THE EUROPEAN RECOVERY IN 2022

Ensuring a competitive European Single Market for financial services to address the important European challenges

MARCH 2022

European Financial Services Round Table

The European Financial Services Round Table (EFR) was set up in 2001. The Members of EFR are Chairmen and Chief Executive Officers of international banks or insurers with headquarters in Europe. EFR Members believe that a fully integrated EU financial market, a Single Market with consistent rules and requirements, combined with a strong, stable and competitive European financial services industry will lead to increased choice and better value for all users of financial services across the Member States of the European Union. An open and integrated market reflecting the diversity of banking and insurance business models will support investment and growth, expanding the overall soundness and competitiveness of the European economy.

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16 September 2020 - State of the Union Address by **President Ursula von der Leyen**:

"*We must now use this opportunity to make structural reforms in our economies and complete the Capital Markets Union and the Banking Union. Deep and liquid capital markets are essential to give businesses access to the finance they need to grow and invest in recovery and in the future. And they are also a prerequisite to further strengthen the international role of the euro. So let's get to work and finally complete this generational project.*"

25 November 2021 - **Executive Vice-President Valdis Dombrovskis**:

"*Europe needs vibrant and integrated capital markets to boost the real economy and bounce back after the COVID-19 crisis.*"

21 April 2021 - **Commissioner Mairead McGuinness**:

"*The financial system plays a crucial role in the delivery of the EU Green Deal, and significant investments are required to green our economy. We need all companies to play their part, both those already advanced in greening their activities and those who need to do more to achieve sustainability. Today's new rules are a game changer in finance. We are stepping up our sustainable finance ambition to help make Europe the first climate-neutral continent by 2050. Now is the time to put words into action and invest in a sustainable way.*"

12 October 2021 - **ECB President Christine Lagarde**:

"*Combating climate change requires action from all parts of society.*"

19 November 2021 - **Executive Vice-President Margrethe Vestager**:

"*Competition makes European businesses strong – it keeps down prices, it makes supply chains more resilient by preserving real choice. And it keeps markets open for innovative companies to grow and succeed.*"

A. INTRODUCTION

2021 was a year of many challenges, especially with the continued COVID-19 pandemic and on the economic front. In the second half of the year, disruption of global production, supply chain bottlenecks, rising energy prices, rising inflation and geopolitical tensions started to create new challenges. At the same time, the European economy performed better than expected, due to the vaccination programs, the support measures that governments have been providing and the adoption of the EU Recovery Plan NextGenerationEU.

While the good economic recovery initially led to a growth forecast of 5% for 2022, the IMF World Economic Outlook update of 25 January 2022 lowered its expectation to 4.4%. This is mainly due to the high energy prices and the continued global production disruption, while inflation appears more persistent than expected. According to Eurostat[1], the euro area annual inflation rate was 5.0% in December 2021, while EU annual inflation was 5.3% in December 2021. On several occasions, the President of the ECB, Christine Lagarde, has stressed that the ECB expects inflation in Europe to remain high at the beginning of 2022, but that it will decline later in the year. In this context, it was indicated that the ECB might not raise interest rates until the fourth quarter of 2022, in contrast to earlier decisions by the Bank of England and the US FED.

2022 will be very important for the European Recovery. The European Commission has already approved several proposals by EU Member States in the context of NextGenerationEU, which is aimed at helping to rebuild a post-COVID-19 Europe that will be greener, more digital and resilient.

The EFR Members reiterate their unwavering commitment to continue supporting the European economy and their clients as they collectively did during the pandemic.

The EFR Members and their institutions stand ready to play a key role in helping the European economy to recover. However, a big challenge will be to ensure that the financial sector can indeed make its expected contribution. Banks and insurers supply "fuel" to the economy. Important growth and funding potential will be unlocked if banks and insurers are able to channel capital and risk efficiently between investors and savers to businesses and individuals. Ensuring that EU financial markets remain open and connected to international capital markets will further boost the growth potential for European economies.

Several issues concerning the investment and economic growth agenda will need to be addressed. While, in recent years, the EU has enacted legislation within an ambitious roadmap to create the right environment in Europe for investment, the challenge still exists. The EU should ensure a level playing field at both European and global level and recognise the European financial industry as a central player in the European economy. In the Investment Chapter of this Report, we ask for attention to be paid to various actions that need to be taken.

In 2015, the Juncker Commission started its work on the Capital Markets Union (CMU) as part of the Investment Plan for Europe, with the von der Leyen Commission earmarking the CMU as a key priority for the financial services agenda. On 16 December 2021, the conclusions of the Euro Summit, in which all 27 Member State leaders participated, noted that a completed banking union and a deep, integrated and well-functioning capital markets union are key to ensure a stable financial system, to support the EU's competitiveness and to channel the necessary financing for the green and digital transitions. EU leaders called for acceleration of the deepening of the capital markets union. On 17 January 2022, the political groups of the EPP, S&D and Renew Europe in the European Parliament concluded a Mid-Term Agreement "Agenda 2022-2024 – our Priorities for Europeans", in which they support, among other things, the completion of the Banking Union and the Capital Markets Union.

The EFR welcomes these commitments to the Banking Union and to the CMU, especially since both have been a key priority for years. Important advances must still be made and the development of European capital

1 The EU statistical office.

markets and the Banking Union should remain a top priority. Given that all three European Institutions have committed themselves to this, it is time to put words into action.

In order to play its full role in the recovery, the financial sector asks explicitly a renewed attention from EU policymakers to ensure a truly competitive European financial sector. The European Commission has already recognised this aim in the Digital Finance package. As the Competitiveness Chapter in the EFR Report 2022 shows, there are several policy areas where unlevel playing field issues of the European financial sector need to be addressed. While the EU's policy of open markets and strong cooperation has made it one of the world's most thriving and competitive regions, the rapid digitalisation, the transition to a sustainable economy, and fragmentation driven by political developments (Brexit and ongoing trade tensions) pose big challenges for the EU's competitiveness and global position. The EFR acknowledges that a sound financial regulatory and supervisory framework is essential. At the same time, the EFR considers it vital that there are no unnecessary legal or regulatory restrictions preventing the European financial sector from playing its envisaged role in the European economy. In order to bolster its position as a global political and economic leader, the EU will need to take an ambitious, outward-looking and strategic approach to improving the EU's competitiveness and counter current fragmentation trends by removing barriers and impediments to doing business in the EU, including delivery of inward investment.

In short, Europe should strive for a competitive, fair and robust economy. It should look holistically at the current regulatory frameworks and determine whether they suit what Europe needs to support the European recovery as well as the competitiveness of the European economy.

A large part of the EU Recovery Plan, NextGenerationEU concerns fighting climate change, with 30% of the EU funds earmarked for this. To steer the plan towards the goals of the European Green Deal, in July 2021 the European Commission adopted the Fit for 55 legislative package targeting the European business community with proposals to make the EU's climate, energy, land use, transport and taxation policies fit for reducing net greenhouse gas emissions by at least 55% by 2030, compared to 1990 levels. For the financial sector, the European Commission had already adopted the sustainable finance package in April 2021 with measures aimed at improving the flow of money towards sustainable activities across the European Union. While a lot of progress can be made in fighting climate change with these proposals, it is noted that there is still a lack of progress on globally coordinated carbon pricing. This needs to be addressed by policymakers as a matter of urgency.

The EFR is strongly supportive of the EU's sustainable finance agenda and the financial sector should be considered a partner in delivering the EU's climate commitments. The EFR would like to stress that getting the right balance between the packages for the broader economic actors and for the financial sector is very important, since currently the willingness and capacity of the financial sector to finance sustainable projects significantly exceeds the availability of suitable/bankable/investible assets. A pipeline of sustainable investments is therefore needed. Furthermore, to reach the goals of the Green Deal, incentivising investment in the transformation of companies should be prioritised and the overall policy framework needs to support such transitional pathways so as to enable the financial sector to support its customers in their transition. The availability, high quality and comparability of sustainability data is essential. Moreover, governments should step up the protection against physical risk from climate change by means of insurance coverage and adaptation measures.

EFR Members are supportive of the European Union and stand ready to cooperate with the European Commission, the European Parliament and the European Council to foster economic growth in Europe and secure a sustainable, competitive and open European financial sector. The recommendations given in this report will enable the financial sector to play its role.

B. SUMMARY OF MAIN ISSUES AND KEY RECOMMENDATIONS

In order to enable the European financial services sector to support the European Recovery, the European Financial Services Round Table gives the following key recommendations.
Full details are given in Section C of this report.

GENERAL PRINCIPLE

Regulation should be aimed at transparency and stability in financial markets, that ensures a European and global level playing field and be supportive of the European financial industry in its central role of financing the European economy for the benefit of all parts of society.

KEY RECOMMENDATIONS

A. Recommendations for the first chapter on Competitiveness

1. It is crucial that the recent European reform proposals ensure level playing fields (in the implementation of Basel III as well as in the on-going review of Solvency II, for instance), foster the deepening of EU financial markets (CMU initiative, securitisation market, etc.) and enable the emergence of strong European players and an efficient deployment of the available capital in the markets. The Solvency II review, in particular, can support the latter while improving the global competitiveness of European insurers. The Banking Union should also be completed in order to allow banks greater freedom to utilise their capital and liquidity more efficiently and optimise their ability to use their balance sheets to support their customers across EU markets.

2. European authorities should effectively take account of the elements of attractiveness and competitiveness in their regulatory and supervisory work. This would, for instance, imply:
   a. ensuring that, for each envisaged evolution of the regulatory framework, the impact on the attractiveness of EU capital markets and on the competitiveness of EU market participants is systematically assessed, alongside the current assessments of the impact on investor protection, financial stability and market integrity.
   b. adding the consideration of attractiveness and competitiveness as a secondary statutory objective for selected European authorities (first and foremost the European Supervisory Authorities).

3. In order to enable the Digital Transformation of the financial services industry, the EU authorities need to ensure that the regulatory framework for EU financial services is consistent at international level, ensures fair competition, reduces the prudential burden for the non-core business of regulated entities and adequately regulates new entrants. Furthermore, the EU should enable its financial sector to reap the benefits of a horizontal data sharing framework and easily take up new technologies and develop digital innovations (AI, cloud, DLT, crypto assets).

B. Recommendations for the second chapter on Transition

4. The transition of the economy should ensure sustainable growth and job creation. Public policy should set the right incentives, particularly in high emitting sectors and in industries that need the deployment of clean technologies that are still not competitive. These incentives should include removing existing subsidies to fossil fuels and implementing a meaningful price on carbon emissions globally. The Fit for 55 package should be rapidly implemented in order to provide the necessary certainty for corporates and financial institutions to support the sustainable transition and to significantly increase sustainable investments.

5. The taxonomy should be extended to reflect different levels of environmental impact, to better capture the dynamics of the transition and to set stronger incentives to improve companies' environmental performance. All activities that have a transition potential on the basis of a robust, science-based, measurable transition plan should be transparently indicated as such, given that financing is needed for these activities, in particular. However, the extension of the Taxonomy should not render the framework disproportionately complex and overly burdensome.

6. Globally harmonised mandatory ESG disclosure standards, with core KPIs that are common across sectors and jurisdictions based on the work already carried out by several organisations, must be developed urgently to achieve the necessary transition to a net-zero planet.

C. Recommendations for the third chapter on Investing in Europe

7. We need to move forward with greater urgency to accomplish a genuine internal market for financial services in which to create the scale to compete successfully, e.g. completion of the Banking Union. Open EU borders should be maintained to ensure that the EU continues to attract investment from international (financial) institutions.

8. As a priority, a framework for securitisation should be developed which is fit-for-purpose, along the lines of the recommendations of the High-Level Forum (HLF) on CMU (June 2020) which have been well received by all stakeholders (both market participants and regulators).

9. The current Solvency II review should be leveraged to remove excessive layers of prudence, and artificial volatility in insurers' balance sheets (specifically in the VA, risk margin) while taking stock of the current observed rate environment with attention paid to the rate outlook in order to avoid being one cycle late (the extrapolation of the risk-free rate curve and shock on interest rates). At the same time, any changes to Solvency II should be considered against the backdrop of the global competitiveness of the European insurance industry – already the world's most closely regulated and best capitalised.

10. A level playing field between banks and non-bank financial institutions should be ensured. In this respect, policy-makers should most notably be alert to the risks emanating from the non-banking or tech sectors.

C. MAIN ISSUES TO BE ADDRESSED SO THAT THE EUROPEAN FINANCIAL SERVICES SECTOR CAN PLAY ITS ROLE IN THE EUROPEAN RECOVERY

1. Ensuring competitiveness of the European financial sector

Background

When it was first launched in 2015, the Capital Markets Union (CMU) initiative was grounded on the need to change the European economy's financing model by giving financial markets a bigger role, taking into account the increasing restrictions that the reinforcement of the prudential framework was imposing on bank lending. This objective to build deeper and more integrated EU financial markets remains all the more valid at a time when the Union faces ever growing financing needs to ensure the decarbonation and digital transformation of its economy. The European Commission (EC) recently evaluated the additional investments needed to reach the EU's 2030 climate and environmental policy goals at EUR 470 bn per year, and the EU's needs to pursue the digital transformation of its economy at EUR 125 bn.

Still, two major shocks have renewed the importance of fostering the development of the EU's financial markets:

- following the departure of the UK from the EU, the most significant European pool of financial market expertise and resources now sits outside it. The financial services ecosystem remains vital to the functioning of the European economy, and policymakers must consider the way their markets operate with external locations as well as building capacity within the single market,
- the Covid-19 crisis has deeply affected EU-27 economies and caused a surge of the indebtedness of companies and states, further confirming the need for the EU to develop its market-based financing capacity. More than anything, it has revealed the need for the EU to regain autonomy in strategic areas, finance undoubtedly being one of these.

With this in mind, EFR strongly supports the EU's ambition to pursue a model of open strategic autonomy for the development of its financial markets. "Open", as excessive fragmentation would isolate EU financial markets and limit their ability to serve the needs of EU economies. "Strategic", as the ability of the EU to reach its green transition, digital transformation and social justice objectives are conditional on the availability of sufficient financing resources. "Autonomy", as the EU must control enough of such resources independently to preserve its sovereignty.

EFR Members strongly believe that the achievement of such open strategic autonomy in the area of financial markets requires ensuring the attractiveness of EU financial markets and the competitiveness of EU financial market participants remains a cornerstone of the EU's financial strategy. It should also be underlined that these attractiveness and competitiveness considerations need to be integrated into every aspect of the legislative work of the Union in relation to financial markets to account for the diverse needs of EU investors and corporate companies, to raise capital (equity listing, private equity, bonds, etc.), invest (funds, structured products) and hedge risks (OTC derivatives). These concepts have not always been given sufficient weight in the design of regulation adopted in recent years.

Competitiveness in the digital space

As the EFR has stated over the last few years, the economy is becoming more digital than ever, and Europe needs the right public policies to catalyse innovation and build on them so that its economy remains competitive and ready for the critical challenges ahead.

The European Commission is already building the required foundation with its Digital Finance package, as well as with the initiatives stemming from the cross-sectoral Digital Strategy, such as the Data Governance Act (DGA), the Digital Markets Act (DMA), the Artificial Intelligence Act and the upcoming Data Act. All these initiatives are intended to make markets more competitive, empower users and open up more opportunities for European firms on a global scale.

In this context, and as fundamental pillars of the economy and key actors in the European strategic autonomy, financial institutions must also be able to digitise themselves and compete fairly in digital markets. Both objectives require a regulatory framework that:

- is consistent at international level: as the EU financial sector is part of a globally interconnected market, this is critical for maintaining financial stability and protecting end users, as well as for addressing gaps in supervision across jurisdictions that could create systemic vulnerabilities.
- ensures fair competition among financial institutions as well as with new players: in particular, we support the EC's work to address the imbalances in the digital economy that arise with the gatekeeper role of the big online platforms.
- reduces the burden for the non-core business of regulated entities: the regulatory framework should consider how to limit the negative implications of prudential consolidation, advancing towards more activity and risk-based regulation – consistently applying the principle of "same activities, same risks, same rules".
- adequately regulate new entrants: including new players in the regulatory and supervisory perimeter is an important step towards enforcing the above-mentioned principle, applying, for example, the same AML / CFT[2] supervision to BigTech and FinTechs that offer financial services or considering a holistic entity-based regulation for non-banks, such as BigTechs, entering financial services.

Going forward, the competitiveness of the financial sector will also significantly depend on being able to:

- fully reap the benefits of valuable data exchanges and flows amongst all actors within a clearly articulated framework. This is already an important part of the EC EU´s strategic digital and data agenda, although they might fall short of the ideal end goal. For that reason, the EC needs to address the challenges ahead by putting an ambitious horizontal framework in place to facilitate cross-sectoral data sharing with specific sectoral add-ons where needed.
- facilitate the uptake of technologies and digital innovation. The use of cloud or AI and of the different digital infrastructures like payments or Distributed Ledger Technology (DLT) and being at the forefront of initiatives like digital identity are at the core of the evolving business models of financial institutions.
- ensure that crypto-assets don't disturb financial markets. There needs to be clear and consistent rules for crypto-asset services so as to enable banks to be part of the development of these markets and

2 Anti-Money Laundering / Combating the Financing of Terrorism.

contribute to a level playing field among different players. This would also require a prudential treatment of bank exposures to crypto assets that is proportional to their risks and enables banks which want to be involved to compete in these new markets.

This has to be done in a way that guarantees that the entire digital financial ecosystem is resilient, secure and trustworthy. This applies to all actors in the financial services value chain, including third-party providers that should be equally committed to existing obligations and be supervised. In this regard, the EFR strongly supports the development of a robust EU digital operational resilience framework by the EC and particularly welcomes the initiatives around cyber security (i.e. through the Digital Operational Resilience Act for financial services).

EU Competitiveness and sustainable finance

The development of a robust sustainable finance framework is critical to finance the massive public and private investments[3] needed to re-orient the economy onto a sustainable and competitive pathway. Europe leads other jurisdictions in this effort and the EFR strongly supports EU leadership in the development of internationally-designed standards. The EFR also welcomes the objectives set by the EC in its Renewed Sustainable Finance Strategy, in particular the enhanced emphasis on better recognising transition financing in the EU Taxonomy and its ambition for international coordination.

The EU Taxonomy is a building block of the EU sustainable finance framework. It provides very detailed, scientific based definitions for sustainable economic activities, protects private investors against greenwashing, and supports companies as they plan their green transition. The Taxonomy, however, is still very much a work in progress and there is a risk, in our view, that the current design of the Taxonomy could be construed as a binary tool, one that market participants may use to steer financing away from non-taxonomy aligned economic activities. However, not-yet green activities constitute most of the economy today and are most in need of financing to enable their transition to carbon neutrality. For this reason, the EFR welcomes the EC's intention to consider options to extend the Taxonomy to recognise transition efforts. We elaborate further on this in Chapter 2 of the Report. Besides, regulations can help, but the transition to a sustainable economy requires much more: green investments and projects are crucial and far from sufficient today.

As global financial firms, EFR members are keenly aware that achieving global convergence among taxonomies and sustainability reporting standards under development in different jurisdictions will be essential to maintaining Europe's leadership and competitiveness in sustainable finance. Although the EU Taxonomy disclosure requirements have a role in reaching the Paris climate objectives, greater consistency at the global level will be necessary to define what is sustainable across various jurisdictions. While Europe has taken the lead in developing a sustainable finance framework, climate change is a global challenge and financial markets are also global, so it will be essential to achieve common ground and convergence of taxonomies and disclosure regimes at international level in order to enable global capital flows and ensure a level playing field for European companies. We appreciate the EU's leading role at international level and urge the EU to work closely with international authorities and standard setters in defining the sustainable finance framework and thereby encourage global alignment and co-creation of sustainable finance standards to avoid market fragmentation.

3 The EC estimates that Europe will need EUR 470 bn in additional investment annually over this decade to meet its 2030 environmental goals and globally, a GFMA report has estimated the funding need at USD 100 tn -USD 150 tn over the next three decades to support the decarbonisation of ten sectors representing 75% of global carbon emissions.

Unlevel playing field with respect to Solvency II

Solvency II is globally the most modern and risk-sensitive framework for insurance supervision and has worked well, particularly through the pandemic crisis. However, past crises have shown that the current framework can also bring undue market volatility for the solvency measurement of EU insurers, particularly with respect to long-term insurance business. The framework needs further adaptation to better reflect the economics and specific risks of a long-term business model. Artificial volatility of available capital forces insurers to hold artificially increased levels of capital in order to comply with regulatory capital requirements at all times. Since long-term business is particularly sensitive to artificial volatility, getting it wrong has the potential to reduce the contribution of insurers to long-term financing of a green recovery of the EU.

Any increase in regulatory capital requirements would further raise capital costs for EU headquartered groups, impeding their external growth capacity to compete with non-EU players. This relates both to direct impact from artificial volatility, increasing actual capital requirements, as well as new proposals for potential supervisory intervention before a breach of the SCR. Both effects would result in an ineffective use of available capital and a decline in relative attractiveness of the EU insurance sector for global investors and, as such, may cause difficulties in providing the resources that would help the EU's goals in terms of the capital markets union, green recovery and wellbeing of people in general.

Unlevel playing field with respect to European Banks

One of the key messages of the EFR has always been that internationally operating financial groups based in the EU benefit from global standards that provide added value to their customers through efficiency gains and increased competition as a result of an international level playing field. It is furthermore important that the EU should ensure that measures taken in the EU do not create global competitive disadvantages for the European financial sector.

At the presentation of the Banking Package 2021 on 27 October 2021, both EVP Dombrovskis and Commissioner McGuinness stressed that *Europe needs a strong banking sector to keep lending to the economy as we recover from the COVID-19 pandemic and that banks have an essential role to play in the recovery. In the proposals of the Banking package, it is stated that, thanks to the globally adopted rules in the aftermath of the financial crisis, EU banks remained resilient during the COVID-19 crisis, as evidenced by the fact that they continued lending. The proposed reforms aim to complete the post-financial crisis agenda with a view to substantially boosting the competitiveness and sustainability of the EU's banking sector.*

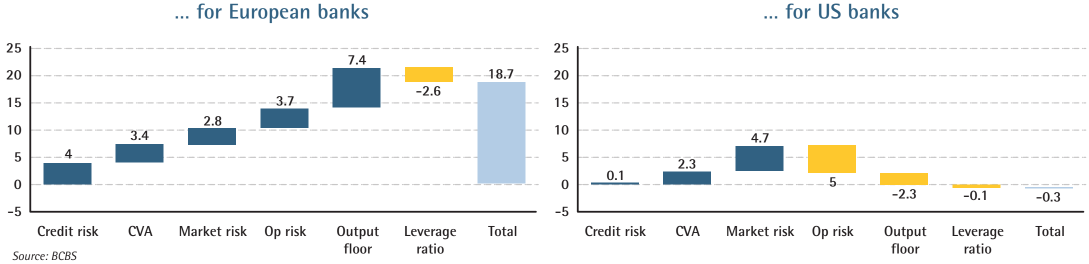
The EFR welcomes the aim to boost the competitiveness of the EU banking sector, since the current reality is a different one. The global market share of EU banks has been declining over the years, which is also due to regulatory and policy measures taken by EU institutions. While the financial crisis rightfully prompted structural reform and new regulatory measures, the financial regulation was heavily focused on risk and less so on growth.

The following graphs show how the competitiveness of European banks has been under stress over the last few years.

1. Basel III

The "fully phased-in" level of the Basel III framework clearly induces a significant distortion between European and US banks, to the detriment of the former.

Impact on minimum required capital of fully phased-in final Basel III framework...



Source: BCBS

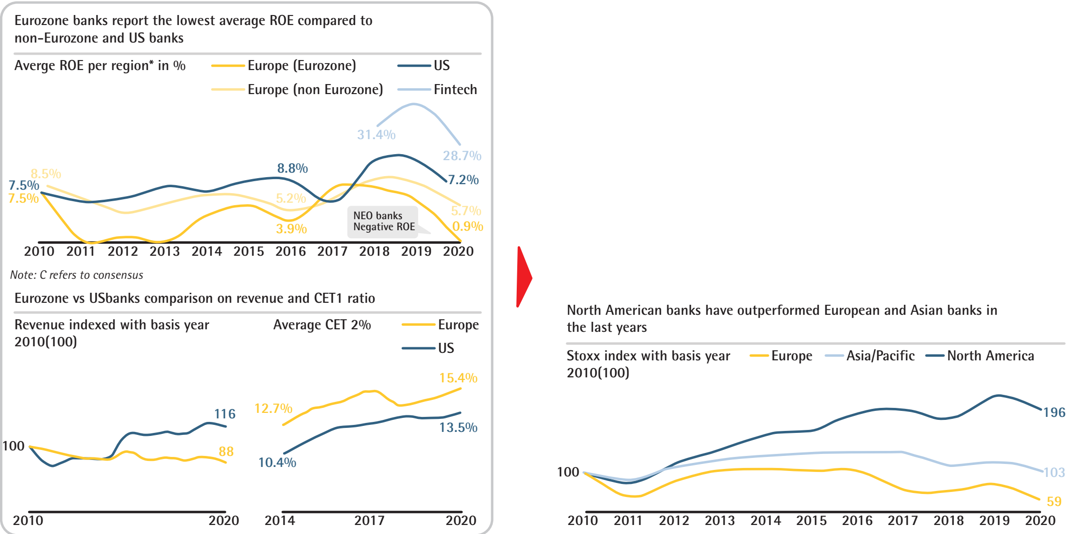
It is noticeable that the stronger requirements imposed on European banks are not linked to lower levels of capital that would need to be corrected (see for instance BCBS Basel III Monitoring Report, December 2020, page 26), but rather to the difference in the structure of balance sheets: compared to US banks, which benefit from a deep (and government-supported) securitisation market. European banks keep large pools of low-risk assets in their balance sheet, which are penalised under the "fully phased-in" Basel rules. It should also be noted that FRTB (Fundamental Review of the Trading Book) rules favour more developed capital markets, and hence thwart the ambition to develop the market activities of European banks.

2. Revenues & market share

European banking profits have been under significant and increasing pressure since the global financial crisis. Negative interest rates and muted lending demand have a material impact on the Net Interest Income of European banks. EU banks face continuing pressure on interest margins, as eurozone banks continue to suffer from the negative rates environment. TLTRO and Tiering provide some relief but do only offset the negative consequences of the low and negative rate environment to a limited extent. Additionally, EU banks face an increasing competition from US CIBs, that can rely on a deeper and more concentrated domestic market. In that context, the weighted average RoE of European banks over the last decade did not surpass the 5% hurdle. The graphs below show how the EU banking sector falls behind on aggregate compared to US peers.

Furthermore, with regard to revenues and market shares, it is important to understand the conditions that have enabled the development and current supremacy of US banks in market activities. Contrary to Europe, the US constitutes a unified legal, regulatory, fiscal and, in some areas, infrastructure framework. Critical US reforms undertaken in the 70s and the 80s have enabled the consolidation of banks and the emergence of champions in the Corporate & Investment Banking (CIB) area, that was also supported by a strong public involvement in selected domains (securitisation and lending to SMEs), the depth of the securitisation market and the consistency of the pension funds ecosystem.

European banks potentially left behind



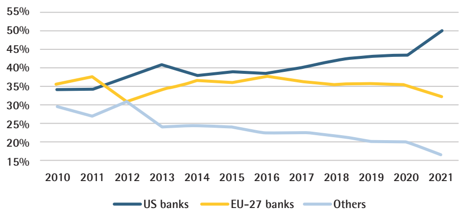
Source: Stoxx.com (Stoxx North America, Asia/Pacific and Europe 600 banks) and Bloomberg
** Eurozone banks: ING, KBC, ABN Amro, Commerzbank, Deutsche Bank, BNP, SocGen, Credit Agricole, Santander, BBVA, Intesa SanPaolo, UniCredit. Non-Eurozone banks: Lloyds, Barclays, HSBC, RBS, Nordea, Handelsbanken, SEB, DNB Nor, Swedbank, Danske Bank, UBS, Credit Suisse. US banks: JP Morgan, Citigroup, Morgan Stanley, Bank of America, Wells Fargo, Goldman Sachs ** Adyen went public in June 2018, no public ROEs available for 2016 and 2017*

- **The market share of the different banks in the Investment Banking market in Europe have followed diverging paths** (in the geographical sense EMEA: EU-27 + UK + Switzerland + Middle East and Africa, IB market being DCM, ECM, M&As and syndicated loans)

According to the Refinitiv league tables, the market share of US banks has grown very significantly since 2010, first on the back of the weakening of other non-EU-27 banks, and more recently to the detriment of EU-27 banks.

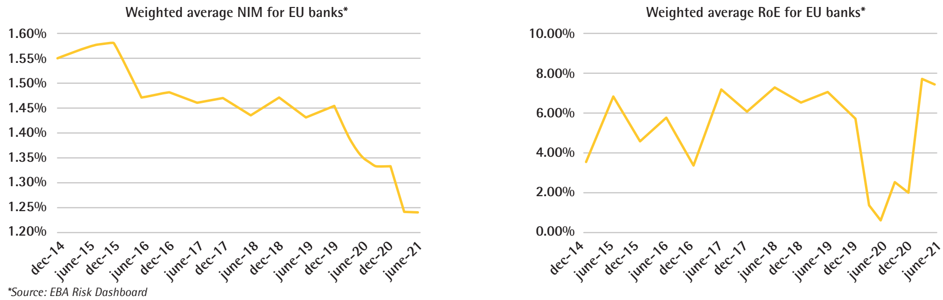
It is notable that this market share gain accelerated in 2021. The return to better fortunes of European institutions hides the fact that, in relative terms, US banks have seen their European business grow very quickly.

Split of the commission pot earned by the top 20 banks on the European IB market



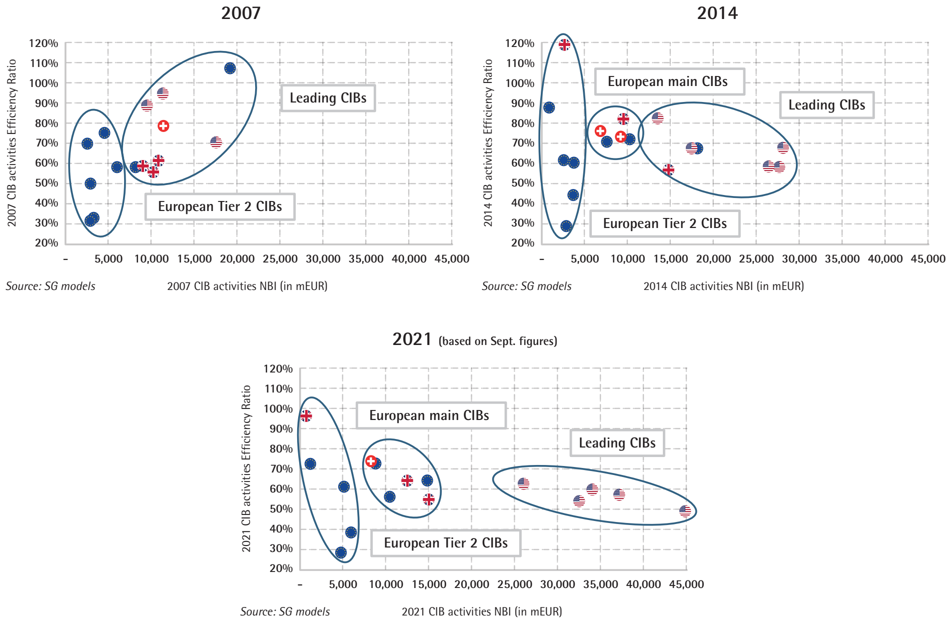
- **The profitability indicators of European and US banks, both globally and limited to the CIB activities, clearly show the stall of the former.**

Profitability of European banks



*Source: EBA Risk Dashboard

US and European CIBs diverging evolution in terms of revenues and efficiency ratio since 2007



The vision here is global, not limited to the scope of European activities. This graph shows the stalling of European banks compared to US banks quite well.

This is due to a narrower, less profitable and highly competitive "domestic" market, a US market organised to the benefit of US banks, and an unfavourable prudential development for European banks compared to US banks, following a more brutal impact of the 2008 crisis for the latter.

EFR Recommendations

- It is crucial that the recent European reform proposals ensure level playing fields (in the implementation of Basel III as well as in the on-going review of Solvency II for instance), foster the deepening of EU financial markets (CMU initiative, securitisation market, etc.) and enable to keep significant European players that need to be enhanced rather than weakened by an excessive regulation and an efficient deployment of the available capital in the markets. In particular, the Solvency II review can support the latter while improving the global competitiveness of European insurers. The Banking Union should also be completed in order to allow banks greater freedom to utilise their capital and liquidity more efficiently and optimise their ability to use their balance sheets to support their customers across EU markets.

- European authorities should effectively take the elements of attractiveness and competitiveness into account in their regulatory and supervisory work. This would for instance imply:
    - ➜ ensuring that, for each envisaged evolution of the regulatory framework, the impact on the attractiveness of EU capital markets and on the competitiveness of EU market participants is systematically assessed, alongside the current assessments of the impact on investor protection, financial stability and market integrity. To ensure that competing priorities are managed properly, a Do Not Significantly Harm (DNSH) principle could be applied, by reference to the principle applied for the green transition. It should be recalled that the European Economic and Social Committee proposed such a test in its answer to the CMU action plan.
    - ➜ adding the consideration of attractiveness and competitiveness as a secondary statutory objective for selected European authorities (first and foremost the European Supervisory Authorities). It is noted that this approach is currently being proposed in the UK, for the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA), in the consultation on the Regulatory Framework Reform.

- In order to enable the Digital Transformation of the financial services industry, the EU authorities need to ensure that the regulatory framework for EU financial services is consistent at international level, ensures fair competition, reduces the prudential burden for the non-core business of regulated entities and adequately regulates new entrants.

- Additionally, in the wider digital context, the EU should enable its financial sector to reap the benefits of a horizontal data sharing framework and easily take up new technologies and develop digital innovations (AI, cloud, DLT, crypto assets). This should be done through a robust EU digital operational resilience framework (DORA).

2. Financing the transition to a sustainable European future

Background

The EFR strongly supports the European Union's efforts to foster the transition to a low-carbon, more resource-efficient and sustainable economy. Since the adoption of the 2018 Action Plan on financing sustainable growth, and with the development of relevant legislative measures such as the Taxonomy Regulation for sustainable activities, the Sustainable Finance Disclosures Regulation (SFDR), or the Corporate Sustainability Reporting Directive (CSRD), only to name a few, the European regulator has managed to position itself as a pioneer and benchmark authority in the field of sustainable finance.

In light of the climate change and environmental challenges and risks the world is facing, we welcome the fact that several jurisdictions and international organisations are accelerating the development of new sustainability standards and regulatory frameworks.

The financial sector also plays an essential role in financing the transition to a sustainable future. Individual strategies and actions increasingly focused on sustainability, but also coalitions such as the Glasgow Financial Alliance for Net Zero (GFANZ), show the financial institutions' commitments to accelerate the transition to a net-zero global economy. But in order to continue developing sustainability strategies, it is essential for banks and insurance companies to rely on global, clear, solid and coherent regulatory frameworks that encourage sustainable financing.

It is in this context that the EFR would like to share some reflections and recommendations on the developments that are still needed to allow the financial system to support its clients and promote sustainable growth of the economy.

EFR considerations cover relevant issues such as:

- the need for a policy framework that incentivises investments in non-emitting technologies and that supports the transformation of companies and their transitional pathways. There is no lack of financing but, rather, a lack of sustainable investments.
- the role of governments in setting the transition paths and policies that will produce the right balance between climate policies directed at financial institutions and those addressing the environmental impact of other sectors and industries, while ensuring the transition is just and enables sustainable growth and job creation. The financial system has an important role to play in promoting the transition to a sustainable economy, but the key impact on climate change will come from the reduction of emissions from high emitting industrial sectors.
- the importance of an enabling transparency and disclosure framework at global level, with available high quality and comparability of sustainability data in order to steer sustainable investments successfully and identify and manage sustainability risks correctly.
- the relevant role of public and private carbon markets. Simply put, it is too inexpensive to emit carbon and other greenhouse gases.
- the importance of maintaining the key principles of risk-sensitivity and financial stability in prudential regulation.

Risks and opportunities

1. Decarbonisation

Decarbonisation is a formidable challenge that requires the deployment of carbon-free technologies across all sectors. This massive transformation requires colossal capital investments.

Although there is often a focus on divestment of unsustainable assets or activities, the solution relies on driving investments in non-emitting technologies that can replace existing emitting technologies. The amounts required to achieve net zero are very large and, for them to happen, investors need projects with positive Net Present Value (NPV).

The business case for much of this investment is already very clear, because the reduced operating cost associated with deploying existing clean technologies more than offsets the initial outlays. This seems to be the case for investments in renewable power generation, electric vehicles, energy efficiency and some relevant parts of agriculture. In other instances, especially in industrial sectors, it will take more time and there is a need for public incentives to develop and to deploy clean technologies that currently are still not competitive.

The public sector also has a major role to play in this context. First of all, by establishing regulation and incentives to mobilise private capital, thus ensuring a pipeline of sustainable investments. Second, by providing real economy companies with clear and feasible transition pathways, the adequate incentives to re-engineer their production processes and reliable policy frameworks which in turn provide some of the certainty financial actors need to make investments. The EFR welcomes the Fit for 55 package and asks for its rapid implementation in order to support the sustainable transition. Clear, credible and predictable regulation from governments is needed.

Financial institutions play an important role helping and engaging with their clients and investees in their transition towards a more sustainable future with financial support and advice. This view is compatible with reducing the exposure to heavy emitting activities. Financial institutions should start putting particular emphasis on those CO_2-intensive industries, such as power generation, steel and cement production. This can be done by setting intermediate targets for the decarbonisation of financial entities' portfolios, and by supporting clients and investee companies in these sectors with financing, advice and innovative solutions in their decarbonisation efforts. All in all, it is about how we support our clients and investees in their transition towards a sustainable future with robust plans to decarbonise their activities in line with net zero pathways. We need to maintain a forward-looking perspective to assess our clients and investee companies and we also need to report and explain very well our performance vis-à-vis our own net zero targets.

It is important to note that, while the financial system is an important element in the economic transformation, the ultimate goal is a sustainable economy that enables growth and job creation. Policy actions should therefore be balanced between broader economic actors and the financial system financing their investments.

Last but not least, the EFR would like to underline the importance of global action to achieve decarbonisation. **Authorities should also be mindful of the reality of most emerging markets and the transition of their economies** – which is critical if the world is to hit net zero. These countries' populations are growing, and energy demand will grow, which is why their energy mix must be affordable and reliable. Without the support of emerging markets, we would have to revise the collective carbon budget for the planet; we would not be able to effectively implement a global carbon market; and finally, we would not take advantage of their potential to develop green projects. In this context, leaders of developed countries and the multilateral development banks can play a key role in channelling funds to emerging economies to help them in this transition. Neither emerging markets nor the banks present in those markets should be unduly penalised as a result of different starting points or speed of the public policies in a way that hinders the growth and transition of these economies.

2. The EU Taxonomy and transition pathways

The Taxonomy is an important first step to make environmental impact measurable and create transparency. It provides a good, present-day scientific understanding of where we should be heading and is thus a valuable navigation tool for target setting and tracking. However, from an investor's point of view, the assessment of companies is not only about the current level of environmental performance and the future goal to reach climate neutrality by 2050, but about the journey in between. In order to reach a broad transition of the economy, financing credible transformation pathways of companies is critical. A better recognition of the decarbonisation efforts of corporates with credible and robust transition plans is therefore the prerequisite to ensure a global and inclusive transformation of the economy. Extending taxonomies beyond green activities to those which may be relevant for transition will be important to ensure they support short-term planning as well as long-term strategies for meeting 2050 targets. The envisaged Taxonomy extension introducing "intermediate performance" (IP) has the potential to 1. mitigate the current binary character of the Taxonomy by providing an additional nuance to the environmental impact of activities; 2. create more transparency on actual environmental performance levels of companies; 3. shed more light on the dynamic nature of the transition process by acknowledging existing transformation efforts in companies' paths to improving their sustainability performance; 4. create a stronger incentive to transform away from "significant harm" (SH) activities towards more sustainability; and 5. provide more clarity to all market participants. However, SH activities with a robust transition plan should not be stigmatised and transition financing of the respective corporates should not be undermined. Moreover, the Taxonomy represents for investors only one instrument for a company's sustainability assessment that factors into an overarching evaluation of transition readiness and progress. Lastly, if the extended Taxonomy is to play an important role in the transition, it cannot be overly complex, and the investors must have certainty that the economic activities defined in the classification system as sustainable or transitional will maintain their label for the foreseeable future.

Extending the taxonomy so that it better recognises investments made to improve the environmental performance of companies' economic activities, even if they do not yet achieve the level of Substantial Contribution to environmental objectives, will be crucial for financing the transition towards a zero-carbon economy. As the overriding issue is to decarbonise the economy in a dynamic and progressive way, this means not only stopping harmful activities but also, crucially, better recognising transition and improvements in the environmental performance of companies. This is where the greatest financing needs are.

All in all, the Taxonomy is still in the development phase, but with 1. increased availability of data; 2. the coverage of more activities; 3. the envisaged taxonomy extensions; and 4. clear policy signals to the real economy sectors that they need to transition (Fit for 55 package), the desired effects of reorienting capital flows towards the transition to a sustainable economy may be reached.

3. Engagement with clients, investee companies and other stakeholders

The role of engagement is an effective and meaningful tool to address ESG concerns in investment, lending and underwriting portfolios and support sustainable programs of real economy companies. It is important to exchange with companies to understand their overall governance and strategies, constraints and opportunities, and how they plan to ultimately achieve the Net-Zero transition. Engagement can be effective both via bilateral engagement and collaborative engagement (i.e. multiple financial market participants addressing a single company or addressing multiple companies and sectors at the same time).

ESG engagement with investee or borrowing companies plays an essential role in their transition. When investee companies emphasise creating value for all stakeholders, they are better positioned to generate sustainable and long-term business success and thus better results for our – i.e. the financial sector's – customers, whose premiums/savings we invest. The aim of taking ESG considerations into account in investments and lending is to create a lasting positive impact and ensure that sustainable business practices improve the financial performance of companies.

Moreover, financial sector engagement with customers, society and member states can support the needed transition and adaptation to climate change. Systematic engagement with electricity companies, for example, is an opportunity to support the transformation of the electricity sector while maintaining reliability given a greater supply and demand variability. In addition, through dialogue with stakeholders and the sharing of expertise with clients, the financial sector helps to improve overall risk awareness and mitigation. With extreme weather events such as floods, storms, heatwaves and droughts becoming more common and intense, continuous research by insurance experts is furthermore essential to assess current and future impacts of climate change in order to provide the best possible risk advice to society and customers.

4. Developing global sustainability reporting standards

An enabling transparency and disclosure framework to inform markets, authorities and society at large is needed, but the tools to evaluate companies' transition paths towards more sustainable activities are still a work in progress at both European and international level. EU companies with global portfolios need consistency and convergence between the various standards under development.

Providing transparency to market participants on the trajectory of companies' transition plans and performance improvements will be the driver of transition financing. However, if the taxonomy remains too binary, there will be a high risk that reporting will result in a misallocation of capital away from transition financing. Thus, emphasis needs to be given to measuring and reporting on companies' transition plans, which would provide incentives for lenders and investors and send a much more accurate signal to the markets. To that end, we recommend that the Commission should work on a standardised framework for corporates' transition plans based on recommendations by the Task-Force on Climate-Related Financial Disclosures (TCFD) and existing Net Zero / Paris agreement commitments, ensuring an international approach to the development of these plans as far as possible.

Moreover, we are of the view that in order to better recognise and incentivise companies with credible transition pathways and financial institutions, there should also be disclosure of a Transition-Aligned Ratio for financial institutions, based on their financing of and investments in clients that are effectively seeking to transition.

Europe is at the forefront in the development of the ESG policy agenda yet global ESG momentum is now accelerating among public authorities, financial institutions, non-financial corporates and civil society at large. The EU CSRD (Corporate Sustainability Reporting Directive) initiative will improve the availability and quality of sustainability data. However, a high degree of comparability can only be achieved via global convergence. Globally harmonised standards are urgently needed to achieve the necessary transition to a net-zero planet. The announcement by the International Financial Reporting Standards (IFRS) Foundation of the formation of the International Sustainability Standards Board (ISSB) to develop a comprehensive global baseline of high-quality sustainability disclosure standards to meet investors' information needs is therefore welcomed by the EFR, and we encourage the European Financial Reporting Advisory Group (EFRAG) to work closely with the ISSB on the definition of the reporting standards.

Mandatory disclosure

Disclosure of ESG data by all large (both listed and non-listed) corporates in all jurisdictions provides an incentive to accelerate the transition. The availability of reliable ESG data through harmonised, ideally global standards is key to the channelling of funding to both green and transitional activities, as it gives transparency to investors to understand and monitor the sustainability impact of their investments, reducing the complexity, duplication and compliance concerns for those financial institutions subject to different jurisdiction requirements.

The CSRD proposal will contribute to improving ESG data availability. However, appropriate sequencing and consistency between the scope and content of corporates' disclosure standards and financial sector disclosure requirements is critical to (i) adequately price climate related risks and opportunities, (ii) further develop carbon markets and (iii) enable financial sector compliance which is conditional on the availability and reliability of corporate ESG disclosures.

Regarding proportionality, the EFR supports the CSRD proposal to exempt non-listed SMEs from mandatory disclosure, while offering the possibility to "opt in", based on an appropriately reduced standard. In any case, the entity scope and resulting corporate data availability should be reflected in financial institutions' reporting requirements.

The EFR also supports the double materiality principle. It provides information on how companies reach sustainability goals while providing a more complete view of companies' context, including their risks and opportunities, helping them and their stakeholders to gain a more comprehensive and long-term view of their activities.

The EFR recognises the recent statements of G7 and G20 leaders expressing support for the development of mandatory global reporting standards, building upon the TCFD framework and the work of sustainability standard-setters. The EFR is cognisant, however, that moving from voluntary to mandatory disclosures creates challenges in a context where ESG data is scarce and, even when available, its quality is not based on robust and comparable definitions across jurisdictions. Hence, in a first stage, the move from voluntary to mandatory reporting requirements would be most effective if based on already existing and accepted standards such as the FSB TCFD.

ESG-related metrics

While ESG transition pathways are necessarily specific to each sector/country, disclosure frameworks should include core KPIs that are common across sectors (plus some sector-specific indicators) and jurisdictions. Investors will need to be able to aggregate these common KPIs to monitor and disclose their own ESG performance.

ESG disclosures cannot be limited to qualitative aspects, given that the monitoring of progress towards alignment with the Paris Agreement requires measurable quantitative KPIs. The concept of a Green Asset Ratio (GAR), i.e. the proportion of underlying activities/investments that are "green" as currently defined under the EU environmental taxonomy, may emerge as a key concept for ESG disclosure at global level. In this context, it is important to note that the GAR is a static metric that does not reflect financial institutions' sustainability strategies. The GAR should therefore be complemented with other KPIs that reflect the transition efforts of financial institutions and their clients in transitioning towards clean activities.

5. Sustainability considerations in prudential regulation

The financial sector prudential regimes, developed over decades, are risk-based and aimed at firms that adequately manage risk and maintain financial stability. While there seems to be growing momentum behind incorporating climate change considerations into prudential standards, it is of utmost importance that prudential regulation remains risk-based. We support a risk management approach that includes climate and environmental risks, while mitigating climate change through an economy-wide transformation to net zero, and with cautious use of the prudential regime as an instrument to achieve this.

We value the works undertaken by regulatory and supervisory bodies in relation to climate risk, in particular the PRA 28th October non-paper. They acknowledged if capital requirements can address the physical risks consecutive to the climate change, they cannot be applied to the transitional aspects for the various reasons explained below and a lot of work is still needed to address that issue.

Climate and environmental risk evaluation poses significant challenges given long-term horizons, and climate uncertainties[4]. Forward-looking assessment remains experimental research, rather than business-as-usual.

The results of the first climate risk exploratory exercises have shown modest financial impacts of climate change-related risks to date, illustrated by the pioneering DNB[5] efforts in 2018 as well as more recent ACPR[6] results in 2021. The ECB and ESRB work has also revealed financial impacts that are lower than those that occur in the core financial stress tests. Everyone has understood these as initial learning exercises. Thus, authorities and regulators should be cautious about adjusting prudential regime calculations in the absence of clear and comprehensive data as to what risks need to be accounted for and how they should be treated, also accounting for potential overlaps between the different parts of the prudential framework. Authorities should also consider the adverse consequences of potential capital impacts – what it would mean for growth overall, and for developing economies in particular.

4 It is noted that the last IPCC report and IEA scenario have already shown that there are uncertainties in terms of impacts of the warming path we are on, what needs to be adapted and what needs to be stopped.

5 De Nederlandsche Bank.

6 Autorité de contrôle prudentiel et de résolution.

To conclude, there is a need for mutually supportive policy frameworks across financial and real economy sectors that allow for more evidence to emerge that could inform future prudential frameworks. Thus, we welcome the Fit for 55 package and are committed to supporting our clients through that transformation. This will allow firms to prioritise resources and support clients through transitions.

6. Carbon Markets

We observe increasing investor appetite for directing capital towards a low-carbon and sustainable future[7]. However, in the absence of consistent data, financial markets cannot fully price climate-related risks and opportunities and thus may not realise the full potential of products to support the transition.

The most efficient tool to move forward would be clear, globally applicable market incentives, such as a carbon price. A well-designed carbon price is a critical part of a strategy for reducing emissions: it provides incentives both to reduce energy consumption and to develop and deploy clean technologies that are still not competitive. A fair carbon pricing can be a key step to manage climate risk and drive the appropriate allocation of capital during the transition.

Carbon markets, both public and private, therefore have a key role to play in achieving Carbon Neutrality by 2050. Regarding public carbon markets, while the EU's emission trading system currently only covers economic sectors that account for around 41% of total carbon emissions, the Fit for 55 package envisages an expansion of the system, which is highly welcomed. On the private side, voluntary carbon markets are a helpful and necessary complement to public markets, as they will help companies realise their increasing commitments to net zero through the purchase of high-quality carbon credits to offset those carbon emissions that companies cannot reduce independently.

Public policies need to support the transition to a low carbon economy by broadening the scope and converging compliance and voluntary markets as they will not, on their own, minimise the short-term costs of the transition or fully unleash the long-term benefits. The private sector must take the lead in offering true value-added market-based solutions. Coordination between the public and private sector is therefore a must.

EFR Recommendations

Decarbonisation

- The transition of the economy should ensure sustainable growth and job creation.
- Public policy should set the right incentives, particularly in high emitting sectors and in industries that need the deployment of clean technologies that are still not competitive. These incentives should include removing existing subsidies to fossil fuels, putting a price on externalities (carbon pricing), sending "demand signals" with procurement or regulation, and directing public money to research areas.
- The Fit for 55 package should be rapidly implemented in order to provide the necessary certainty for corporates and financial institutions to support the sustainable transition and to significantly increase sustainable investments, which are the cornerstone of the decarbonisation of our economy.

7 See work by the Institute of International Finance (IIF) Taskforce on Scaling Voluntary Carbon Markets.

- The leaders of the developed world and the multilateral development bank institutions should be bolder in their financial support for the decarbonisation of developing countries.

The EU Taxonomy and transition pathways

- The taxonomy should be extended to reflect different levels of environmental impact, to better capture the dynamics of the transition and to set stronger incentives to improve companies' environmental performance. All activities that have a transition potential on the basis of a robust, science-based, measurable transition plan should be transparently indicated as such, given that financing is needed for these activities, in particular. However, the extension of the Taxonomy should not render the framework disproportionately complex and overly burdensome.
- The taxonomy can only serve as reliable guidance for companies, governments and investors if the criteria are not changed too frequently. Forward-looking transparency of the expected future review of the criteria needs to be provided by the Platform on Sustainable Finance/ the EC as a minimum.

Engagement with clients and other stakeholders

- Financial market participants are keen to understand and monitor the sustainability impact of their portfolios. In order to facilitate engagement processes with portfolio companies, the availability of reliable ESG data (transition strategies, pathways, milestones and efforts) is crucial.

Developing global sustainability reporting standards

- Globally harmonised mandatory ESG disclosure standards, with core KPIs that are common across sectors and jurisdictions based on the work already carried out by several organisations, must be developed urgently to achieve the necessary transition to a net-zero planet.
- The IFRS Foundation's ISSB's work on developing climate-related reporting standards should be articulated properly with existing regional initiatives, such as those currently being developed in the EU so as to ensure international convergence. The EU and EFRAG should cooperate with the ISSB and work towards a global common approach to achieve a high degree of data comparability. The ISSB's work should be completed quickly to encompass other sustainability dimensions as early as possible. How to best integrate the concept of double materiality into the sustainability reporting standards should be considered at international level, taking into account the practical complexities of the inside-out impact perspective.
- Public Authorities should ensure an appropriate scope of EU sustainability reporting to make sure that EU standards do not imply distortion of competition between EU and non-EU financial institutions. They should take account of the specific challenges and difficulties that both EU and non-EU headquartered financial institutions will face in reporting information on their operations in third countries where companies will not be subject to (equivalent) EU sustainability disclosure requirements in the short/medium term.
- In order to ensure the compliance of disclosure requirements by the financial sector, which is conditional on the availability and reliability of corporate ESG disclosures, a one-year lag between corporate ESG disclosures and financial sector disclosures is needed.

Sustainability considerations in prudential regulation

- Prudential regimes should not be considered a first line of defence and should not deviate from their role of safeguarding financial stability and the resilience of the financial sector. Accurate guidance and a solid risk-based empirical analysis should therefore be a prerequisite for considering amendments to prudential frameworks. Excessive haste can be a source of transition risk that could hinder lending to those companies that have credible transition plans towards a sustainable business model.
- The ECB climate stress test in 2022 must be a learning exercise with no capital implications for financial institutions, given the limitations of the methodologies and availability of data. European authorities should take stock of lessons learned. This should include outreach to supervisors in other countries with major financial centres that have completed tests. Discussion should take place through the Network of Central Banks and Supervisors for Greening the Financial System (NGFS) and the Basel Committee Task Force on Climate-related Financial Risks (TFCR) to arrive at a consensus view on the way forward internationally on the prudential framework's three pillars.

Carbon Markets

- Beyond taxonomies and disclosures, the EU and the Member States should implement a meaningful price on carbon emissions and advocate for pricing carbon globally. This will align economic incentives with reduced carbon dependency and help decouple economic prosperity from carbon emissions.
- As voluntary private carbon markets are a helpful and necessary complement to public carbon markets, coordination between the public and private sector in this field is a must to help scale up the voluntary carbon markets in terms of standardisation, trading infrastructure, price transparency and liquidity.

3. Investing in Europe and the role of the European financial sector: strengths and weaknesses

As Europe emerges from the pandemic, it will face a significant need for investment. This comes about as a result of a long-standing shortfall in long-term investment (infrastructure[8] and research and development) coupled with the efforts required, in the short term, to relaunch the economy.

1. Europe's significant investment needs

Even before factoring in the impact of the pandemic, Europe's investment needs are considerable.

The NextGenerationEU plan, mainly based on the Twin Transitions (Green and Digital), will require essential private investments to allow a sustainable and solid recovery.

- For instance, the GFMA/BCG report on Climate Finance Markets and the Real Economy (December 2020[9]) estimated that the Climate Finance market must grow to $3-5 trillion+ of investment per year to achieve the ambitions set out in the Paris Agreement.
- Moreover, about €330 billion would be needed every year by 2030 to achieve Europe's climate and energy targets, and around €125 billion per year to carry out the digital transformation according to ECB President Lagarde in a speech given in May 2021[10] [11].

If Europe as a whole enjoys a current surplus, a vast part of these savings is short term as the majority of European households prefer investing in short-term savings products rather than investing in securities. The maturity transformation operated by banks is bound to be constrained by some features of Basel III (in particular the NSFR) making the mobilisation of savings through capital markets urgently crucial.

The pandemic only increases the investment challenge. With debt to GDP ratios impacted by the very effective crisis response, private capital must be harnessed and used more effectively. However, a recent study by the EIB showed that 45% of the companies surveyed were expecting to reduce investments, particularly in innovation, in the aftermath of the pandemic.

There is little doubt that the financial capital needed to address the funding needs of the future exists both within and outside Europe. The primary issue faced is ensuring that the capital can get from where it is to where it needs to be.

The aim of this chapter is to make constructive suggestions for a public policy response that will help create the conditions for the private sector to bring its firepower to finance the EU's long-term investment needs.

8 G30 report.
9 www.gfma.org/policies-resources/gfma-and-bcg-report-on-climate-finance-markets-and-the-real-economy/
10 Speech by Christine Lagarde, President of the ECB, at the EC's high-level conference on the proposal for a Corporate Sustainability Reporting Directive, 6 May 2021.
11 The EC has evaluated the total additional investment needs at EUR 470 bn per year, which includes also "environmental objectives" outside climate.

2. What is currently hampering the ability of the financial sector to play its full role as an investor?

Banks and insurers are currently more resilient than at any point in the recent past thanks to stronger prudential rules and better supervision. At the same time, the resilience agenda in Europe has reduced the return on invested capital of European financial institutions in comparison to their main international peers, threatening investor interest and their ability to expand, grow and fund.

2.1 Common denominators

There are a range of macro-factors playing into the loss of the profitability and competitiveness of European financial institutions in recent years. These include:

- a less favorable economic environment than in other parts of the world.
- loose monetary policy in the last 10 years, which makes them consequently less attractive for investors.

There are also a range of structural factors impacting the competitiveness of both the banking and insurance industries, including:

- fragmentation of the markets, which has increased with the successive crises (financial, sovereign, and pandemic) rather than decreasing.
- lack of a single market, aggravated by regulations increasing fragmentation.
- a lack of consolidation of the banking and insurance sector in several European countries and with a European resolution system that needs to be reviewed to make it more effective.
- a quasi-non-existent Capital Markets Union (CMU) and the lack of risk-taking culture.
- supervisory over-caution as illustrated, for example, by the recent uncertainties on dividend policies.

2.2 Europe needs to be more attractive

Among the factors hindering investment in Europe are:

- alternative sources of financing such as venture capital are quite limited in Europe which paves the way for American players to take over potential European unicorns.
- European stock markets are less attractive as listing rules are still too burdensome which hampers access to capital market funding by European companies particularly medium-sized companies.

2.3 Bank-specific issues

Banks, primarily medium-term investors themselves, must mobilise longer-term savings through capital markets. But they face significant hurdles:

- Based on the EC Capital Requirements Regulation (CRR) proposal, the finalisation of Basel III[12] will increase capital requirements by around 8-9 % or even much more in a fully loaded approach, and even though banks are already well capitalised according to supervisory authorities and reporting capital ratios well above regulatory and supervisory requirements. This strong focus on the need to have banks that are excessively capitalised may limit banks' ability to channel additional funding into the real economy.
- the prudential treatment of specialised lending and equity stakes makes it very difficult to promote these instruments to fund infrastructure investments.
- an inability to wind down their balance sheets in order to lend again, as securitisation is still in the doldrums.

2.4 Insurance-specific issues

Regarding the insurance sector, whilst the current Solvency II framework has proved its risk-based nature and value during the pandemic, some elements of the rulebook do not sufficiently reflect the long-term business models of insurers. This results in excessive capital requirements in some areas and brings volatility which, in turn, prevents insurers from effectively fulfilling their long-term investor role.

The right changes are needed to further mitigate the volatility currently remaining in the Solvency II framework:

- keeping the Volatility Adjustment simple but increasing its general level;
- reducing the absolute amount and volatility of the risk margin;
- having long-term equity capital charge requirements that better reflect long-term investment.

These changes would increase the efficient deployment of capital by freeing up capacity for much needed investment, risk absorption and protection, while still keeping policyholders extremely safe. It would be disappointing to see the UK moving faster to facilitate long-term infrastructure investments than the EU.

These corrections are necessary if the European insurance sector is to maintain its long-term business and product offering for the benefit of consumers and play its part in enhancing financial stability. An ambitious Solvency II review would enable the industry to play its full role in financing the transition to a sustainable economy and contribute to other EU political objectives, as well as to compete internationally.

12 Draft CRR 3 CRD6.

3. What needs to change to foster investments? Europe needs to be more attractive for investors as well as for companies

There are a range of macro and micro-level actions that should be prioritised in order to drive a more attractive long-term investment environment.

3.1 Common denominators

Investors in European bonds need to be reassured regarding perspectives for the management of European public deficits and debts. It is necessary to prepare the European economy for a possible sharp increase in interest rates, which could, if not anticipated, hamper the European economy through domino effects.

Predictability and proportionality should underpin the EU's rulebooks for banks and insurers so as to avoid absorbing an excessive amount of capital that is needed to sustain the recovery and promote investments. It should be acknowledged that the prudential rule book is on the verge of being duly completed with the finalisation of Basel III and the review of Solvency II and that no new regulation would be necessary, except in the event of obvious market failure acknowledged both by policymakers as well as industry.

Political steering is necessary to achieve the CMU and make it a reality. In particular, the EC, as well as EU and national supervisors active in capital markets, should fully engage with the European Parliament, as well as retail investors and savers, to convince them that the financing of the European economy will no longer be possible solely through banking channels and that other methods of financing need to be developed. In particular, fostering an appropriate financial education culture across the EU and convincing retail consumers to choose long-term financial products rather than short-term products and fostering a responsible risk-based culture across the EU.

There are a range of other CMU issues that need to be addressed:

- Although very complex to implement, proposals on the harmonisation of insolvency regimes will also be needed at some point.
- Alternative sources of financing such as venture capital are quite limited in Europe, which leads potential European unicorns to choose other funding locations (such as the US) including for listing.
- European stock markets are less attractive on account of listing rules still being too burdensome, which hampers access to capital market funding by European companies, particularly medium-sized companies.

3.2 Banks

Capital market and bank financing are complementary channels for funding the European economy. We need European banks to be strong in both lending and capital market services in order for the economy to flourish.

Over the course of the last decade, the European banking sector has de-leveraged considerably but now stands at the point where it needs to be allowed to invest in order to fulfil its role in both direct lending and capital market services. European banks have rationalised as far as they are able and can no longer be expected to shrink their way to international competitiveness.

The core of the regulatory framework for banks is of course the prudential framework. Policy makers should:

- Fully recognise the potential of the EU banking landscape, better capitalised thanks to Basel III and the huge management buffers accumulated over the years (500 bp over the capital requirements).
- Be careful not to restrict cross-border access from, and to, jurisdictions outside the EU while ensuring that there is a Level Playing Field between the EU and non-EU actors in terms of capital requirements.
- Establish an enabling framework for securitisation.

Beyond the prudential area, the policy-making focus should be on:

- Ensuring a level playing field between the banking sector and non-bank institutions, particularly private market actors and the tech sector.

3.3 Insurers

The insurance industry has significant potential and capacity to support the Green Deal, Capital Markets Union and the NextGenerationEU plans for recovery after COVID-19 if the Solvency II revision is balanced and well-calibrated. Improving capital efficiency by freeing up a number of excessively conservative capital requirements, the EC's proposal to review Solvency II will allow the insurance sector to use its investment capacity to invest directly in long-term, real economy projects such as smart, clean infrastructure projects in various areas such as transport, communication, healthcare, energy and/or digitalisation. The role of the insurance sector will be even more crucial to supplement public intervention as a phasing-out of State Aid is anticipated.

What should the Solvency II review do?

- The existing VA risk correction methodology (which accounts for default risks) should be maintained. The VA should be fine-tuned so that it can better act as the countercyclical tool it is intended to be, which can be achieved by improving the general level of the VA. In addition, the country-specific VA triggers can be improved to mitigate any cliff effects, and the VA risk correction should avoid setting procyclical investment incentives.
- The review should address the current excessive calibration of the risk margin, which deters long-term investments and immobilises over €160 billion, which could instead be invested in the EU's recovery and dual transitions. The risk margin also introduces volatility into the framework, as it increases when interest rates get lower.
- The provisions regarding long-term equity need to be reviewed effectively to ensure that insurers can indeed invest safely in this.
- The calibration of the new extrapolation method for risk-free interest rates should be improved to avoid negative effects on the long-term investing capacity of insurers.

What should the Solvency II review not do?

- As risk managers and with a long, collective history of servicing customers and communities regarding natural catastrophes, insurers are acutely well placed to know the realities of climate change across the EU and beyond. That being said, the industry does not support the creation of a green supporting factor in the prudential rules governing insurance. Indeed, the rules must remain risk-based. There is a strong risk of creating artificial asset bubbles through the creation of a green supporting factor. Instead, we believe that stronger adjustments to the prudential framework to

improve capital efficiency will allow companies to free up more capital that can then be directly invested in long-term sustainable projects contributing significantly to the financing that is needed to achieve net-zero by 2050.
- The review should avoid adding to the complexity of Solvency II by avoiding changes beyond areas where there is evidence of a real need and that the benefits outweigh the costs.

The review will also enable the industry to support the competitiveness of the European industry on the global stage and thus deliver on the EC ambition to strengthen Europe's leadership in the world. Therefore, it is imperative for EU insurers to operate in a level playing field with their international peers.

4. EFR Recommendations

Ultimately, the European market needs to be fully integrated, attractive to foreign investors, and competitive with other markets around the globe.

The key EFR Recommendations are

- We need to move forward with greater urgency to accomplish a genuine internal market for financial services in which to create the scale to compete successfully, e.g. completion of the Banking Union.
- Develop as a priority a framework for securitisation which is fit-for-purpose, along the lines of the recommendations of the HLF on CMU which have been well received by all stakeholders (both market participants and securities regulators).
- Leverage the current Solvency II review to remove excessive layers of prudence and artificial volatility in insurers' balance sheets (specifically in the VA, risk margin) while taking stock of the current observed rate environment with attention paid to the rate outlook to avoid being one cycle late (the extrapolation of the risk-free rate curve and shock on interest rates). At the same time, consider any changes to Solvency II against the backdrop of the global competitiveness of the European insurance industry – already the world's most closely regulated and best capitalised.
- EU regulators and supervisors should take account of profitability, considerations more prominently in their decision-making processes allowing banks and insurers to make the necessary investments to capture strategic growth opportunities.
- Ensure that there is a level playing field between banks and non-bank financial institutions, most notably that policy-makers are alert to the risks emanating from the non-banking or tech sectors [e.g. risk to consumers where they hold what amounts to a deposit on a fintech app but it is not protected via a deposit guarantee and the fintech has no requirement to deliver information to their clients about the protection of their funds, or risks to society where banks are divesting from fossil fuel intensive industries but the slack is being picked up by private market entities not subject to the same climate reporting or risk management standards].
- Keep EU markets open, in particular ensuring that European and other global players and investors can continue to use the most efficient financial market infrastructure and venues, without any restrictions on location.
- Take a fresh look at the current listing rules to make EU public capital markets more attractive for listing both European and global companies.
- Ensure that new investor protection rules are only introduced when a clear "market failure" is identified.

ANNEX I: EFR VISION

The European Financial Services Round Table (EFR) was set up in 2001. The Members of EFR are Chairmen and Chief Executive Officers of international banks and insurers with headquarters in Europe.

EFR Members believe that a fully integrated EU financial market, a single market with consistent rules and requirements, combined with a strong, stable and competitive European financial services industry will lead to increased choice and better value for all users of financial services across the Member States of the European Union. An open and integrated market reflecting the diversity of banking and insurance business models will support investment and growth, expanding the overall soundness and competitiveness of the European economy.

Increased fragmentation as a result of the post-crisis regulatory response underlines the need to safeguard the single market and protect the level playing field. The EFR therefore strongly encourages national governments and the EU institutions to continue their efforts to create a truly single market for wholesale and retail financial services, which will play an essential role in providing long-term financing for the economy in Europe. Furthermore, strong market discipline is essential to ensure fairness and alignment of interests of the financial sector and the rest of the economy towards serving the citizens of Europe and the world.

The integration of financial markets does not stop at the EU's borders – markets are increasingly global. EFR Members therefore encourage both national and European leaders to establish internationally consistent and coherent financial regulation and supervision and to support and promote free and open markets throughout the world.

As of March 2022, EFR Members' companies combined represent

- Around 964 million customers[13]
- Around 2.02 million employees
- €22.62 trillion total assets
- €19.73 trillion assets under management

13 Please note that double counting of customers may occur.

EFR Members - March 2022

Jean Lemierre
EFR Chairman and
Chairman
BNP Paribas

Denis Duverne
EFR Vice-Chairman and
Chairman of the Board of Directors
AXA

Paul Achleitner
Chairman of the Supervisory Board
Deutsche Bank AG

José Antonio Álvarez
Chief Executive Officer
Banco Santander

Oliver Bäte
Chairman of the Board of Management
Allianz SE

Lorenzo Bini Smaghi
Chairman
Société Générale

Edward Braham
Chairman
M&G

Philippe Brassac
Chief Executive Officer
Crédit Agricole SA

David Cole
Chairman of the Supervisory Board
NN Group

William Connelly
Chairman of the Supervisory Board
Aegon NV

Sir Howard Davies
Chairman
NatWest Group

Sergio Ermotti
Chairman of the Board of Directors
Swiss Re Ltd.

Gabriele Galateri di Genola
Chairman
Assicurazioni Generali S.p.A.

Nigel Higgins
Chairman
Barclays

Antonio Huertas Mejías
Chairman and CEO
MAPFRE

Axel Lehmann
Chairman of the Board of Directors
Credit Suisse Group

Michel Liès
Chairman of the Board
Zurich Insurance Group Ltd.

Pietro Carlo Padoan
Chairman of the Board of Directors
UniCredit Group

Steven van Rijswijk
Chairman of the Executive Board and CEO
ING Group

Carlos Torres Vila
Chairman
BBVA

Mark Tucker
Group Chairman
HSBC

Björn Wahlroos
Chairman
Sampo Group

Axel Weber
Chairman
UBS

ANNEX III: ABBREVIATIONS

ACPR	Autorité de contrôle prudentiel et de résolution
AI	Artificial Intelligence
AML	Anti Money Laundering
BCG	Boston Consulting Group
CIB	Corporate & Investment Banking
CMU	Capital Markets Union
CoE	Cost of Equity
CRR	Capital Requirements Regulation
CSRD	Corporate Sustainability Reporting Directive
CFT	Countering the financing of Terrorism
DGA	Data Governance Act
DLT	Distributed Ledger Technology
DMA	Digital Markets Act
DNB	De Nederlandsche Bank
DNSH	Do Not Significantly Harm Principle
DORA	EU's Digital Operational Resilience Act
EC	European Commission
ECB	European Central Bank
EFR	European Financial Services Round Table
EFRAG	European Financial Reporting Advisory Group
EIB	European Investment Bank
EPP	European People's Party
ESAs	European Supervisory Authorities
ESG	Environmental, Social and Governance
EU	European Union
EVP	Executive Vice-President
FED	Federal Reserve Board
FCA	Financial Conduct Authority
FRTB	Fundamental Review of the Trading Book
FSB	Financial Stability Board
G7	Group of 7 industrialised countries
G20	Group of 20 world's largest economies
GFANZ	Glasgow Financial Alliance for Net Zero
GFMA	Global Financial Markets Association
HLF	High Level Forum
IFRS	International financial Reporting Standards
IIF	Institute of International Finance
IMF	International Monetary Fund
IP	Intermediate Performance
ISSB	International Sustainability Standards Board
KPIs	Key Performance Indicators
NGFS	Network of Central Banks and Supervisors for Greening the Financial System
NPV	Net Present Value
NSFR	Net Stable Funding Ratio
OTC	Over-the-Counter
PRA	Prudential Regulation Authority
RoE	Return on Equity
S&D	Socialists & Democrats
SFDR	Sustainable Finance Disclosure Regulation
SH	Significant Harm
SME	Small and Medium Enterprise
TCFD	Task-Force on Climate-Related Financial Disclosures
TCFD	Task-Force on Climate-Related Financial Disclosures
TLTRO	(ECB's) targeted longer-term refinancing operations
VA	Volatility Adjustment
UK	United Kingdom
US	United States of America

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