

# EUROPEAN INSTITUTIONS AND FRAMEWORKS FOR GREATER FINANCIAL INTEGRATION

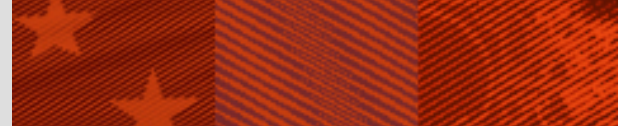
**José Viñals**

**Deputy Governor**

**Banco de España**

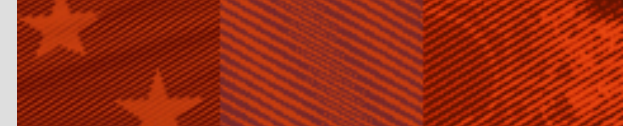
Singapore, September 18, 2006

# Contents



- **Financial Integration and its impact on efficiency, growth and financial stability**
- **Financial integration in Europe**
- **The European framework for greater financial integration**
- **Lessons**

# Benefits of financial integration

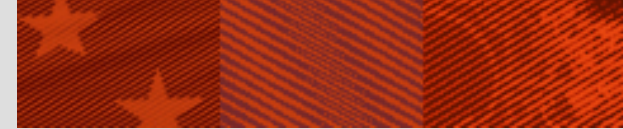


## Efficiency

- **Improves the channelling of funds from surplus to deficit agents**
- **Better diversification and risk-sharing**
- **Deeper and more liquid markets**
  - increased availability of funds
- **Increase in competition and innovation**
  - lower intermediation costs
  - more efficient allocation of capital

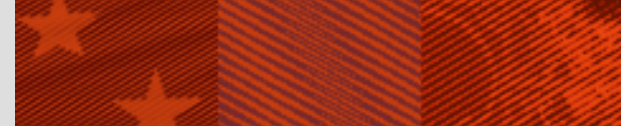
## Economic growth

# Financial integration and financial stability



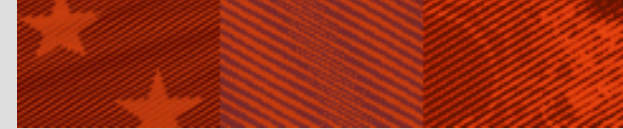
- **Pros and cons**
  - On the one hand, intensified cross-border financial links might increase potential contagion
  - On the other hand, more integrated financial markets increase risk diversification opportunities, thereby boosting the economy's shock-absorbing capacity
- **Overall, enhanced financial integration has a long term positive impact on the stability of financial systems and of the economy**
  - Increased resilience to shocks as a result of enhanced risk-diversification

# Financial integration in Europe



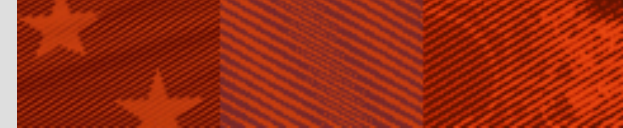
- **The Euro has been a major catalyst for the integration of the euro area financial markets**
  
- **However, the speed and scope of market integration has not been the same across all market segments**
  1. The unsecured interbank deposit market has been almost completely integrated since the beginning of EMU in 1999, at all maturities
  
  2. Interest rate derivatives markets also display almost complete integration

# Financial integration in Europe



3. Among money market segments, the least integrated is the short-term securities market
  - *the commercial paper market remains segmented*
  
4. Integration in the euro area government bond market is very high
  - *no exchange rate risk*
  - *remaining differences are result of different liquidity and credit risk*
  
5. The corporate bond market is relatively integrated and has increased its scope to riskier issuers

# Financial integration in Europe



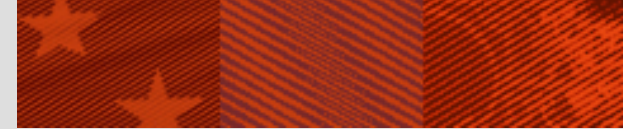
## 6. Equity markets remain fairly fragmented

- *country effects are still very important in explaining stock price changes*

## 7. Banking markets

- *interbank or wholesale activities are fairly integrated*
- *retail markets show a slower process of integration*

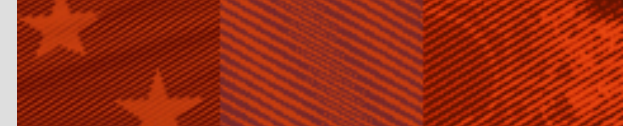
# Retail banking integration in Europe



- **The view of a slower path of integration in European retail banking markets, while correct, must be qualified**
  - Lower standard deviation of interest rates for mortgages and loans to firms across European countries
  - Local banks have certain advantages vis-à-vis national and multinational banks
    - *relationship banking, proximity to customer (convenience)*
  - Profitability is not positively related to size
    - *different banks might have different strategies*
  - Significant competition within national markets can discourage foreign entry
- **While retail banking markets remain fragmented, there are certain signs of increasing integration: some cross-border M&A and internet banks**

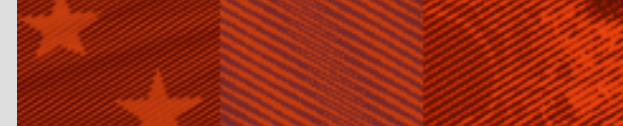


# Institutional framework in Europe



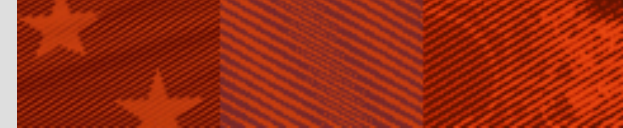
- **In 1999 there was a single currency but not a single financial market in Europe**
- **The Financial Services Action Plan (FSAP, 1999-2004) contributed significantly to the construction of a single financial market in Europe**
- **Main objective: integration of financial markets in Europe**
- **Until FSAP: new regulations were needed but the changes in the European Union (EU) financial regulatory framework were not enough to complete the single financial market**
- **Directives were too complex and detailed**
  - rigid
  - difficult to change
  - long lags in their implementation in each EU country
  - differences in application in practice: single regulation, but 25 different interpretations
- **As a result, there was a need for an increase in efficiency of regulation**

# Institutional framework in Europe



- **FSAP three main strategic objectives**
  1. To promote a single wholesale financial market
    - e.g. *investment services directive, accounting strategy, collateral, ...*
  2. To make retail financial services markets more open and secure
    - e.g. *information and transparency (mortgages), consumer protection, ...*
  3. To improve the prudential framework
    - e.g. *money laundering, capital requirements for banks and investment firms, solvency of insurance companies, conglomerates, ...*
- **42 initiatives, 39 adopted by EU countries as of today**
- **23 new Directives in 5 years**

# Institutional framework in Europe



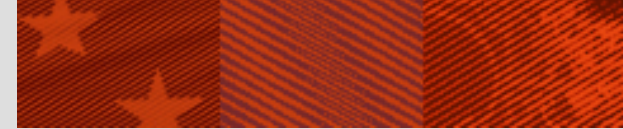
- **The response is the Lamfalussy framework (3 levels):**
  - Level 1: Basic regulation
  - Level 2: Technical regulation (need to upgrade frequently)
  - Level 3: Application of the regulation
  
- **Level 1. Framework Directives**
  - Containing high level principles
  
- **Level 2: EU Commission and Regulators' (Treasuries) Committees**
  - In charge of technical regulation
  - Easier to change and/or update (Comitology procedures, EU jargon)
  
- **Level 3: Committees of Supervisors**
  - Ensure convergence of supervisory practices: common application of common regulation
  
- **Applied in 2000 for securities, extended to banks and insurance in 2003**

# Institutional framework in Europe



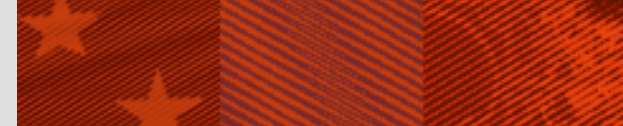
- **In sum: FSAP + Lamfalussy framework are huge steps forward**
  - flexible model: it can respond to changes in needs of EU single financial market
    - *e.g. from supervisory cooperation to coordination / joint action if needed*
  - We have an EU system of regulation and supervision...
  - ... though not yet a single EU regulator / supervisor

## Some further important steps



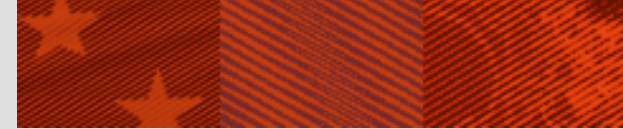
- **Integration of payments, clearing and settlements systems**
- **Implementation of Basel II and Solvency II**
- **Enhancement of cross-border competition in retail services**
- **Reduction of obstacles to cross-border retail banking integration**
- **Reduction of state involvement in several national financial systems**
- **Improved collaboration among European supervisors**
- **More intense dialogue between European financial authorities and those of other areas**

# Some lessons to be learned



- **Financial market integration requires both public and private initiatives**
- **Financial market integration is not an instant process, at least not in all dimensions**
  - Capital mobility, single currency and single monetary policy have been very important steps
  - Retail banking integration takes more time
- **Great benefits to be obtained from integration (significant increases in efficiency)**
  - particularly true for the banking system: liberalisation increases competition (lower intermediation costs and greater innovation)
- **As financial integration progresses, improved financial frameworks and cooperation among supervisors are fundamental**
  - crisis prevention and promotion of financial stability
  - the institutional framework is a key element to support coordination between supervisors

# Some lessons to be learned



- **Relevance of the institutional setting**
  - Flexibility needed to respond to new challenges and requirements
- **A lot has been done in Europe but ...**
- **...comparing the monetary policy framework with the financial stability framework...**
- **... many things can still be done in the financial area when and if needed**



THANK YOU