gaps remain in the sustainable finance framework that could hinder its effectiveness in leveraging private finance for the net-zero transition.

The definition of 'sustainable investment' is broad and non-prescriptive, leaving the assessment entirely to financial-market participants

First, the SFDR definition of "*sustainable investment*" is broad and non-prescriptive, leaving the assessment entirely to financial-market participants. While flexibility is warranted to cater for different approaches to sustainable investment – especially for socially-focused investments, in the absence of a social taxonomy – the lack of minimum requirements creates a risk of greenwashing and reduces the comparability of SFDR disclosures for the consumers of investment products.

Second, while the Taxonomy defines very clearly what should be considered 'green', the concept of transition finance is not equally well defined in EU legislation. The Transition Finance Recommendation (2023) includes a list of investment types that are considered by the Commission to constitute "*transition finance*", but it is unclear whether all of these qualify as "sustainable investment" under the SFDR, and under which conditions.

Recommendations

Consistency

Your primary duty is to advance the transition to a consistent EU system of financial regulation, and especially supervision, that would align with the subsidiarity principle. Capital markets supervision offers the most immediate opportunity for progress and would finally give substance to the CMU project. The ECB President (Lagarde, 2023) and your predecessor[1] have created momentum through clearly-worded calls for supervisory integration, as have leaders from some member states.

European Securities and Markets Authority reform

Start with in-depth reform of ESMA to make it an effective financial supervisor, which it arguably cannot be under its current design

Start with in-depth reform of ESMA to make it an effective financial supervisor, which it arguably cannot be under its current design. The model to follow is the governance and financing template of AMLA, itself based on lessons learned from previous experience. This means a compact executive decision-making board and funding by an *ad-hoc* levy on supervised entities under scrutiny of the European Parliament. To allow greater connectivity with market participants, the reconstructed ESMA should establish offices in the EU's major financial centres, if not in every member state; some of these offices may also host teams that lead supervision of specific market segments, thus alleviating concerns about excessive geographical centralisation in Paris. In parallel or following ESMA reform, but not before, you should work to significantly broaden ESMA's scope of direct supervision, including relevant critical financial infrastructure (in appropriate interaction with the ECB), audit firms and accounting enforcement.

Don't give up on banking union

You should not give up on the aim of completing the banking union and should learn from the shortcomings of previous attempts in that area. Specifically, you should address the challenge of banks'

1 Mairead McGuinness, 'Vested interests must not block the EU's capital markets union,' *Financial Times*, 19 March 2024, https://www.ft.com/content/f1270cc3-eb3d-4e8b-a2d7-264aeab51c6d.

concentrated domestic sovereign exposures and make it explicitly part of the banking union agenda. And you should reset the discussion about European deposit insurance, with a new blueprint for a European deposit guarantee scheme that would be better articulated with the resolution mechanism than the 2015 proposal, in line with the Commission's 2023 proposed legislation on Crisis Management and Deposit Insurance. (You will also coin a new acronym for that, since EDIS now means the European Defence Industrial Strategy).

Other areas are ripe for further pooling of decision-making authority at the European level in line with the subsidiarity principle. They include the prudential supervision of EU-significant insurers, financial sanctions implementation, macroprudential policy and financial consumer protection. Given political sensitivities and the opportunity of progress on the CMU front, however, you should not frontload these areas. Rather, be opportunistic in case exogenous developments create openings for new initiatives. You should also devote appropriate resources to ensure the successful inception and early development of AMLA.

Accept limitations

There are only limited opportunities for breakthroughs in structural areas that are critical to the CMU agenda

We see only limited opportunity for breakthroughs in the above-mentioned structural areas that are critical to the CMU agenda but are beyond what we see as the current scope for major EU-led change. These areas include taxation (especially of investments), insolvency law, pension finance and housing finance. In these areas, you should establish a robust approach of purposeful mapping and benchmarking of national practices and reform, and possibly consider ambitious harmonisation initiatives at a later stage. In order to ensure independence and resilience from national political pressures, this could take the form of a separate monitoring organisation funded by the Commission but not directly governed by it. Such an approach would allow you to avoid obfuscation and distraction from the effort towards supervisory integration.

Sustainable finance framework

To develop sustainable finance, you should streamline the EU framework to make it more effective. First, the SFDR definition of "*sustainable investment*" should be clarified, introducing minimum exclusions requirements for an investment to be considered sustainable. The set of minimum exclusions proposed by the Commission in 2020 for the so-called EU Paris-aligned Benchmarks would constitute a natural reference. In this, you should specifically form a view on how investment in the defence sector should be treated, to reconcile with changed geopolitical conditions.

The definition of "*transition finance*" in the EU legal framework should similarly be clarified, including how different types of transition finance should be evaluated when assessing their eligibility as sustainable investment under SFDR. At present, investment in economic activities that are aligned with the Taxonomy automatically qualify as sustainable investment under SFDR, but it is much less clear whether and how general debt or equity funding to transitioning issuers may also qualify. As transition plans become more common across EU companies in the coming years, they should be used as the basis for that assessment. Relatedly, you should pursue the development of a standard for sustainability-linked bonds and other types of target-based transition finance, including common key performance indicators, criteria to ensure ambition in target-setting and a methodology to evaluate the credibility of plans.

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ESG ratings review

You should also push for a review of the proposed ESG (environmental, social and governance) Ratings Regulation to require ratings sold in the EU to incorporate a double materiality approach and to include an assessment of entities' transition plans. The European Sustainability Reporting Standards developed on the basis of the 2022 Corporate Sustainability Reporting Directive (2022/2464/EU) constitute the cornerstone of climate transition plans for large or listed companies and embed a double materiality approach. A similar approach should be required for the entities that evaluate the credibility and ambitions of those same companies' transition plans, as well as their sustainability credentials.

Evaluate EU-UK financial linkages

The transition from Brexit is still unfolding. You should work at identifying any linkages between the EU financial system and the UK market in which the balance of efficiency gains and systemic vulnerabilities would not be beneficial for the EU. This concern is justified by the extraordinary dependency of the EU on London as an offshore financial centre, which is unprecedented and unparalleled among major jurisdictions. In this, you should resist protectionist impulses while being clear-eyed about genuine potential drivers of systemic risk, a difficult balance to maintain. Such analysis should guide you for the decision on whether to renew the equivalence recognition of UK clearing services, which expires in mid-2025.

Bring the digital euro to fruition

On the digital euro, you should bring your predecessor's proposal to fruition, ensuring that the project makes a positive contribution to the performance and resilience of the EU payments infrastructure – even though this is only an enabling framework for concrete decisions which will ultimately be made by the ECB.

International standard-setting and coordination

Finally, you should work to preserve and strengthen the global infrastructure for financial standard-setting and policy coordination, in line with the EU's strategic interest in a functioning open and rules-based international system. For that, you should improve the EU's own compliance with international financial standards, particularly those of the Basel Committee on Banking Supervision, with which the EU has been assessed as the least compliant of all the world's jurisdictions represented in the Committee. You should also identify ways to encourage EU countries to accept the rebalancing of bodies such as the Basel Committee and the Financial Stability Board, in which an excessive aggregate number of representatives from the EU undermines global reputation and buy-in from third-party jurisdictions. Specifically, since supervisory policy in the euro area is now under a single framework, the ECB alone could appropriately represent all euro-area countries in the Basel Committee, with the Commission and EBA retaining observer status.

You should improve the EU's own compliance with international financial standards, particularly those of the Basel Committee

Due disclosures: Silvia Merler works at Algebris Investments, an asset management firm subject to EU sustainability disclosure requirements. Nicolas Véron is an independent non-executive director of DTCC Derivatives Repository Ireland, a trade repository supervised by ESMA.

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