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This volume, titled **"Regulatory and Compliance Insights"**, focuses on the significant progress and ongoing challenges in the field of financial regulation and compliance. The articles are organized to cover key themes such as, capital markets, independence of financial supervision, digital transformation, and capacity building, reflecting the comprehensive approach needed to address the dynamic nature of financial markets.

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Professional Insight

The Pursuit of Potency - Capital Markets in the EU

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Author's Bio

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Abstract

This paper critically examines the development of the European Union's (EU) Capital Markets Union (CMU) initiative, introduced in 2015 to create a more integrated and resilient capital market across EU member states. Despite the evolution of the free movement of capital in the EU over time, and substantial reform efforts aimed at reducing dependency on bank financing and encouraging a shift toward diversified funding and investment sources, it illustrates how EU capital markets remain underdeveloped, insufficient, and fragmented in comparison to the United States. In light of increasing social and economic challenges facing the EU, and the significant financing needs to address those challenges, the paper underlines how renewed political attention on the crucial role of capital markets must be backed up by decisive, transformative efforts under the rebranded Savings and Investments Union.

The Pursuit Of Potency - Capital Markets In The EU

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01

The functioning of capital markets

At their most basic level, capital markets are a place where investors and those seeking investment meet to trade and deal with each other. Yet, beneath lies a complex system of institutions, companies and intermediaries providing different services and functions to allow this market to operate efficiently. Each actor plays an important role in facilitating the flow of capital, managing the associated risks, ensuring transparency, accountability, and compliance with laws and regulations.

Most people need not concern themselves with the mechanics of capital markets insofar as that system is working effectively and soundly. Public trust is bestowed on the market, as well as financial regulators and supervisors, to ensure that the system functions with integrity and stability. In an optimal environment, companies will be able to tap different sources and types of investment for their business activities at competitive rates, while those providing that capital will be able to command good returns.

However, the healthy functioning of capital markets can be affected by a number of challenges and obstacles. Most notably, like any part of the economy, it is susceptible to the fortunes and misfortunes of economic cycles. The demand for, and availability of business finance is driven by the state of the economy and can be easily disrupted by volatility and shocks, for example the COVID-19 pandemic. Moreover, capital market efficiency can be affected by more structural and rudimentary issues such as the legal, regulatory, and supervisory environments, different cultural and political conventions, or fragmented market formations and practices.

For some time now, the European Union (EU) has contended with the reality that its capital markets are not optimal. This has primarily been due to structural and historical challenges that remain unresolved.[1] Admittedly, the complexity of integrating 27 different capital markets is a momentous task. It involves confronting different cultures and attitudes towards investing, in which varying levels of financial education across the EU can hinder an individual's ability to properly manage their future financial needs. It entails uniting capital markets of different sizes, specialisms, languages, and levels of development. It means dealing with competing interests within the broader financial sector, most notably the banking sector for which EU businesses and citizens have historically shown an overreliance on. Most importantly, in a world of competing priorities, it requires building political attention, momentum and consensus for policy changes that can make a difference.

Reflecting on these challenges and the state of EU capital markets today, this paper explores whether recent reforms might finally unlock the EU's capital market potential or if further transformative changes under the Savings and Investments Union are necessary to achieve a truly unified capital market.

02

Capital Markets Union: the origin story

The free flow of capital within the EU was enshrined as one of the four fundamental freedoms when the Treaty of Rome established the European Economic Community (EEC) in 1957.[2] However, at that time, significant national controls and barriers to capital movement remained, so the free movement of capital was not an immediate priority for the founding members[3]. Following the establishment of the Single Market in 1993,[4] the Maastricht Treaty (1992)[5] further advanced economic integration by paving the way for the creation of the Economic and Monetary Union (EMU), which formally began in 1999. This marked a significant milestone in achieving full free movement of capital, with the introduction of a single currency and a unified monetary policy, which helped to ensure exchange rate stability, facilitate cross-border transactions, and build deeper economic integration among participating member states.

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1 European Court of Auditors, 'Special Report 25/2020: Capital Markets Union – Slow Start towards an Ambitious Goal' (Publications Office of the European Union, 2020).

2 Treaty establishing the European Economic Community (EEC) (25 March 1957) Official Journal of the European Communities, Preamble, Articles 1-248.

3 T Padoa-Schioppa, 'Capital Mobility: Why is the Treaty Not Implemented?', in *The Road to Monetary Union in Europe: The Emperor, the Kings, and the Genies* (Oxford University Press, 1993) 26 – 43.

4 Single European Act (17 February 1986). Official Journal of the European Communities, L 169, 29 June 1987, 1-28.

5 Treaty on European Union (Maastricht Treaty) (7 February 1992). Official Journal of the European Communities, C 191, 29 July 1992, 1-112.

Building on this major development, the EU turned its attention to advancing the single market for financial services. The Financial Services Action Plan of 1999 set out to build more harmonised, efficient, and competitive financial markets by implementing 42 specific measures at EU level.[6] However, as many of these measures were still being embedded, the Global Financial Crisis hit and shifted policymakers' efforts to new reforms that focused on addressing vulnerabilities that were exposed by the crisis and build a more stable and resilient financial system. Amongst these reforms, was the creation of the European Supervisory Authorities, of which the European Securities and Markets Authority (ESMA) was designated as the EU regulator for capital markets.

Post-crisis reforms naturally focused predominantly on the banking sector, from which the crisis originated. Though the crisis also exposed another crucial vulnerability within the European financial system. It illustrated an overdependence on banks by businesses and households in the EU, and with a lack of other diversified sources of financing and saving, this concentration of financial risks exacerbated the impact of the crisis. In response to this, the Capital Markets Union (CMU) initiative was born in 2015, which aimed to deepen, widen, and diversify opportunities for investment and financing in the EU.

03

Building a single market for capital

Since 2015, over 58 wide-ranging actions and measures have been instigated by the European Commission. They aimed to address issues across the full spectrum of financial markets – ranging from aligning supervisory practices to reducing regulatory burden on companies.

The first action plan was quite ambitious, introducing 33 measures that focused on core issues like access to finance for businesses, especially small and medium sized enterprises (SMEs), and broadening investment possibilities for investors.[7] Such new investment options included new pan-European investment fund products for venture capital and social entrepreneurship. It also created the pan-European pension product (PEPP), a long-term retirement savings solution for EU citizens.[8]

In 2017, following a comprehensive review of the state of play of the CMU, a further nine priority actions were added.[9] These actions responded to developments in the EU which put a renewed focus on both the green and digital transitions, and as such focused on promoting sustainable finance and technology-driven innovation.

6 European Commission, 'Financial Services Action Plan: Implementing the Framework for Financial Markets: Action Plan' COM (1999) 232 final (11 May 1999).

7 European Commission, 'Action Plan on Building a Capital Markets Union' COM (2015) 468 final (30 September 2015).

8 Regulation (EU) 2019/1238 of the European Parliament and of the Council of 20 June 2019 on a pan-European Personal Pension Product (PEPP) [2019] OJ L198/1.

9 European Commission, 'Communication on the Mid-Term Review of the Capital Markets Union Action Plan' COM (2017) 292 final (8 June 2017).

Most recently in 2020, a new CMU Action Plan was issued by the European Commission.[10] This new action plan doubled down on efforts to build deeper and more liquid capital markets at a time where political focus had been diverted to more pressing issues such as the economic recovery following the COVID-19 pandemic. 16 new actions therefore aimed to support this recovery while expanding on the objectives of the original action plan.

04

Are we there yet?

The development of capital markets involves a multitude of complex solutions and interrelated factors that can make it difficult to discern obvious instant results. Especially in a region like the EU, this cannot be viewed as a short-term project.

Of all the actions initiated since 2015, agreement amongst EU co-legislators has been reached on the majority of these measures and implementation is complete or underway. Of course, as the final outcomes are frequently less bold due to compromises made between the European Parliament and Council during the co-legislative process, the envisaged impact of these reforms may be unclear for some time. The implementation phase can also be lengthy and involve substantial work. For example, the crucial European Single Access Point, which aims to improve transparency and access to company information, will only become fully operational in 2027, once the system and detailed functionalities have been put in place.[11]

Furthermore, it is important to acknowledge that while most of the measures to date are necessary, they are not game changers in and of themselves. Alone, they are unlikely to shift market dynamics or the choices of investors and business. For example, a company is unlikely to choose to go public on an EU stock market simply because the listing process is somewhat simpler than other global markets. Nonetheless, each of these measures are important and incremental, as collectively they contribute to building a more conducive capital market ecosystem.

10 European Commission, 'A Capital Markets Union for People and Businesses – New Action Plan' COM (2020) 590 final, (24 September 2020).

11 Regulation (EU) 2023/2859 of the European Parliament and of the Council of 13 December 2023 establishing a European single access point providing centralised access to publicly available information of relevance to financial services, capital markets, and sustainability [2023] OJ L 289/1.

05

Still lagging behind

While years of regulatory reform at EU level have resulted in improvements, the reality is that the overall appeal and performance of EU capital markets remains much lower than hoped.

Loan and debt financing remains the preferential source of funding by EU corporates as other diversified equity funding options are less developed and accessible.[12] For innovative startups and scale-ups, venture capital can be a crucial source of financing as it pursues higher reward through higher risk. Yet, in the EU, the venture capital industry is 20 times smaller than that of the United States (U.S.)[13] and European startups get less than 60% of the venture capital funding than that of their U.S. peers.[14] This may inhibit the growth potential of these companies at crucial moments in their lifecycle and push them to seek funding elsewhere.

Europe's struggles are perhaps best demonstrated by its languishing stock markets. In terms of size, EU equity markets represent only 11% of the global equity market, while the U.S. equity market stands at 42.6% of the global market capitalisation of approximately €106 trillion, as of year-end 2023.[15] As a percentage of Gross Domestic Product (GDP), the EU's market capitalisation is also lower than that of Japan, China, and the UK.[16] The depth and liquidity of U.S. stock markets versus the EU, alongside other alluring factors, immediately attracts companies seeking better funding conditions or considering an initial public offering (IPO). Since 2010, 40 EU companies have launched IPOs in the U.S. (including several high-profile companies such as Ferrari, Spotify, BioNTech), compared to only one U.S. firm conducting an IPO in the EU.[17] U.S. markets have shown how companies listed there generally command higher valuations in comparison to their peers in Europe, across all industries.[18]

While the emergence of innovative companies depends on many factors outside of capital markets, a major component in retaining them in the EU is ultimately the demand for investment. Yet, the EU again lags considerably behind in attracting long-term capital from its institutional and retail investors. In 2023, the household saving rate in the EU was 13.2% and household financial assets amounted to over €37 trillion – illustrating that European citizens are good savers.[19] However, a significant proportion of those assets sat in cash and bank deposits, earning minimal interest at a time when the annual inflation rate in the EU averaged approximately 9.2% in 2022 and 6.4% in 2023.[20] The average EU adult holds approximately €42,000 in market-based investments, substantially less than

12 Association for Financial Markets in Europe (AFME), 'Capital Markets Union Key Performance Indicators 2024' (November 2024).

13 N Arnold, G Claveres and J Frie, 'Stepping Up Venture Capital to Finance Innovation in Europe' IMF Working Paper (WP/24/146).

14 European Investment Bank, 'From starting to scaling How to foster startup growth in Europe', (May 2020).

15 *Securities Industry and Financial Markets Association (SIFMA),* '2024 SIFMA Capital Markets Fact Book' (July 2024).

16 European Commission, 'Communication on Long-term Competitiveness' (16 March 2023).

17 Association for Financial Markets in Europe (AFME), 'Integration, Sustainability and Competitiveness' (November 2023).

18 Katie Martin and Nikou Asgari, 'Why Europe's stock markets are failing to challenge the US' Financial Times (25 April 2023).

19 Eurostat, 'Households - statistics on financial assets and liabilities and statistics on income, saving and investment'.

20 Eurostat HICP inflation rate data.

the €190,000 for Americans, €80,000 for the British and €50,000 for Japanese.[21] In addition, €300 billion of those EU savings are invested in overseas companies, primarily the U.S.[22] While it makes sense for EU citizens to diversify their investments by owning U.S. shares, which also have consistently provided better returns than other global markets, this remains a substantial opportunity cost for the EU.

The availability of basic and attractive investment products is crucial in mobilising those savings into capital markets, and for retail investors, indirectly investing through pension and investment funds is often the simplest and most cost-effective way. Yet only 12.9% of euro-area households own shares in investment funds, compared to 54.4% of U.S. households.[23] In the U.S., public pension schemes provide a more limited share of retirement income compared to many European countries. This has led to a stronger investment culture amongst U.S. citizens who must better prepare for retirement through private initiative, most notably through employer-sponsored, tax-incentivised 401(k) plans and Individual Retirement Accounts (IRAs). The EU's attempt at launching a similar pan-European pension product has so far flatlined, in particular due to the inability of Member States to agree on a harmonised tax treatment.[24] The taxation of investments for individuals is often a crucial factor influencing where people choose to allocate their savings. However, as tax policy remains a national competence rather than an EU-wide one, the role of tax incentives in mobilising investment has not been a key feature of the CMU discussions.

06

Turning the tide - what's next?

Over the course of 2024, CMU shot back into the limelight. Member States are becoming more acutely aware that the future financing needs of Europe cannot be met by public spending and bank financing alone.[25] Europe's green and digital transitions alone require a combined additional investment of €745 billion each year.[26] Geopolitical developments in recent years have also prompted officials to focus more on economic autonomy and competitiveness. In a landmark report on the future of EU competitiveness, former president of the European Central Bank and former Prime Minister of Italy, Mario Draghi, makes a stark case on the need to urgently rejuvenate the EU economy to strengthen its standing on the global stage.[27]

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21 Association for Financial Markets in Europe (AFME), 'Capital Markets Union Key Performance Indicators 2024' (November 2024).

22 Enrico Letta Report, 'Much More than a Market' (17 April 2022).

23 Sources: Euro area household participation rates from ECB Household Finance and Consumption Survey 2021. US household participation rate from Investment Company Institute, 4Q23 data.

24 European Insurance and Occupational Pensions Authority (EIOPA), 'Staff Paper on the Future Pan-European Pension Product' (September 2024).

25 Eurogroup, 'Statement of the Eurogroup in Inclusive Format on the Future of Capital Markets Union' (Council of the European Union, 11 March 2024).

26 European Commission, 'Strategic Foresight Report' (July 2023).

27 Mario Draghi Report, 'The Future of EU Competitiveness' (September 2024).

Several notable reports, including from former Banque de France Governor Christian Noyer,[28] former Italian Prime Minister Enrico Letta,[29] and ESMA,[30] as well as many position papers from European industry, have begun to converge around a set of transformative ideas. They point to a two-pronged approach, where the European Commission should bring forward a number of EU-level reforms, while Member States should unify around progressing on a set of issues that are rather in their domain. At European level, the focus should be on some structural market reforms, such as revitalising the securitisation market, addressing barriers to the integration of trading and post-trading services, evaluating further EU-level supervision, and improving regulatory efficiency and agility.

While such EU-level structural reforms are fundamental, they will not transform EU capital markets. The elusive goal of the CMU initiative remains a wider and deeper capital base. This is where Member States must coalesce on the use of tax incentives to empower citizens to engage in capital market investments, while better educating people on managing their finances. The concept of an EU Investment Savings Account is gaining traction in this regard[31]. In tandem, Member States must cultivate more sustainable pension systems that foster occupational pensions and personal pension savings as a complement to the core, publicly managed pension schemes. Doing so has the potential to unlock substantial capital which could more productively support innovative businesses, leading to positive effects for households and the EU economy.

This shift in realisation, that capital markets are ultimately about investment and investors, is what has prompted the European Commission President Ursula Von der Leyen to rebrand CMU and Banking Union into an all-encompassing 'Savings and Investments Union' (SIU)[32]. The aim is to better resonate with EU citizens, to intertwine their long-term financial wellbeing and betterment with the strength of EU businesses and capital markets. A dynamic SIU can then be at the heart of the EU's competitiveness and growth ambitions – a catalyst to finance innovation, drive decarbonisation and reinforce security, as outlined in the EU's Competitiveness Compass[33]. In March 2025, an SIU Strategy launched by the European Commission provided a roadmap with policy measures that now gets this initiative underway.

Ultimately, striving for stronger capital markets in the EU will always be a perennial task, but the need for tangible progress is now more compelling.

28 Direction générale du Trésor, 'Developing European capital markets to finance the future' (25 April 2024).

29 Enrico Letta Report, 'Much More than a Market' (17 April 2022).

30 European Securities and Markets Authority (ESMA), 'Building More Effective and Attractive Capital Markets in the EU' (ESMA position paper, May 2024).

31 President of the European Commission, 'Mission Letter to Commissioner-designate for Financial Services and the Savings and Investments Union' (11 September 2023).

32 *European Commission*, 'Statement by President von der Leyen at the European Parliament' (18 July 2024)

33 *European Commission*, 'A Competitiveness Compass for the EU' (29 January 2025)