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Financial Integration in Europe: Facts and Policy Challenges

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José Viñals
Deputy Governor of the Banco de España

Good afternoon.

First of all, I would like to thank IESE and the Financial Management Association for their kind invitation to address such a distinguished audience in this international conference.

Conferences like this are doing an excellent job in fostering interaction between academics and practitioners and in disseminating state-of-the art research in finance. I am glad that this year the European Conference of the Financial Management Association is being held at IESE, which is now widely recognised on one of the leading European and international business schools.

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We are currently living in a period of remarkable institutional changes in Europe, which are particularly visible in the economic sphere. In particular, during the nineties in the previous century we witnessed a period of monetary integration which changed markedly the economic landscape in Europe after the creation of the euro area in 1999.

If the nineties was for Europe the monetary integration decade, I believe the current decade could in the future be recalled as a decisive period for financial integration. There is currently ample agreement on the potential benefits of fully developing a single market for financial services in Europe. This is a general claim shared by savers, entrepreneurs and intermediaries. Moreover, although it is not difficult to identify some specific examples of an unjustified “pseudo-nationalism”, authorities are generally giving proof of growing support for the overall objective, helped by social demand and the traditional peer pressure mechanisms of the European Union. My experience attending meetings of different EU Committees has taught me that these apparently loose coordination mechanisms are frequently much more effective than often thought.

I therefore think that this is good opportunity to reflect on the current state, prospects and policy implications of the process of financial integration in Europe. In doing so I will be dealing with an issue of high relevance for the world economy, as Europe represents roughly one-third of the global financial system. For instance, at the end of 2006 the share of European stock exchanges in terms of world market capitalisation was 30%, moderately below the US share of 38%. Europe also represents around 30% -in terms of assets- of the institutional investment industry. Finally, about 27% of the outstanding stock of debt securities and 26% of central banks’ reserves were denominated in euros at end-2006.

In the rest of my talk I will first describe recent developments and discuss the main drivers and achievements of the process of financial integration in Europe. I will then address the remaining

steps to attaining a truly single financial area in Europe and summarise some of the most recent public and private initiatives in this domain. Finally, I will comment on the implications of this process for both agents' behaviour and public policies, stressing the challenges for monetary and prudential authorities.

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Arguably, over the last ten years we have already witnessed a remarkable increase in cross-border financial activity. Let me give you some figures to illustrate this. The share of bonds issued by euro area residents and held by euro area residents outside the issuing country rose from 10% in 1997 to more than 55% in 2005. The figures for the equity market show a smaller but still significant increase, from 13% to 27%. This fall in the home country bias has been especially visible in the portfolio of institutional investors and, in particular, investment funds. Also illustrative for me is the increasing use of cross-border collateral used for Eurosystem credit operations, the share of which climbed from 28% in 2002 to 50% in 2006.

Another sign of increasing integration is the consolidation process of financial institutions, as illustrated, for example, by the recent rise in cross-border M&A transactions involving financial firms although, as you know, most operations are still at the national level. We have also observed a downward trend in the number of entities operating as a central counterparty, which fell from 13 in 1998 to 7 in 2006, expressing a clear integration of this type of activity within a framework in which national borders progressively lose importance.

Finally, traditional measures of financial integration based on prices, which exploit the law of one price, also suggest a growing degree of financial integration. For instance, some empirical research shows that the proportion of the variance of the returns on securities explained by domestic factors has fallen in recent years in Europe.

In order to understand the drivers of these developments in European financial activity, we must consider first a number of global factors which are fostering financial integration worldwide. In particular we should focus on at least three main elements: changes in regulation, the institutionalisation of saving and the improvement in information technologies. Let me briefly deal with these in turn.

Regulation has progressively shifted to a prudential control system. This has meant the abolition of regulations and restrictions on investment and financing positions in certain instruments, and facilitated cross-border financial operations. No doubt this has contributed to larger international capital flows and to reducing the home country portfolio biases.

The second global factor is the institutionalisation of saving. This process means that households tend to invest in financial markets through institutional investors - such as mutual funds, pension funds, insurance companies, private equity firms or hedge funds - rather than taking direct positions in securities. Institutional investors are better equipped, due to their size and better financial knowledge, to reap full benefit from geographical diversification.

Finally, improvements in information technologies have fostered cross-border trading in various ways. First, greater connectivity between operating systems and enhanced clearing and settlement systems have reduced the transaction costs associated with cross-border operations. And second, IT improvements have increased the speed of diffusion of information.

Beyond those global elements, the European financial environment has been directly influenced by the process of economic integration in Europe. The single financial area was quickly seen as a key component of the single market initiative and became one of the areas which attracted most policy initiatives. In particular, European authorities have already launched a number of initiatives to harmonise financial market legislation in the European Union. The Financial Services Action Plan (FSAP), initiated by the European Commission in 1999 and completed in 2005, was a major step forward in this regard.

Another relevant development has been the application of the so-called Lamfalussy framework, which consists, as many of you know, of three levels. The first is the basic regulation containing high-level principles. The second is the technical regulation, which is in the hands of the EU Commission and Regulators' Committees. And at the third level are the committees of supervisors, whose aim is to ensure convergence of supervisory practices. This framework was applied in 2000 for securities and extended to banks and insurance in 2003.

Still, a major driver of the process of financial integration has been the creation of a monetary union. That acted as a key catalyst for the intensification of cross-border financial flows. In principle, it could be argued that in a frictionless world, the introduction of the euro and the single monetary policy should not have had a positive impact on the internationalisation of portfolios. In particular, the elimination of exchange rate variability and a higher correlation of returns across countries could have reduced the gains from international diversification. Indeed, the empirical evidence shows that co-movements in national stock indices have intensified in the recent past in conformity with the high synchronisation of economic cycles in different euro area countries. However, in practice the introduction of the euro meant the removal of some existing legal barriers to cross-border holdings for certain institutional investors, which were subject to restrictions on investment in assets denominated in foreign currency. Additionally, the design of the operational framework of the single monetary policy and the initiatives by the Eurosystem to facilitate a smooth

and homogeneous transmission of monetary policy actions acted as a powerful engine to favour the reduction of costs associated with cross-border financial operations.

Specifically, the Eurosystem has contributed to financial integration in various relevant ways, including the adoption of an eligibility criterion for collateral in its monetary policy operations that permitted credit institutions wishing to receive liquidity from the central bank to use a wide range of securities issued in any Member States. The most effective initiative by the Eurosystem in that regard has, however, probably been the establishment of TARGET, introduced at the beginning of Stage Three of EMU, which has permitted the creation of a safe and efficient mechanism to process cross-border payments based on the interconnection of national real-time-gross-settlement systems.

As I commented earlier, all these initiatives have already had a noticeable impact on the degree of financial integration in Europe. However, the process is far from complete and progress has not been homogeneous across market segments. More concretely, at the most advanced extreme of the integration scale we can find money markets which are practically fully integrated. Liquidity is currently transferred across banks in the euro zone in virtually identical conditions regardless of the location of the institutions participating in each interbank operation. In the upper-mid reaches of the scale we would locate government and corporate bond markets. Here the degree of integration is high, as illustrated by the sizable proportion of foreign fixed-income instruments in the portfolios of international investors. The lower-mid segment would be for equity markets, where despite the increasing volume of cross-country operations, a significant home country bias remains. For both bonds and stocks a major obstacle to full integration is the lack of integration of security settlement systems, which makes cross-border operations comparatively more expensive than pure domestic operations. In any case, the market segment in which integration seem to be lowest is retail banking markets. As of today, the participation of foreign institutions in domestic markets of regular commercial banking services is still quite low in many Member States.

Therefore, despite the progress made, the project to achieve a single financial area has not yet been fully realised in Europe. The only reasonable corollary of this statement is that more needs to be done to further increase the degree of financial integration.

Against this background, European authorities have been working over the last few years on new initiatives to further develop the European market for financial services. In December 2005 the European Commission released the White Paper on Financial Services Policy 2005-2010, which contains a clear policy strategy in the field for the short and medium term. The policy's main priorities are the completion of unfinished measures, the removal of the remaining economically significant barriers and the enhancement of supervisory co-operation and convergence in the European Union.

The full implementation of the Markets in Financial Instruments Directive (the so-called MiFID) will be a major step forward for the integration of capital markets in Europe. In particular, by November 2007 the stock exchange monopoly in trading shares will have come to an end and investment firms in one Member State will be able to use the clearing and settlement system of any other Member State.

The Eurosystem continues fostering financial integration through various means. Let me mention two recent initiatives. The first is TARGET2. As I said earlier, TARGET was an important step towards integrating the interbank market in Europe. The launch of TARGET2, scheduled for the end of the current year, will introduce an even more uniform wholesale payment infrastructure. In particular, TARGET 2 will provide harmonised services and prices for domestic and cross-border payments, which would de facto imply the abolition of any relevant distinction between the two types of operations. The second initiative is the TARGET2-Securities project, which aims to harmonise and simplify the settlement of securities transactions and, ultimately, to process both securities and cash settlements on a single platform. This will provide for easier and cheaper access by investors to instruments issued in any national securities settlement system participating in the new platform.

This process has also been boosted by private-sector initiatives. In particular I should emphasise the "European Code of Conduct for Clearing and Settlement" signed at the end of 2006 by the European industry associations for exchanges and post-trading. This Code will significantly support public-sector competition-promoting objectives and improve the efficiency of clearing and settlement in the EU.

In the retail area the banking community, with the support of European authorities including those of the Eurosystem, is actively working for the creation of the single euro payments area, which could eventually permit people to process payments in other countries under similar conditions to those in their own country. Specifically, the so-called SEPA project aims to bring about a fully integrated market for retail payment services. I believe this initiative is probably that which will be most visible to European citizens, as they will be able to perceive the implications in their everyday life. In particular, starting in 2008, individuals will be able to use payment schemes –in particular, for credit transfers, direct debit and credit and debit cards- which will be identical across European countries. Only two years later, all existing infrastructures should be able to process SEPA instruments.

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I am sure all these initiatives will ultimately allow the euro zone economy to develop a truly single market for financial services, providing important benefits for European society as a whole. In particular, a more integrated financial system broadens the opportunities for investors to diversify

their portfolio, thereby improving the risk-return combination and favouring more efficient consumption-savings decisions. Demanders of funds will also benefit from the greater opportunities to raise funds in deeper financial markets. Therefore, these developments contribute to a better intertemporal allocation of financial resources which, by definition, implies higher social welfare.

But, in order to allow society to fully grasp the benefits of greater financial integration, public policy must adapt itself to a new environment. Let me devote the last part of my intervention to the implications of this process for policymakers and, in particular, for central banks and prudential authorities.

From the monetary policy perspective, a well-integrated financial system facilitates a homogenous and effective transmission of monetary impulses across the euro area. The integration of money markets has been an important achievement in this respect. But, as I said, further progress is needed in banking retail markets, which play an important role in the transmission of the single monetary policy impulses to those interest rates that actually influence private-sector expenditure decisions.

Another implication for monetary policy is the upgraded role played by financial developments in the assessment of the macroeconomic outlook. Already evident in several countries is an expansion of financial assets and liabilities of households and firms, largely induced by financial integration and the modernisation of the financial system, that has made consumption and investment decisions much more sensitive to financial shocks. This process is therefore strengthening the links between macroeconomic and financial stability in a policy-relevant way. In that setting, central banks –with the help of the academic literature- have identified the limitations of monetary policy strategies that make interest rate decisions depend exclusively on the deviation of predicted inflation from a more or less explicit target. In order to maximise their contribution to safeguarding macroeconomic stability, central banks should also pay attention to abnormal developments in financial markets and the financial sector that may eventually cause abrupt corrections with high potential costs in the medium to longer term. The ECB is well equipped to address these challenges by following a robust monetary policy strategy which embeds not only a standard macroeconomic analysis of future output and inflation prospects but also a careful monitoring of relevant monetary and financial indicators.

In the field of prudential policies, financial integration also generates some key implications. As you would agree, financial stability is an elusive concept; as has sometimes been said, you only know what it is when you lack it. While trusting that I will not be suspected of taking any of the central bank policy functions lightly, I can safely confess that, as a central banker, the task of preserving financial stability poses in some respects more challenges than the conduct of monetary policy.

For the latter, we have clear, even quantified objectives; we also have at our disposal a rich set of analytical tools to evaluate the future course of the policy-relevant variables, and a relatively wide consensus –based on a wealth of knowledge accumulated over many years- on how central banks should normally react to different types of incoming information. But, more importantly, monetary policy has a well-defined set of instruments –and, in particular, those helping control short-term interest rates- which have proven effective in achieving and preserving price stability.

By contrast, in the domain of financial stability –a non-quantifiable concept- authorities have to face the lack of a sufficiently robust understanding of the factors triggering episodes of financial distress and the absence of a universally valid set of tools to prevent and counteract those situations. Although well-designed regulation and supervision no doubt helps reduce the likelihood and the adverse consequences of financial turbulence, it is neither possible nor, probably, desirable to build a prudential shelter that could be effective under any conceivable shock. Moreover, the design of policies for both prevention and resolution must face the singularity of almost all crisis episodes. Finally, although academic research in the field has been making substantial progress in the last few years, there is still a relatively large number of unresolved issues.

For example, as you well know, the academic literature provides extensive and convincing evidence on the welfare benefits associated with the international integration of the financial industry, but it is much less unanimous on its implications for financial stability. On one hand, as a result of geographical diversification, national financial systems are increasingly exposed to shocks arising in other parts of the world and, therefore, contagion becomes more likely. But, on the other, greater risk diversification means that financial institutions have a higher capacity to absorb these shocks. Clearly, adequate supervision and regulation should help ensure the positive welfare effects prevail over the less favourable ones. However, identifying the optimal degree of regulatory intervention and the specific form that this should take is open to a debate on which the guidance provided by the academic literature is arguably still scarce.

Another controversial area is that of competition policy. In a more integrated system financial institutions can find incentives to grow to fully exploit economies of scale. Users of the services provided by these institutions can potentially benefit from these efficiency gains to the extent they would translate into lower prices. However, this will largely depend on the compatibility of the integration process with the preservation of a satisfactory degree of competition which may not always be the natural market tendency. Public authorities therefore face a difficult task: they should be vigilant to avoid restricting the growth of institutions through mergers and acquisitions on grounds not related to clear supervisory risks but, at the same time, they should avoid the proliferation of dominant players in the different segments of the industry.

So far, the risks of excessive public intervention in the industry's development have become more evident than the emergence of natural monopolies. In this respect, initiatives to limit unwarranted protectionism have become more pressing. In particular, the recently agreed directive on mergers and acquisitions is a step forward to ensure that cross-border operations are judged on supervisory grounds by the European supervisory authorities, and goes in the direction of reducing State involvement in national financial systems.

From an organisational standpoint, supervisory arrangements should evolve so as to be able to capture the change in the size and nature of the risks faced by financial institutions operating in a more internationally integrated environment. Available information shows that despite the remaining fragmentation in retail banking in the euro area, a number of large and medium-sized banks have significant cross-border activity. According to a survey conducted by the ESCB Banking Supervision Committee, in 2005 there were 33 internationally active banking groups in the euro area whose consolidated group assets accounted for 53% of total euro area banking assets. Their degree of internationalisation, measured as the percentage of consolidated assets held in foreign branches and subsidiaries, varied across home countries but was on average above 30%.

Therefore, efforts are needed to avoid excessive duplications and inconsistencies of supervisory rules and practices across Member States as this may damage the activity of institutions which currently conduct cross-border business and, therefore, may act as an implicit barrier to a further expansion of the sector's international integration.

To bring this about, in the short to medium term I see no better alternative than further enhancing co-operation between regulators and supervisors and increasing consistency in supervisory practices. In this regard, the Lamfalussy framework, based on a network of Level 3 Committees and convergence instruments, should play a greater role in the immediate future.

This role poses a clear challenge for EU public authorities in general and supervisors in particular, because it entails a review and an enhancement of the functioning of the Level 3 committees and the creation of new instruments of cooperation and convergence of supervisory practices.

In relation to the functioning of the Committees, two of the issues I believe are worth reviewing are the decision-making mechanisms, which are currently based on consensus of the members, and the "enforcement" of level three, where compliance with the principles or recommendations agreed are at present voluntary.

When dealing with the concrete instruments, it is also worth mentioning that a number of incentives are being studied to enhance compliance with Level three measures. I might just mention here peer reviews, supervisory transparency and mediation mechanisms.

On the issue of the organisation of supervision, I have only talked about the short to medium term. What do we want and what can we expect over a longer timespan? I believe that in that horizon we could see a less decentralised organisation of the European supervisory structure. It could be some form of federal system or some kind of common supervision at the EU level, at least for pan-EU banks. Any of these systems raises important and difficult questions related, for example, to the role of the European Central Bank in the framework, supervision by objective versus sectoral supervision, the role of principles-based regulation and the use of risk-based supervision. But to get there, there are first a number of prerequisites that we are far from being able to comply with: today our institutional frameworks have a large number of significant differences in supervisory models, and in civil and company law, that would have to be ironed out. And we also see major differences in our financial system structures and financial cycles.

One last thing I wish to mention in this respect is the issue of financial crises. As you know, public authorities and supervisors have been pooling their efforts in the EU on the issue of crisis prevention and crisis resolution. This is a very difficult subject with a number of challenges.

If we divide this question into two, that is, into liquidity crises and solvency crises, we could say that National Central Banks have worked together in the European Central Bank and have been able to devise clear and orderly mechanisms of liquidity assistance. The issue of solvency is more complex: crisis-resolution exercises have been developed, MoUs have been signed, and work has been done, and is ongoing, on issues such as the development of similar tools for crisis prevention and resolution, the impact of cross-border crises on the functioning of those instruments, the role, characteristics and differences between Deposit Guarantee Systems in different countries, etc. Nevertheless, even though we are now in a fairly good position to tackle a financial crisis of a cross-border, pan-EU bank, and we are not expecting a crisis to take place, more work has still to be done.

Let me recapitulate with a list of the main things I have mentioned and what we expect to be principally dedicating ourselves to in the short, medium and long term, something that I would call, if you will allow me the term, “the ten commandments”: (1) the integration of payment, clearing and settlement systems; (2) the implementation of MiFID; (3) the implementation of Basel II and Solvency II; (4) the enhancement of cross-border competition; (5) the lifting of obstacles to cross-border retail banking integration; (6) the reduction of State intervention in national financial systems; (7) improved cooperation between EU supervisors, to which I would add the need for a more intense dialogue between European financial authorities and those of other areas; (8) increased convergence of supervisory practices and enhancement of the functioning of the Lamfalussy approach; (9) an adequate structure and distribution of responsibilities of EU supervision that could eventually lead to a federal system of supervisors or some form of unified supervisory body for

pan-EU banks; (10) an adequate framework for crisis prevention and resolution geared specially towards cross-border banks.

In any event, as the financial system is constantly evolving and posing fresh challenges for policymakers, it is likely that the above list will soon have to be expanded accordingly. For example, one relevant recent development has been the transfer of risks from banks to other financial institutions, a process fostered by the emergence of an active market for credit derivatives and securitised loans. As a result, banks have been able to improve their risk management strategies, becoming less exposed to some specific shocks affecting the solvency of their borrowers.

As those risks have now been spread out across a variety of investors, we might expect the financial sector to have become less vulnerable as a whole, in principle. But the concern is that supervisors have a limited knowledge of who is taking up this or that type of risk and we cannot therefore exclude the possibility of some less regulated financial institutions, such as hedge funds, eventually becoming excessively exposed. In a context in which loose monetary conditions are increasing the risk appetite of investors wishing to secure satisfactory returns, this concern has become a major policy issue and has been on the agenda of meetings of all relevant international financial institutions and fora. The challenge for policymakers is twofold. Firstly, to make an effort to identify concrete ways to improve the information on the activities of these institutions that is available for investors and supervisors. Secondly, to assess whether current regulation is sufficient to prevent these institutions from accumulating an amount of risks that could eventually jeopardise the stability of the global financial system.

In sum, policymakers are currently facing some key challenges from financial integration in Europe. But as I hope to have made clear in my intervention, there is a need for more analytical and empirical work to provide the right guidance to national and European authorities. I am fully aware of the high analytical complexity of these issues and of the difficulty of designing formal models and empirical exercises that could directly fit policymakers' preoccupations. But, in the relatively short history of finance as a scientific discipline, it is not difficult to find examples of highly sophisticated technical work that has effectively helped to improve our financial decisions and to make our financial systems more efficient and safer. With that in mind let me encourage you to address in your research some of the issues I have outlined in my talk. I wish you all success in this International Conference.

Thank you very much.