POLICY PRIORITIES FOR THE EU FINANCIAL SECTOR

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We need inclusive EU capital markets

The European Union is the greatest and the most successful peace and prosperity project in the world. Many who have contributed to its creation and sustainment can rightfully be proud. Nevertheless, this pride and satisfaction has, perhaps, created a false sense of completion, as lately most of our improvements and initiatives come only after major shocks or emergence of external challenges. The EU still has a lot of endogenous structural issues to overcome, one of the most important ones being the lack of an integrated capital market.

The EU enhanced the stability of bank financing through big steps in building the Banking Union. In contrast, the progress in integrating capital markets has been limited to date and the Commission's measures had little catalytic effect so far. Capital markets in the EU remain highly concentrated and strikingly heterogeneous between Member States. They vary significantly in size, maturity, average financial literacy of SMEs and businesses and even financial products available.

More progress on Capital Markets Union could have a substantial positive effect on EU economy, which is experiencing much lower growth rates compared to the US. The EU has a predominantly loan-based financial system relying strongly on bank-based financing with little alternative funding sources. It is one of the reasons why large discrepancies between Member States persist in the size of the SMEs' financing gap and the availability of funding sources. The so-called 'debt-equity bias' is a disincentive for the development and integration of capital markets. Other issues, such as a lack of harmonized insolvency proceedings and the general diversity of company law across the EU, are well known.

Having in mind that reaching EU-wide solutions takes time, while having divergent situation across the EU in terms of capital markets development, it is essential to push forward less advanced capital markets in parallel to their EU-wide integration into Single Capital Market. We have to unlock European private funding potential to invest in the real economy by overcoming key cross-border barriers to investment as well as ensuring better returns for citizens throughout the EU. Without political dedication in building a truly European and inclusive capital market and further measures to tackle key cross-border barriers, it will be difficult to deliver added value for EU businesses and investors.

> **It is essential to push forward less developed capital markets in parallel to EU-wide initiatives.**

Therefore, fostering efficient local capital markets would contribute to building a genuine CMU. The lack of development of capital market is best seen in the Eastern part of the EU, where its activity is only a small fraction of the one in the west. This has incentivised some regional initiatives, like efforts of three Baltic states to move forward by developing the pan-Baltic capital market. Thus, the first step should be to render local capital markets deeper, more liquid and better aligned with regional counterparts. This will require willingness, comprehension, substantive efforts and delivering real structural reforms. Commission should use more actively all available tools, such as technical support and country-specific recommendations, to incentivize and help build financial ecosystems across Europe, not relying solely on national initiatives or demand.

We should also not forget about stability and resilience of our financial system. We have made much progress with the Banking Union, but we need to implement European Deposit Insurance Scheme to finally finish it. This would further reduce fragmentation and potential volatilities of the banking sector. Of course, risk sharing when the risks are not evenly distributed is always politicly difficult. However, the whole EU would benefit from added stability of EDIS, even the Member States with low risks currently, as the EU economy is heavily interconnected and prone to positive as well as negative spillovers.

Lastly, I would caution against following the US example of deregulation, which seems tempting as it brings fast results and, in some cases, fast growth. Unfortunately, it also breeds crises with potentially much greater declines. We should avoid unwarranted booms as they are always followed by inevitable busts. Therefore, I am confident that in the EU we have to continue implementing our simplification agenda aiming to reduce administrative burden and excessive requirements but not compromising on financial stability.

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In the SIU we trust, but how is trust built?

Europe has ample savings, but insufficient investment. The channeling of private savings into investments is a necessary paradigm shift, given the public sector's limited fiscal space and the need to reduce bank-based funding.

It is a paradigm shift, because savings are currently largely held in deposits with credit institutions. Deposits are sums repayable on demand or at a contractually agreed point in time (with repayment of the principal being unconditional with or without interest), benefit from deposit-protection schemes and are used for the credit institutions' own account. Conversely, long-term investments typically involve an investment fund, an investment account or another investment arrangement. They also require an extended investment horizon, usually accompanied by liquidity constraints. In addition, the investment takes place for the benefit of the investor and the principal amount invested is subject even to full loss, without any deposit guarantee-like mechanism.

Given those diametrically opposed investment concepts, EU and national policy priorities should:

- Intensify financial literacy to enable citizens to familiarize themselves with their role as long-term investors and the benefits of the European Single Access Point (ESAP), which improves transparency and data availability;
- Provide tangible benefits for channelling deposit-held savings into long-term investments, such as tax incentives (e.g. for equity-based savings plans), while allowing Member States relevant flexibility; and
- Foster trust into such channelling by providing for co-investments by EU and national bodies.

A distinction needs also to be drawn between growth of capital markets as a result of additional pools of assets created by the said channeling, on the one hand; and improving performance of capital markets on the other hand. While the former can be supported through policies that encourage retail participation and channel private savings into long-term investments, the latter also depends on factors outside a policymaker's reach.

The Savings and Investment Union has been announced as a horizontal enabler that will create a financing ecosystem to benefit investments in the EU's strategic objectives. While there is unanimous support for the end objective, the way the said ecosystem will function and be supervised is the subject of policy debates and issues, such as the ones below:

- Will supervisory responsibilities for capital markets remain with National Competent Authorities, or will there be, through a more or less gradual centralising process, a shift towards a single regulator (ESMA)? Even the second limb of this question is a debate per se.
- Will there be a consolidation of stock markets, in particular of the post-trade environment by means of a single settlement platform, or will trading competition among national ecosystems continue?
- The simplification efforts, including simplification by means of non-action letters by the ESAs, to counter overregulation have not reached the desired scale.
- There is a pressing need to ensure a credible pipeline of green and digital investment projects, backed by reliable disclosures and transition plans.

Unlocking of long-term capital and improvement of cross-border investment allocation face the common challenges of asset accessibility and asset tradability. Bearing this key premise in mind, the following additional policies should be deployed beyond securitization:

- Incentivize the use of dedicated long-term investment vehicles, such as the European Long-Term Investment Fund (ELTIF) and of venture capital funds, by also recognizing these as eligible or privileged investment partners for projects co-financed by EU public bodies;
- Reallocate private savings into investments instead of deposits, given that banks usually avoid cross-border lending;
- Improve access to cross-border investment platforms, so that EU savers can benefit from EU-wide solutions;
- Promote further the use of crowdfunding platforms as a mini-IPO tool for SMEs and (innovative) start-ups;

Challenges and policy recommendations for the SIU

- Highlight the potential of tokenisation as a tool to enhance tradability of property and other illiquid non-financial assets. Tokenisation can also support SME financing through the issuance of utility tokens offering access to goods and/or services; and
- Communicate the importance of the Multiple-Vote Share Structures Directive (the **MVSSD'**). Its quick transposition can facilitate the public funding of SMEs, start-ups, even of mature companies, since founding owners can retain control while seeking liquidity on secondary markets (MTFs).

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Towards a stronger euro: Strategic priorities for the EU financial sector

The global financial landscape is shifting. In April, following the US's sweeping tariff announcement on "Liberation Day," U.S. Treasuries saw sharp price declines, and the dollar weakened further. The fall is partly driven by investor *outflows* from U.S. Treasuries and corporate bonds, which reached a record US$11 billion in the second quarter of the year. This stands in stark contrast with inflows that averaged US$ 20 billion over the previous 12 quarters. These recent outflows reflect growing uncertainty about the safe-haven status of the dollar, driven not only by the trade policies pursued by the U.S. administration but also by deepening concerns over the sustainability of the country's sovereign debt.

During the same period, the euro area has witnessed significant *inflows* from international investors. Since the beginning of the year, it has appreciated by more than 13 percent against the dollar. The euro is increasingly seen as a source of stability in an uncertain world, which provides an opportunity for the currency to strengthen its international role. Reaping the associated benefits requires concerted action by European authorities to seize this opportunity, by completing the euro area architecture, making Europe more resilient, and boosting economic growth. Deepening the single market, building a true savings and investments union (SIU), and pursuing a digital euro stand out as key strategic priorities.

Because of its high dependence on trade, the European economy is highly vulnerable to geoeconomic fragmentation. Deepening the single market is therefore key to enhancing Europe's strategic autonomy, securing supply chains, and facilitating effective resource allocation. A more integrated single market would lower transaction costs, allow businesses to scale up and strengthen EU competitiveness, thereby increasing the economy's attractiveness for foreign investors. Despite years of progress, trade barriers remain within Europe, notably for services. Many companies with the potential to become European champions are held back from operating efficiently across borders by local regulations.

A true SIU would provide more capital for investments to enhance productivity, optimise capital allocation, and generate higher returns on European savings. Broadening retail participation and pursuing pension system reform are key policy priorities to deepen capital markets. Banks can also play a key role; if European banks can reach scale and operate efficiently across borders, they will be able to support deeper and more integrated capital markets, e.g. through securitisation of their loan portfolios. As such, completing banking union is a critical success factor for the SIU. This requires reinforcing resolution funding arrangements, including through the backstop for the Single Resolution Fund, completing the crisis management and deposit insurance (CMDI) reform, and creating a European Deposit Insurance Scheme.

Now is the moment to strengthen the euro area financial architecture.

In addition, a digital euro would reinforce monetary and transactional independence and may also mitigate the threat posed by stablecoins. A swift rollout of the digital euro in combination with the Markets in Crypto-Assets Regulation (MiCA) is key to containing the dollarisation of euro area economies and promoting euro-backed alternatives, which would support strategy autonomy. A digital euro could also facilitate cross-border transactions, thus enhancing depth and liquidity in capital markets.

Finally, taking more decisive steps towards common financing of European public goods would increase the supply of euro-denominated safe assets, which are in high demand. Additional supply of such assets would help increase the euro's share in international reserves.

Now is the moment to strengthen the euro area financial architecture; it is a strategic opportunity we cannot afford to miss.