Unlocking capital markets for everyone: A union for the common good

By Loukas Kaskarelis, Arndt-Gerrit Kund, Mathias Skrutkowski, Juan Sol

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There is currently a window of opportunity to confront Europe's investment challenges, but it requires broadening the role of capital markets. The European Commission's initiative on capital markets union (CMU) is a fundamental step in this direction. First floated as a concept more than a decade ago, CMU's political impetus is regaining momentum in response to Europe's multi-faceted hurdles to boosting productivity and growth.

The ESM seeks to contribute to this project by proposing policy measures that benefit European firms and citizens alike, while also being mindful of the financial stability implications. Namely, we propose well-designed incentive schemes and pension system reforms to expand the range of financial vehicles available to households, as well as measures to boost cross-border retail investments and reduce financial fragmentation. [1]

Moving from capital markets union to a savings and investments union

Europe is at a crossroads where substantial investments for the foreseeable future are required. Three high-level reports have recently taken stock of Europe's challenges.[2] While their specific recommendations differ, they concur that Europe needs significant long-term funding in key areas such as the green and digital transitions and defence, among others. Estimates for these additional needs range from EUR700 billion to EUR800 billion annually until 2030, which begs the question: how to meet these sizeable financing needs?

Europe possesses the necessary arsenal to tackle this challenge head on with an estimated EUR9.5 trillion in savings.[3] However, these savings are conservatively invested. Most European citizens adhere to a rather risk-averse asset allocation, holding a large portion of their financial wealth in bank deposits (see Figure 1). Something needs to change to redirect this capital into more productive and strategic endeavours.

Figure 1: Households' distribution of financial assets

(in %, Q4 2023)

Sources: The European system of national and regional accounts (ESA 2010) Statistics and Haver Analytics

Relying on banks to finance growth may prove insufficient. While it appears that Europe could meet its own investment needs, an overreliance on banks to funnel the required capital to firms may not be efficient: banks have limited risk-taking capacity and favour lending against collateral. To meet Europe's investment needs, firms need wider access to direct financing. Equity finance enables innovative firms to take on more risk and scale up operations, while bond markets allow companies to tailor the risk-return trade-off to a wider range of investors' preferences. Therefore, broadening the role of capital markets to fulfil Europe's financing needs is paramount. This shift in focus explains why CMU has recently regained impetus and prompted a renaming of the initiative to "savings and investments union" (SIU).

Bold action needed to deepen financial integration

The ESM aims to contribute to SIU design by proposing measures that enhance firms' financing options and benefit European citizens, while preserving financial stability and fiscal sustainability. Pension reforms, tax-preferential investment accounts, and deeper securitisation markets are means to ensure that wider benefits of future investments are reaped.

Deeper securitisation[4] markets will help bridge firms' financing needs by increasing the funding available from banks. To this day, small and medium-sized enterprises continue to be the backbone of the European economy. Yet, they often face financing constraints from the limited risk-taking capacity of banks. Against this background, securitisation can free up banks' regulatory capital, channeling more credit to smaller businesses, unlocking capital for innovation, and broadening the investor base across borders. Consequently, diversification benefits would be enhanced.

Ageing European populations pose additional challenges, but SIU can help here too. With a larger share of the population entering retirement, the fiscal strain on those financing retirement entitlements will grow.[5] We argue that SIU can help address this challenge by facilitating a greater role for funded pension schemes. Countries that have promoted funded pensions (either occupational or private[6]) have also fostered the development of their capital markets (see Figure 2). In other words, fostering the growth of funded retirement savings across Europe is crucial to increase the availability of long-term equity and bond capital for firms, and enhance fiscal sustainability.

Figure 2: Stock market capitalisation as % of GDP and household holdings of pension, life insurance, and annuity entitelments as % of hosuseholds' financial wealth

Sources: The European system of national and regional accounts (ESA 2010) Statistics and World Bank

Well-designed incentive schemes for retail investors can make SIU a win-win proposition for firms, people, and governments. Tax-preferential investment accounts could encourage European households to take a longer-term perspective on investments and allocate more of their savings towards capital markets. This approach would need to be carefully calibrated to avoid eroding the tax base. Several EU Member States have successfully broadened retail participation through such vehicles. Surveys and cross-country benchmarking can help to identify best practices that can be replicated across Member States. Appropriate incentives would make financial investments - which are currently concentrated among the upper class - accessible to a broader population (see Figure 3). Further efforts are needed to identify best practices and develop effective, possibly pan-European, products.

Figure 3: Households' wealth distribution of selected assets

(in %, Q4 2023)

Sources: European Central Bank Wealth Distribution Database and ESM staff calculations

Turning challenges into opportunities

Europe stands at a critical juncture. It must address internal challenges such as demographic changes and the green and digital transitions, while also responding to external threats. The solution demands significant investments to bolster productivity and competitiveness. Meeting these challenges may seem daunting, yet they present an opportunity to positively shape Europe's future.

Fortunately, Europe is in a privileged position to tackle the challenges from within using substantial accumulated wealth in savings which, if better allocated, could support its objectives. Increasing the share of funded pensions could unleash additional long-term capital for investments while also making national pension systems more sustainable and resilient to ageing. Measures to boost cross-border retail investments and reduce financial fragmentation, including through securitisation, would improve resource allocation while also diversifying household investment portfolios. Naturally, these measures need to be carefully calibrated to avoid worsening fiscal imbalances and be accompanied by education initiatives to improve financial literacy, enabling households to make well-informed investment decisions.

Tax incentives for investment, funded pension systems, and securitisation are concrete policy areas on the CMU agenda that would facilitate a mutually beneficial shift. European households would benefit from higher returns on capital market instruments, European firms would gain access to a broader range of financing sources, and deeper capital markets would enhance financial stability.

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Footnotes

[1] For an earlier ESM contribution to the CMU discussion see "Momentum builds for Europe's capital markets union".

[2] See high-profile reports by E. Letta - Much more than a market (April 2024); M. Draghi - EU competitiveness: Looking ahead - European Commission; and C. Noyer - Developing European capital markets to finance the future.

[3] See ECB: Deposits | ECB Data Portal.

[4] The financial practice of pooling various types of debt, such as residential mortgages, car loans or credit card debt, and selling their related cash flows to third party investors as securities.

[5] See Rolf Strauch, 'Demographics and Financial Stability' (Sept. 2024).

[6] Occupational and private pension plans are often referred to as Pillar 2 and Pillar 3 plans, respectively.