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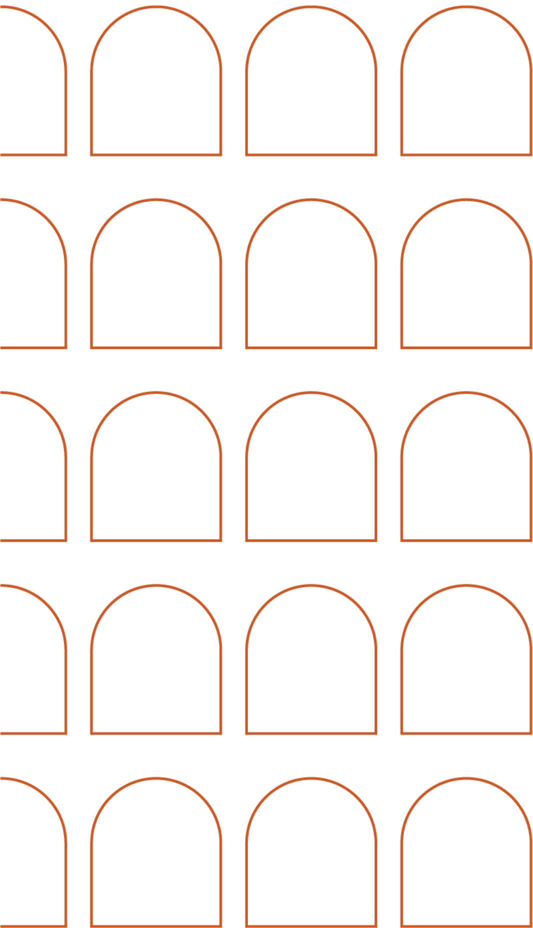

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WORKING PAPER

EU Financial Sector Priorities for 2030

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Abstract

This paper discusses financial sector priorities for the European Union in the next five years. We discuss the progress that has been made in several areas, in digital finance, anti-money laundering and micro- and macroprudential regulation, and also areas in which progress has stalled, most prominently in completing the Banking Union and building a Capital Markets Union. We also note several areas in which additional regulatory and supervisory efforts need to be made: artificial intelligence, digital financial literacy and green financing. The agenda for financial sector policymakers in Europe for the next five years is a long one, but making Europe's financial system more efficient can help speed up and deepen the twin transition and help foster innovation and growth.

Keywords

banking union, capital markets union, financial education, European commission, EU green deal

1. Introduction[1]

A new European Parliament has been elected, and a new Commission will take office later this year. This quinquennial process is happening against a background of significant, if not existential, challenges for European economies and societies. The next Commission will work in an even more fragmented political environment, making the political decision process more difficult, forcing uncomfortable compromises and possibly delaying critical reforms. At the same time, Europe faces daunting challenges, including the increasingly urgent need to address climate change (accelerating the transition to net zero but also preparing for the impact of higher temperatures on economies and societies), increasing geopolitical tensions, including a possible fracturing of the US-European alliance in 2025, and a critical need to improve the innovation and competitiveness of European firms and industries. Europe will need to learn how to deal with complex trade-offs, for example in the area of sustainability and resource allocation, if it wants to preserve its strategic autonomy while remaining open to the outside world. In addition, it will become increasingly important to develop a narrative and explain to citizens the cost of no EU action, as has been recently attempted by the European Parliament (European Parliament. 2024).

This paper discusses European priority areas in the financial sector and links them to broader economic and societal challenges. We start with the observation that although the financial sector is currently not necessarily at the centre of the challenges faced by European economies and societies, it can play a critical role in addressing them. However, the financial sector itself has to adjust in order to be able to play this critical role. Most importantly, there is an urgent need to create a truly single market in finance, which currently does not exist.

This paper discusses what has been achieved in recent years in strengthening the stability, integrity and efficiency of European finance, what has been started but not completed and what is still outstanding. We formulate a somewhat ambitious agenda for financial sector reforms and make a strong case that without these reforms the financial systems in Europe will not be able to play their critical roles in helping address the challenges faced by Europe.

Before discussing specific policy areas, we would like to offer a more general discussion on the role of the financial system. Extensive academic literature has shown the importance that a sound and effective financial system has for economic development, but also the risks resulting from financial fragility for economies and societies at large (Beck and Levine, 2018). In the current context, the intermediation capacity of the European financial system is needed for the transition of Europe to a net zero economy, to help improve innovation and competitiveness in Europe, to help support the digital and demographic transitions in European societies, and more generally to help strengthen the resilience of Europe to geopolitical changes and in its objective of strategic autonomy.

Given these high demands, what characterises a financial system that can fulfil such functions? First and most importantly, financial stability is a *sine qua non* for the financial system to be able to support the real economy. Post-crisis reforms, including Basel 3 and the initial Banking Union reforms, have contributed to a more stable banking and financial system in Europe. However, the financial system also has to be efficient, and it is here that little if any progress has been made in recent years. Even though European banks have improved their operational efficiency, banking markets continue to be national and little if any progress has been made towards a European capital market. As the ECB (European Central Bank, 2024) reports, Europe’s financial systems are less integrated now than they were before 2008. This puts a limit on the efficiency gains that European banks have been making over the past decade. Economies of scale and scope, together with an agility to swiftly adapt to changing circumstances, are important in financial service provision so a single market in finance can bring significant benefits to households, enterprises and governments.

1 Comments and suggestions received during an internal seminar at the EUI in Florence, the FBF’s Executive Seminar (27-28 June 2024), and from Nicoletta Mascher are gratefully acknowledged. The opinions expressed are those of the authors.

Start-up tech companies with high funding needs as they plan to go public see national capital markets in Europe as too small, and therefore they prefer US capital markets.

Second, and relatedly, a more diverse financial system is not only helpful for innovation but also for the twin (digital and climate) transitions in Europe. Specifically, a stronger role for non-bank financial intermediaries and (private and public) capital markets can help foster innovation, the transition to net zero and ultimately growth and resilience to economic shocks (Beck et al., 2022; De Haas and Popov, 2022; Langfield and Pagano, 2016). Third, a move towards a more diversified financial system also requires a stronger focus on consumer protection, integrity and stability. This focus requires new institutional structures at the European level (as is being established with the Anti-Money Laundering Agency). Fourth, digitalisation (including artificial intelligence) offers enormous possibilities for increasing efficiency in the financial sector, but also poses new risks that have to be addressed. While several legislative initiatives have been passed or are in preparation, the digital world is changing quickly and requires constant adaptation by financial sector actors, including regulators and supervisors. Finally, after the pendulum has swung from government-driven financial deepening before the 1980s to extensive, if not excessive, reliance on market forces, a balance has to be struck between drawing on competition and innovation through market forces and public interventions that address externalities (including but not limited to climate change) and that can help overcome coordination failures.

The remainder of this paper is structured as follows. The next section discusses what has been achieved and how it has contributed to a more stable and efficient financial system. Section 3 outlines what has been started but not completed and points to specific necessary policy actions. Section 4 discusses the outstanding agenda. Section 5 concludes and looks forward.

2. What is on track?

Outside observers often like to forget achievements, of which there have been many over the past five years. We therefore first discuss several areas in which significant progress has been made or where initiatives are on track to be completed in the next months or years.

a. Digital Transformation

Quite some progress has been made in one of the most fast-moving areas in the financial sector – the digital transformation. First, critical legislation has been passed on digital finance – the Regulation on Markets in Crypto Assets (MiCA) and the Digital Operational Resilience Act (DORA) – and a proposal has been made on Distributed Ledger Technology (DLT). In addition, a package on artificial intelligence (AI) was agreed on by the co-legislators in December 2023, the AI Act was published in the Official Journal of the EU on 12 July 2024 and it came into force 20 days later on 1 August 2024, although the majority of its rules will only start applying on 2 August 2026.

The Markets in Crypto-Assets Regulation (MiCA) institutes uniform EU market rules on crypto-assets that are not regulated by existing financial services legislation. It covers key provisions for issuers and traders of crypto-assets (including asset-reference tokens and e-money tokens) on the transparency, disclosure, authorisation and supervision of transactions. The new legal framework aims to support market integrity and financial stability by regulating public offers of crypto-assets and by ensuring consumers are better informed about the associated risks. It does risk, however, providing crypto-asset issuers and traders with a degree of legitimacy as regulated entities in spite of continual doubts about the societal value of such activities.

The Digital Operational Resilience Act (DORA) is an EU regulation that will apply as of 17 January 2025 and that aims to strengthen the IT security of financial entities such as banks, insurance companies and investment firms, and ensures that the financial sector in Europe is resilient to severe operational disruptions such as cyberattacks. DORA aims to harmonise the rules relating to operational resilience for the financial sector. It applies to 20 different types of financial entities and ICT third-party service providers.

These new regulations and legislative initiatives are in line with the European approach of regulation-driven innovation. While this approach allows less flexibility in terms of adopting new market-based innovations, it has the advantage of supporting a level playing field in the single market in Europe. It is important to stress, however, that these new rules have to be enforced and both national and supranational authorities play an important role in this enforcement.

The proposed regulation on DLT aims to establish a temporary common EU pilot regime for financial services based on DLT to remove regulatory barriers against issuing, trading and settling crypto-assets that are financial instruments and so to help regulators gain experience in the use of DLT. It covers (i) granting, withdrawing and modifying permission to operate DLT market infrastructure; (ii) the operation and supervision of DLT market infrastructure, and (iii) cooperation between DLT market infrastructure operators, national authorities and the European Securities and Markets Authority (ESMA).

The introduction of the digital euro, a *de facto* euro-area instant payment system, is making progress. A Digital Euro Legislative Framework (Single Currency Package) has been put forward and the European Central Bank (ECB) is working on implementing the digital euro. While the digital euro has – strictly speaking – less the character of a central bank digital currency, as has been proposed in many countries and introduced in some, it has the potential to contribute to a single market in banking by providing public infrastructure for fast and efficient cross-border payments within the euro area. It also contributes to the objective of strategic autonomy by making the euro area less dependent on global retail payment systems, most of which are provided by US-based corporations. While the question arises of whether a private-public partnership in developing such a euro area-wide payment system would have been preferable (as has been done, e.g. in Brazil with Pix), regulatory authorities have a key role in overcoming coordination failures. Establishing a payment union can certainly contribute to further deepening the single market.

b. Anti-Money Laundering

Following several scandals related to anti-money laundering and combating financing of terrorism, AML/CFT reform proposals have been pushed forward, with Directive (EU) 2024/1640 on prevention of the use of the financial system for the purposes of money laundering or terrorist financing published in June 2024, which harmonises AML/CFT rules across the single market and thus prevents regulatory arbitrage in this area.

In addition, the Anti Money Laundering Authority (AMLA) was established earlier this year in Frankfurt and will be built up over the coming years as the centre of an integrated system: the authority plus the national authorities with an AML/CFT supervisory mandate. This new structure is an important step towards securing a financial system that prevents money flows related to illegal activities and is also in line with the objective of strategic autonomy as it helps reduce the risk of money inflows that are aimed at undermining (trust in) democracy in the EU.

The structure of the AMLA shows significant differences from that of the three European Supervisory Authorities (ESAs) in the sense that it is the Executive Board (composed of a chair and five independent board members) that will make all decisions on individual obliged entities and individual supervisory authorities, where relevant, rather than the General Board, which also includes chairs of national anti-money laundering authorities. Similarly to the Single Supervisory Mechanism (SSM), there will be Joint Supervisory Teams (JSTs) supervising specific obliged financial institutions.

The effectiveness of the AMLA will depend on a multi-year institution-building process and on close cooperation with other European institutions. It will also require an increase in staff trained in AML, who are currently not available in many countries in the EU.

c. Macro- and microprudential reforms

In the area of macroprudential regulation and as foreseen in the legislation establishing the European Systemic Risk Board (ESRB), a review of the macroprudential framework in Europe, including non-bank financial intermediaries, has recently started. On the other hand, plans for new legislation to expand the macroprudential toolkit to borrower-based measures have been postponed to the next legislative period. At the same time, the ESRB is currently reviewing its structure, which will be followed by a formal review by the European Commission.

Competence for macroprudential policies is currently primarily at the national level (with a few exceptions in which the SSM can activate additional buffers), including the countercyclical capital buffer. Some countries have ample experience with a number of macroprudential tools (including in Central and Eastern Europe), while others have more limited tools available. Importantly, not all countries currently have borrower-based measures, which have been shown to be quite effective in limiting aggressive credit growth.

While microprudential supervision has to a large extent been delegated to the supranational level (with significant institutions being supervised by the ECB), macroprudential policies are still primarily at the national level. It makes sense to have these tools implemented differentially across the economies of the EU (including in the euro area) given asynchronous financial cycles and different financial structures (e.g. with respect to the importance of mortgages on bank balance sheets). However, not only do bank failures in one country have spillover effects in other countries but they also do on credit cycles and the consequent fragility during the bust period (as evidenced by the Irish boom-and-bust mortgage cycle in the 2010s).

Currently, the ESRB, the macroprudential authority of the EU, has only soft powers, i.e. it can issue warnings and recommendations. However, it does not do so, being a third party to the recipients of these warnings and recommendations. Instead, the majority of General Board members are heads of national designated authorities (with the exception of Sweden, the national central banks and thus governors). The question remains whether this is the best setup or whether there should be further centralisation/strengthening of macroprudential regulation and supervision at the euro-area level comparable to the SSM. At a minimum, the ESRB secretariat’s capacity to more carefully monitor developments across the European financial system and thus identify possible new sources of systemic risk through better and more immediate access to data should be improved.

Finally, the implementation of Basel III reforms is in its final stages, although new doubts have arisen about the timetable, given that there are clear indications that the US will delay implementation of the final elements, raising concerns about international competitiveness if the EU pushes ahead with its implementation timetable. After the news from the other side of the Atlantic was confirmed, the Commission announced that the introduction of the section on how banks cover markets risks in their trading books, known as the fundamental review of the trading book (FRTB), will be delayed to 1 January 2026 (EC-DG FISMA, 2024).

3. What has stalled and needs to get back on track?

Over the next few years, the EU banking sector will be crucial to support the continent's ambitious transition to a carbon-neutral economy and to address other pressing issues, such as demographic changes, geopolitical uncertainties and the need to create a degree of strategic autonomy in global financial affairs. Banks are anticipated to serve as key enablers, fostering more competitive and innovative economies across Europe by channelling financial resources to sustainable investments and projects. However, EU banks will not be able to do this alone. To meet all its objectives, Europe's financial landscape will be likely to witness broader diversification, with non-banking financial institutions and capital markets assuming more pronounced roles leveraging a larger space available for providing finance. This evolution is expected to contribute to a more stable, efficient and integrated financial system while working to establish a truly single market in finance.

Two elements are key to the transformation of European finance: the Banking Union and the Capital Markets Union. Both have been discussed and partly started; neither has been completed. Further delay, however, undermines the effectiveness of European finance in supporting the necessary double transition, as we will argue in the following.

a. The Banking Union: state of play

10 years after its creation, completion of the Banking Union is crucial to establish a truly single market in finance. While the limitations of the current system are evident, in the absence of a banking crisis, efforts to complete the Banking Union remain halted. The CMDI (Crisis Management and Deposit Insurance) package introduced after (but not as a reaction to) the banking turmoil in the US and Switzerland in 2023, is currently about to enter the trilogue stage, but the ultimate outcome is highly uncertain. This situation highlights the critical disparity between acknowledging the need for reform and the willingness to enact it, showing that significant progress in European banking reform is improbable without a crisis to catalyse decisive action.

10 Years of SSM Banking Supervision: Accomplishments and Remaining Challenges

The Single Supervisory Mechanism (SSM) has served as a centralised framework for banking supervision within the Eurozone plus Bulgaria since 2020. Reflecting on ten years of SSM banking supervision, a combination of achievements and challenges can be identified. With differentiated governance, the SSM has successfully unified the supervisory approach across the participating countries and promoted greater transparency, consistency and stability in the banking sector (Petit, 2022). Centralised supervision has effectively mitigated systemic risks and enhanced the resilience of supervised entities through rigorous stress testing and tight monitoring of capital requirements. However, weaknesses concerning the Supervisory Review and Evaluation Process (SREP) followed by the SSM persist, as a report drafted by a group of independent experts (Dahlgren et al., 2023) identified. Existing hurdles to this common supervisory methodology include the need for greater proportionality in supervision to account for the diverse sizes and complexities of banks, to adequately address emerging risks such as cybersecurity threats, and to improve cross-border coordination. In addition, as the new Chair of the SSM Supervisory Board (Buch, 2024) recently noted, there is a continual need to adapt the SSM supervision to the evolving financial landscape and ensure that supervisory standards and practices keep pace with innovation and market developments, something that may at times be challenging in an institutional environment with bespoke supervisory measures.[2] The reformed SREP will allow supervisors to concentrate on specific topics annually while distributing their assessments over the course of the year, will better integrate several types of supervisory activities including on-site inspections, targeted deep-dive analyses and horizontal

2 For a more in-depth discussion on the challenges for supervisors to catch up with market developments, see Beck, Carletti and Goldstein (2017).

thematic reviews, and will make full use of supervisory tools.

The Single Resolution Mechanism in 2024: The beginning of a new phase and progress on CMDI

Since 2015, the Single Resolution Mechanism (SRM) has been a cornerstone of the Banking Union, managing the orderly resolution of failing banks with minimal impacts on the real economy and public finances. However, as the newly appointed Chair of the Single Resolution Board (Laboureix, 2024) has stated, the SRB has entered a new phase.

The new phase of the SRB, or as it is often referred to the new SRM Vision 2028, entails further progress in preparedness for crises, changes in governance and transparency by the banking industry, and significant improvements in human resources. Refinement of the response to crisis circumstances depends on assessing the current EU legal framework to ensure consistent application of rules across member states and facilitate the resolution of smaller and medium-sized banks. These are, concisely, the key aims of the Commission's 2023 legislative package known as the Crisis Management and Deposit Insurance (CMDI) review.

In the heart of Europe, the Commission's proposal of CMDI (European Commission, 2023) has sparked heated discussions in the European Parliament and the Council. After more than a year, but before the recent elections took place, the MEPs tabled a report (European Parliament, 2024) favouring enlargement of the scope of application of the EU bank resolution framework to medium-sized and small institutions, as proposed by the Commission, by introducing changes in the public interest assessment (PIA). This position, together with potentially relevant changes in the definition of critical functions of banks, the depositor hierarchy and possible additional contributions made by deposit guarantee schemes (DGS), is not yet final as the usual trilogue procedure has yet to take place before a final text is agreed. Just after the EP elections took place, the Council reached a position (Council of the EU, 2024) that significantly differs from the Commission's intentions, particularly in the changes introduced to the PIA and the possibility of DGSs funding resolutions. Following the Council's position, a resolution process will only commence if deemed in the public interest. The PIA will be conducted in two stages to determine if resolution objectives are at risk and if insolvency is less effective in achieving the resolution objectives than resolution (while considering the costs and seeking to minimise destruction of value). Whatever compromise the co-legislators may reach regarding the CMDI's funding equation, it must ensure results comparable to the Commission's proposal, and a piecemeal approach should be avoided (Arnal, Lannoo and Lastra, 2024). Specifically, if the scope of banks under the SRB's remit is expanded, adequate funding is essential to facilitate successful resolution transfers.

However, it is not clear how additional funding of resolutions can be provided. Recent literature has put forward several alternatives to the European Commission's ambitions: i) enhancing the loss absorption capacity of going concerns by allowing early write-down and conversion, ii) preparing effective pre-structured auctions in transfer strategies (instead of *ad hoc* negotiations and fire sales (Asimakopoulos and Tröger, 2024); iii) improving the design of coco-bonds to enable sufficient recapitalisation capacity that authorities can activate to stabilise a wobbly bank without triggering resolution; and iv) allowing early haircuts on early deposit withdrawals to disincentivise runs (Perotti and Martino, 2024). Even without knowing where the final CMDI text will extend to, any compromise must consider the long-term sustainability of the funding mechanism to ensure it can adapt to future challenges and changes in the banking landscape.

The Missing Pillar and Forward-Looking Challenges

Another critical gap in the Banking Union is the absence of a European Deposit Insurance Scheme (EDIS), which is often referred to as the (third) missing pillar. EDIS is essential to create a fully integrated and resilient Banking Union as it would provide a uniform level of protection for depositors in all the participating countries, thereby enhancing trust and stability in the banking system (Brescia Morra, 2019). The lack of an EDIS leaves the Banking Union incomplete and exposes the banking sector to potential vulnerabilities, including potential risks associated with banks holding large amounts of their home country's government debt. In turn, the absence of limits to exposure by banks to government bonds may lead to bank failures, which would put pressure on the deposit insurance system. Both exposure limits and EDIS involve deepening economic integration in the Banking Union, which requires significant political agreement. Some participating countries are concerned that exposure limits might restrict their ability to finance themselves with domestic banks, while others worry that EDIS might lead to a transfer of risks and financial burdens between countries. To implement EDIS successfully, there needs to be confidence that banks in the Banking Union are similarly stable. This is where exposure limits come in – they would help ensure that no single bank or banking system becomes too risky, which would make a common deposit insurance scheme more viable. Looking forward, the challenge lies in achieving political consensus and addressing concerns related to risk-sharing and moral hazard to implement EDIS effectively.

In April this year, the EDIS Report by Othmar Karas (European Parliament, 2024) was a positive surprise. Unlike the previous report by Esther De Lange in 2015, this report proposes a phased approach to implementing EDIS. Instead of fully covering bank deposits from the outset, EDIS I would only establish a liquidity support mechanism that provides loans to DGSs in need of liquidity and would be supported by a deposit insurance fund funded by other DGSs. Once liquidity concerns are primarily addressed, EDIS II would focus on the risk sharing dimension, which is the area where political consensus is mostly lacking. Immediately after this gradual implementation, the third pillar would be useful to advance to more integrated banking services, for instance reducing the home-bias in deposits by increasing depositors' confidence in banks outside the remit of their own home DGS. Despite the progress made on this front, the inter-institutional mandate has not been voted on in the European Parliament Committee on Economic and Monetary Affairs, which argues that such a vote should be conducted in the next legislature. Following the elections that took place from 6 to 9 June 2024 the newly elected European Parliament will take up this file and continue the work to complete the Banking Union.

The recent banking turmoil, including US regional bank failures and the Credit Suisse failure, in which public intervention was necessary beyond traditional resolution frameworks, has revealed two other weaknesses in the current state of play of the Banking Union: i) the absence of a public backstop to the Single Resolution Fund; and ii) the insufficient liquidity funding available to resolve a potential European G-SIB. These constitute two big challenges without an obvious and immediate solution. The implementation of the backstop is pending ratification by Italy of the agreement to reform the European Stability Mechanism Treaty, and it is unlikely to be unblocked without difficulty. Concerning the funding needs, the resolution of the banking failures in the US and Switzerland prove that the liquidity backstop is the main tool to prevent systemic risk in the case of a big bank failure that would entail depletion of the Single Resolution Fund, and the failures highlighted the urgency of EU authorities working on reinforcement of credible liquidity solutions.

While the EU banking sector has weathered the recent storm in financial markets well, the ability of the SRM to deal with the failure of systemically important banks must be further developed, particularly in relation to the issue of liquidity in resolutions. Given the importance of public backstops to stabilise financial markets during crises, such reform should rank high in the priorities of the EU's financial sector agenda ahead of 2030.

Political deadlock?

The debate on how to create a more integrated and resilient financial system in Europe is not over. In the year of the 10th anniversary of the Banking Union, the bank-sovereign nexus is not yet broken. Establishing EDIS and introducing the public backstop and exposure limits on government bonds would be critical steps forward. The recent deadlock in completing the Banking Union, whether in terms of establishing a fiscal backstop or advancing EDIS, underscores a significant issue. It reveals that, in the absence of a severe economic crisis there is a pronounced lack of political will to address and rectify the evident shortcomings in the existing framework. This impasse highlights the challenges in gathering sufficient political momentum and consensus to push through essential reforms. Despite the clear need for a more robust and resilient banking architecture, the political landscape remains stagnant, and it cannot overcome the inertia preventing necessary advances.

b. Capital Markets Union, now renamed Savings and Investments Union

Another area that has gradually fallen out of the core financial sector priorities and clearly needs to go back in as a top priority for the next legislature is the Capital Markets Union (CMU). Despite two CMU action plans and a number of legislative initiatives undertaken in this area, evidence confirms that the EU capital markets remain significantly smaller than those in other comparable jurisdictions such as the US, and the level of integration still appears unsatisfactory. While in the past the City of London operated in several respects as a *de-facto* single capital market, Brexit radically changed the situation.

Recent geopolitical shifts and the compelling need to support the major financing needs of the twin transitions have brought a new sense of urgency to this policy initiative. In the face of ever-growing challenges it has become clear that Europe will only be able to successfully compete with other major jurisdictions and transform its economy if its capital markets become larger and more integrated.

Just in time for the tenth anniversary of the first CMU Action Plan in 2015, there have been attempts to revive the initiative, including a joint editorial by the French and German Ministers of Finance (Le Maire and Lindner, 2024), an editorial by the Commissioner for Financial Services (McGuinness, 2024), a statement by the Eurogroup (Eurogroup, 2024) and (a bolder) one by the ECB Governing Council (ECB, 2024). In addition, the recent Letta Report (Letta, 2024) on the Single Market touches on the CMU, renaming it Savings and Investments Union, while the Noyer Report (DG Tresor, 2024) and the AFM DNB Report (AFM and DNB, 2024) provide further details, respectively from the French and Dutch perspectives. While such declarations of intent and lists of action points show an increased political emphasis, several deep-rooted obstacles seem to persist. Last but not least, the recent Draghi Report (Draghi, 2024) emphasises the importance of building a genuine CMU.

The next section provides an updated assessment on why we need to strengthen the capital markets at the national and (even more) European levels and which steps could be taken to reach this goal.

Why we need a CMU: an updated assessment

Preliminarily, it is worth noting that while the names seem to suggest this, drawing parallels between the Banking Union and the Capital Markets Union can be misleading and somewhat counterproductive. The Banking Union (or at least what has been put in place) was the result of a crisis and focused on banking stability. It has clear pillars (SSM, SRM and EDIS) and there is a broad consensus on what has to be done, although not as much political will to take the final steps. The Capital Markets Union, on the other hand, is a much broader project focusing on a variety of markets and institutions with both legislation and regulation.

Generally, there is a wide consensus that Europe urgently needs to diversify away from a bank-based or bank-biased financial system to giving non-banks and capital markets a stronger role. This includes both public equity and bond markets, and non-bank intermediaries such as venture capitalists and equity funds. The need for a CMU is supported by a large stream of academic research which provides evidence that a bank-based financial system is not only bad for growth but also for stability. For example, Langfield and Pagano (2016) show that an increase in the size of the banking system relative to the equity and corporate bond markets is associated with more systemic risk and lower economic growth. This seems to be due to the more procyclical nature of bank lending, in which banks overextend and misallocate credit when asset prices rise and ration it when they drop.

The literature also shows that rebalancing the financial system towards non-bank segments of the financial system is also needed for innovation and the green transition. In a recently published paper, Beck et al. (2022) show that liquidity creation by banks is growth- enhancing through the channel of tangible – but not intangible – investment, with the aggregate growth effect of bank liquidity creation becoming insignificant in economies with a larger share of sectors relying on intangible rather than tangible assets. In addition, De Hass and Popov (2023) show that market-based, rather than bank-based, financial systems are better positioned to fund the transition to net zero. They find that banks generally do not fund innovation and intangible assets as they rely on tangible assets for collateral and the track records of companies (which innovative start-ups might not have). Banks are also found to be reluctant to fund the green transition as it might hurt their legacy borrowers.

While the above constitutes a general argument for fostering non-bank segments at the country level, the rationale for doing so at the European level is sometimes questioned in the ongoing policy debate. The academic literature has investigated the issue of market size at length. For example, De la Torre, Feyen and Ize (2013) have demonstrated empirically that economies of scale matter in finance and even more in capital markets, in which network externalities are also important. Larger countries have bigger and more liquid capital markets. Interestingly, when assessing the success or failure of 59 stock markets after four decades of activity, Albuquerque de Sousa et al. (2016) find the most extreme contrast between the stock exchanges of China and Swaziland, which were established in the same year. Finally, there is the issue of path dependence, as a vibrant financial centre relies on many ancillary services such as legal, accounting, auditing etc. ones (which explains why London continues to be one of the global financial centres).

Overall, the literature confirms that moving to a European Capital Markets Union to benefit from such scale and network externalities is critical, and EU policymakers seem to generally agree. What seems to be less consensual is how to achieve such an ambitious goal.

How to achieve a CMU: the state of play and next steps

How to make EU capital markets larger and more integrated has been at the core of discussions and policy initiatives on a Capital Markets Union that have taken place in two main iterations since 2015. This has been a bottom-up approach, as a result of which a number of barriers have been removed to better match the demand for and supply of capital, especially at the cross-border level. Policy initiatives have spanned from ones aimed at facilitating retail investor participation to others focusing on diversifying sources of capital for European businesses or on strengthening market infrastructure.

Certain CMU policy initiatives, especially some of those proposed under the 2020 Action Plan, have certainly been ambitious. For example, the setup of the European Single Access Point (ESAP) and the Consolidated Tape Provider (CTP), and actions under the Listing Act have been important steps in the right direction that should not be underestimated. However, none of these are silver bullets, and several bottlenecks still hamper the (cross- border) matching of the demand for and the supply of capital. Deep-rooted issues persist, for example, in insolvency and securities law, consumer protection, financial literacy, pension systems and taxation.

Last but not least, the consistent implementation of legislation and regulation with common supervision remains the elephant in the room, which begs the important question of who can drive this process. It is clear that a champion on the technocratic side would be able to support progress over time and – most importantly – across the political cycles. ESMA would certainly be in a good position to play such a role, while upgrading ESMA's position as supervisor across more segments of the financial system in the EU could also help. One important impediment is clearly national political interests, as has also been pointed out by Comissioner McGuinness.

With a new legislature upcoming, the question of whether to address such difficult challenges requires a paradigm change, namely a renewed and more ambitious top-down approach, as has been proposed by the ECB President.

Certainly, the history of European integration tells us that while bottom-up processes are often successful in progressively picking low-hanging fruit, top-down shifts (including institution-building) are more difficult to achieve and can be hard to agree on at the EU level. Here, a key point to ponder in the CMU debate is whether there will be a need for a coalition of the willing to move first and break the status quo, leaving the door open for others to opt in at a later stage. Certain EU countries seem prepared to move in this direction. Alternatively, the idea has been floated that it could be left up to market players to opt for a so-called 28th regime, i.e. a fully-fledged single framework of CMU rules and supervision that sits alongside national regimes.

Finally, it should not be forgotten that EU public policy is by no means the only tool to bring an authentic CMU into being, and difficult EU discussions should be no excuse for other players to delay action. In particular, national legislators and the private sector can be active parts of the transformational changes that are needed. On the one hand, while certain CMU issues can only be effectively addressed at the level of the Union, there are some for which national legislators can do a lot, for example when it comes to incentivising and supporting household investments in capital markets. In particular, pension reforms should include robust tax incentives to support investment in pension products, including ones with an EU label, and make sure that households are effectively able to access them. In turn, a broader access to (pension) investment products can be extremely important in providing hands-on financial education to those households that are less exposed to financial investments.

On the other hand, while public policy may be an extremely effective tool to set the appropriate incentives for market players, one should not forget that the CMU is first of all a market integration project. As such, economic actors should contribute to the success of the CMU by making efforts to increase consolidation and integration at the cross-border level. This is the case especially in the area of market infrastructure, where efficiency gains for large groups (leveraging e.g. network externalities) can be significant.

4. What is missing?

There are several areas where limited action has been taken so far, but there are also areas where developments are fast-moving. The following list is certainly far from exhaustive.

a. Artificial Intelligence (AI)

One important area for the near future is the role and impact of artificial intelligence (AI). The opportunities and challenges arising from AI are developing rapidly as the technology is progressing swiftly. On the one hand, there are opportunities both for market players in the financial system and regulators and supervisors. The emergence of RegTech, SupTech and ResTech are clear indications that regulatory and supervisory authorities are trying to benefit from the new opportunities that AI offers. On the other hand, the use of AI in the financial system brings with it new risks and challenges. It can lead to herding trends among financial institutions and market players. It can make the financial system more vulnerable to cyber- attacks and computing outages. This requires more active supervision, both in normal times and also in how financial institutions and market players react in crisis situations caused by AI.

b. Enhancing digital financial literacy for effective financial inclusion in the EU: the role of the next Commission and the role of the industry

The progress in digital innovation makes one think of opportunities for strengthening financial literacy and inclusion, but also of challenges. Despite positive trends, the boom in digital financial services has also led to increasing incidents linked to fraud, over-indebtedness, cyber threats and discrimination in the EU. Overall, the digitalisation of finance has facilitated easier access to financial products, yet it has concurrently exposed consumers to unfamiliar and rapidly evolving risks. While the risks identified in emerging economies like Brazil and Kenya are surely different from those threatening member states in the EU, vulnerable groups such as the elderly, the young and those with low digital and financial literacy face significant risks wherever they live.

Digital financial literacy drives digital financial inclusion (Globabl Partnership for Financial Inclusion, 2016). Although it is essential, the levels of financial knowledge in the EU are low(Demertzis et al., 2024) The European Commission’s Eurobarometer survey on financial literacy published in July 2023 reveals that only 18% of EU citizens possess a high level of financial literacy, 64% exhibit a medium level and the remaining 18% have a low level (European Commission, 2023). These results reveal huge knowledge gaps about simple financial concepts such as inflation, compound interest, basic asset pricing, the relationship between risk and return, and risk diversification. They also bring very bad news for the financial well-being and outcomes of EU citizens, including for their potential savings (Kaiser et al. 2022). What has been done to address this knowledge gap and what else should be done by 2030?

Commission (2024-2029)

Looking at the past 5 years, a lot has been achieved. At the national level, member states have designed or are in the process of designing national financial literacy strategies (OECD Financial Education). Some of them, for instance Cyprus, have proved their success and their potential multiplier effect (Kallenos, Milidonis, and Zenios, 2023). To name a few EU-level initiatives, in its 2020 Capital Markets Union action plan the European Commission (2019-2024) proposed 16 legislative and non-legislative actions to deliver on three key objectives, one of them being to “make the EU an even safer place for individuals to save and invest long-term” with a concrete action of “empowering citizens through financial literacy” (European Commission, 2020). Together with the OECD International Network on Financial Education, DG FISMA developed two financial competence frameworks in the EU: the Financial Competence Framework for Adults in the European Union (OECD and DG FISMA, 2022) and the Financial Competence Framework for Children and Youth in the European Union (OEDC and DG FISMA, 2023) – which can be used by member states to design, coordinate and evaluate financial literacy policies and initiatives. A third initiative adopted in 2023 by the Commission is known as the Retail Investment Strategy and it focuses on enhancing the financial literacy of (prospective) retail investors to foster responsible investment in capital markets (European Commission, 2023).

However, there is a long way to go for the next Commission. Low levels of digital financial literacy worsen digital financial inclusion and make EU citizens more susceptible to digital fraud. The security of digital infrastructure should not be left completely to the market. Tackling digital fraud highlights the crucial role of EU regulation in ensuring that digital operators offer a cyber-secure environment for their customers. In the priorities for the next five years, the European Commission could start by revisiting the results of the 2023 Eurobarometer survey on financial literacy and reflect on why in the US more than 50% of households have financial products other than deposits, but only 24% of European households own a share, fund or bond. This gap between the two sides of the Atlantic reinforces the importance of further advancing the Retail Investment Strategy to boost and simplify retail participation in capital markets, always ensuring a high level of investor protection. This calls for a proportionate EU legislative action that combines features of stability, compliance, resilience and transparency.

The second leg of this equation is education. The two OECD-DG FISMA financial competence frameworks are just the start of a much longer process. All the member states must do more, namely develop policies and initiatives targeting children of early school age and adults who are engaged in their professional paths. Increasing digital financial literacy should rank high in the EU financial sector priorities for 2030.

The EU Banking Industry

The next Commission (2024-2029) and the member states alone will not reach the scale and impact that is required. The EU banking industry must do its share of the work to enhance digital financial literacy to reach effective financial inclusion in the EU.

Providing access to accounts or basic financial services is not good enough. As the sector strengthens its role in addressing Europe’s demographic shifts, banks must ensure their services are inclusive and accessible by all segments of society. This commitment is especially crucial for the elderly, low-income households and those in rural areas, who are often at risk of marginalisation by technological advances. To effectively serve these diverse groups, banks must develop products tailored to their unique needs. Alongside targeted products, banks should also establish robust support systems to assist customers in navigating new technologies and offer education programmes that teach digital skills and financial literacy. To adapt to Europe’s changing demographics, banks must ensure that technological progress enhances, instead of creating difficulties in, accessibility for all members of society.

A good example of an industry-led initiative in this field is the European Platform for Financial Education (European Banking Federation, 2017). Since 2017, the partners in this initiative have agreed to combine their strengths to enhance financial literacy across Europe. There is no time to waste until 2030.

c. The Green Transition

The European Green Deal aspires to set the EU on a trajectory to a green transition, with the objective of achieving climate neutrality by 2050 (European Commission). This massive endeavour aims to drive economic growth through the development of green technology and the establishment of sustainable industries, while simultaneously reducing pollution. This huge undertaking requires substantial investment for the EU to meet its energy transition targets and combat climate change.

In a recent speech on competitiveness for a radical change, Mario Draghi highlighted the significant investment needed for Europe's digital and green transitions (Draghi, 2024). Draghi's estimates serve as a reminder of the substantial capital needed to ensure Europe remains at the forefront of technological and environmental advances, which is critical to achieve climate neutrality and digital leadership by 2050. Estimates of financial needs until 2030 point to €620bn/year for the green transition and €125bn/year for the digital transition (Van Aken and Martins, 2024).

Finance for the twin transitions will need to be sourced mainly from financial markets. As mentioned above, non-bank segments of the financial system are by nature better suited to finance innovation and the green transition. In addition, market financing has substantial space available and can allow overcoming the inevitable constraints of bank finance and those of public funds. On the one hand, only fractions of the EU budget are allocated to the Green Deal and to the Digital Strategy. On the other hand, national budgets are tight due to the difficult situation of public finances in several EU countries which are dealing with other key challenges such as an ageing population, increasing defence expenses, etc.

Failing to secure the necessary financing will have distressing consequences for Europe's global competitiveness at a time when other main jurisdictions are investing heavily in the green transition, mainly through the private sector. Without adequate investment, European companies will struggle to innovate and grow, leading to a potential migration of businesses seeking better financial opportunities, particularly on the other side of the Atlantic. This diaspora would undermine Europe's economic stability and its ability to lead in critical sectors, reinforcing the urgency (and complexity) of addressing the investment gap to maintain and enhance its global competitive stance. An important piece in this transformative puzzle is the speed at which the EU engages in the green transition. On this long journey, the EU is facing significant challenges in positioning itself as a rule-maker rather than a rule-taker on the global stage. This is particularly true in areas like sustainable reporting and double materiality. Sustainable reporting standards, which require companies to disclose both financial performance and environmental and social impacts, illustrate the EU's progressive stance. However, these standards have encountered resistance both within and outside Europe. Double materiality, which considers the impact of a company on both financial performance and broader societal factors, further complicates this already challenging landscape. Many global businesses and non-EU governments view these requirements as burdensome and refuse to adopt these EU standards.

While the EU is still in the lead globally, the ‘Brussels effect’ does not seem to take off in the sustainability battle. To enhance the EU’s ability to export its standards globally, more needs to be done. The EU could engage in proactive and more united diplomacy to build coalitions with like-minded countries and regions, creating a broader base of support for its sustainability standards. However, achieving political consensus to support these ambitious policies remains a significant hurdle. The political landscape in the US shows an increasing backlash against stringent environmental and social regulations, with concerns about their impact on business competitiveness. Similar resistance to the green transition is also felt within the EU, particularly in countries like Germany, as is seen in the loss of seats of the European Green Party in the European Parliament. This presents an additional challenge for the next legislative period, calling for difficult negotiations and compromises to strike a balance between the green transition with efforts to maintain the EU’s competitiveness. There is also a material risk that the complex EU legislative framework on green finance will not be completed, thereby hampering its overall potential and effectiveness.

In this context, sustainable finance remains a pivotal priority for the EU financial sector. While the private sector is working hard to align its financing activities with the EU’s sustainability objectives, the industry is also expected to support its clients in sustainable transitions. An important issue remains that of further pushing ESG products, now that inflows seem subdued, possibly also in the light of (increasingly felt) greenwashing risks. Clearly, incentives are key here and, as was mentioned earlier, taxation is at the core of this discussion. In addition, conditionalities may help make the green element in certain investments more visible and thereby attract more inflows. Finally, it is worth noting that an EU platform on securitisation would have a huge potential in this context.

EU policymakers must preserve the EU’s leadership in sustainable financial regulations in the global context. It is imperative that rules and standards become globally coordinated and convergent to prevent market fragmentation and facilitate the flow of capital to where it is most needed. Achieving these goals by 2030 will require clear and consistent rules and a unified effort to drive investments and industry-led financing towards industries crucial to reach net-zero emissions.

5. Conclusions and looking ahead

This paper has outlined priorities for strengthening the financial sector in Europe over the next six years. It is an ambitious plan, but critical for the broader agenda of the twin transitions and strengthening Europe’s strategic autonomy among geopolitical tensions and uncertainty. In some of the policy areas, significant reforms have been started but have to be completed. This relates to both the digitalisation of the financial sector and the Banking Union. Other policy areas have seen limited, if any, progress. Most prominently, the Capital Markets Union project has been all but dormant.

While some of the initiatives outlined in this paper seem primarily technical and often not even controversial, they require the attention of legislators, the Commission and national governments alike to progress. Other initiatives (including CMDI and the Capital Markets Union) require overcoming vested (national) interests and strong leadership at the European level. Big reforms are often, although not always, undertaken in crisis times when it becomes clear that existing (national) structures are insufficient. The challenge for European policy makers will be to push forward the necessary reforms for the Capital Markets Union, for example, in the absence of such a crisis, making a strong case regarding the foregone growth and catastrophic consequences of climate change if not mitigated with the help of necessary financing structures.

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