VII. The euro and the European financial architecture

Highlights

The introduction of the single currency represents a major landmark in the evolution of the European financial structure. Not only has EMU permanently altered the monetary policy framework within the common currency area, it has also given single currency representation to a large economic bloc that rivals in size the other two leading world economies. At the same time, it has provided a significant boost to the continent's financial markets, supporting their growth and promoting their deepening. The single currency has also had a positive influence on the ongoing unification of the market for financial services in Europe and catalysed the trend towards consolidation in the financial industry. This chapter reviews the impact of the euro on the European financial landscape during its first full year of existence and discusses the challenges that this new reality poses for the future.

Development and progress have not been even across the spectrum of financial markets and financial services. In a way, the advent of the euro has had its greatest impact where pre-existing conditions were the most favourable. Market segments where cross-border transactions had already reached a critical level and where institutional structures had achieved a higher degree of harmonisation benefited most. Despite the impetus from the elimination of exchange rate risk, market forces alone have not always been capable of overcoming the impediments to fuller integration presented by national differences in technical and legal infrastructure and market practices which have been at the root of segmentation in certain sectors.

The arrival of the euro, by highlighting the potential benefits of further progress towards a truly unified financial market in Europe, has helped focus attention on the implicit economic costs arising from insufficient harmonisation of the financial infrastructure across the EMU zone. It has thereby underscored the fact that reaping the full fruits of eliminating the economic barriers to trade will require a firm political commitment by the member states to further align institutional and legal structures that have a bearing on the economic process.

Financial markets

Nowhere has the euro's positive influence been more immediate and clearly evident than in Europe's financial markets, especially the market for interbank deposits and the international corporate bond market. Both markets have grown rapidly and have been transformed into more efficient vehicles for the allocation of liquidity and savings. By contrast, other market segments, such as collateralised money markets and equity markets, have largely retained their national character and have so far not been able to capitalise on the enhanced potential for efficiency and liquidity offered by greater cross-border activity.

Money markets

A pan-European interbank deposit market has emerged …

The conduct of monetary policy in the framework of EMU requires an efficient mechanism for the allocation of central bank liquidity throughout the single currency zone. The interbank market in unsecured credit has provided this mechanism as it rapidly adapted to the new framework. In this role it has been supported by TARGET, the large-value funds transfer system for the euro area, which quickly overcame minor initial operational problems to become the backbone of the euro area's payment system. The early resolution of all uncertainty relating to the money market reference yield curve also contributed to this successful transition. During the first few weeks of 1999 the EONIA (euro overnight index average) rate, extended by the Euribor yield curve and supported by an active derivatives market, emerged as the clear choice of market participants. The establishment of a single money market in euros is clearly evidenced by the convergence of yields across the euro area, and its efficiency demonstrated by the continuing tightening of bid-ask spreads, which are currently about 40% lower than five years ago (Table VII.1).

The emergence of an efficient euro area money market has allowed the treasurers of many large companies to reduce costs by centralising their cash management operations. Banks have formed a two-tiered structure in which larger institutions with a pan-European presence handle the cross-border flow of liquidity and smaller institutions play a more restricted regional role. The significant increase in cross-border interbank activity between institutions in the euro area after the fourth quarter of 1998 is a direct consequence of this development (Graph VII.1).

Three-month money market rate bid-ask spreads[1]

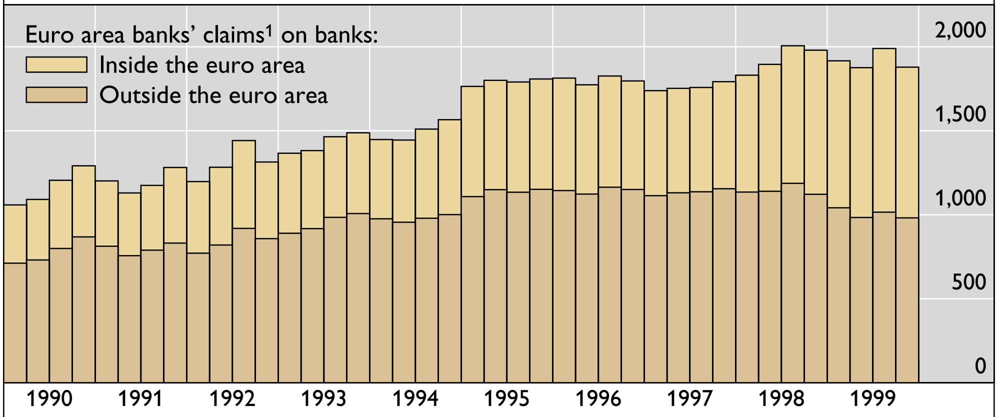
		1996	1997	1998	1999	2000[2]
Euro area[3]	average	14.4	12.4	9.6	8.9	8.4
	stand. dev.	*3.0*	*3.5*	*1.8*	*3.1*	*3.1*
Germany	average	16.5	15.1	8.2	9.2	8.5
	stand. dev.	*6.3*	*7.6*	*2.9*	*4.1*	*3.1*
France	average	14.1	11.2	11.3	8.7	8.5
	stand. dev.	*4.6*	*2.7*	*3.0*	*2.8*	*3.1*
Italy	average	11.3	9.3	10.1	8.9	8.5
	stand. dev.	*2.3*	*2.4*	*2.8*	*2.6*	*3.1*
United States	average	12.5	11.3	8.8	9.0	9.3
	stand. dev.	*2.9*	*5.3*	*4.0*	*2.9*	*2.8*
Japan	average	12.0	9.8	11.5	10.5	10.4
	stand. dev.	*2.0*	*3.8*	*3.6*	*5.9*	*1.1*

[1] Spreads in basis points of eurocurrency deposit rates, London close. [2] Up to mid-April. [3] Prior to 1999, weighted average of the rates of Germany, France and Italy; weights according to the ECB capital key.

Source: Standard & Poor's DRI. Table VII.1

Cross-border interbank activity

Amounts outstanding at end-quarter, in billions of US dollars



[1] Excluding Portugal.
Source: BIS.
Graph VII.1

… but repo markets have remained segmented

In contrast to the unsecured deposit market, the repo market has failed to break out of the segmentation that characterised it prior to the introduction of the euro. Existing market rules and architecture that may have served participants' needs well at national level are not necessarily conducive to the development of a true pan-European general collateral market. Cross-border activity remains limited, keeping the market from achieving its full liquidity potential and resulting in persistent pricing differentials and variations in market depth across segments. The slow pace of harmonisation of national market practices and conventions and the lack of a unified market infrastructure continue to present obstacles to further development. Some of these obstacles, such as the cumbersome interface between delivery systems, settlement procedures and market practices, are technical and hence easier to overcome. Others, however, such as differences in documentation and tax treatment, as well as uncertainty regarding title to the underlying securities, relate directly to deep-seated structural differences in national tax and legal systems. Achieving greater harmonisation across the euro area on this front requires more far-reaching intervention, and hence a significant commitment, by national authorities.

Bond markets

Arguably the most impressive effect of EMU on the continent's financial structure has been the tremendous boost that the single currency has given to European fixed income markets. Issuance of euro-denominated bonds surged in 1999, with total funds raised increasing to multiples of their pre-EMU average. Both government and private borrowers have been attracted to the new currency. However, it is the intensified activity by the latter, especially European corporations, that has been the most significant development.

The second largest government bond market …

At one stroke, the conversion of government debt denominated in the legacy currencies into euros created a market that currently surpasses in size its Japanese counterpart and stands second only to the US Treasury market. At end-December 1999, the stock of long-term euro-denominated debt issued by the euro area governments amounted to around €2.2 trillion or two thirds of the outstanding stock of US Treasury bonds. Over the medium term, the combination of budget deficits in most euro area countries and the ceilings on indebtedness imposed by the Maastricht Treaty are likely to maintain the market at its current size. In contrast, current and projected fiscal trends are pulling the US and Japanese markets in opposite directions, with the former expected to shrink and the latter to expand significantly.

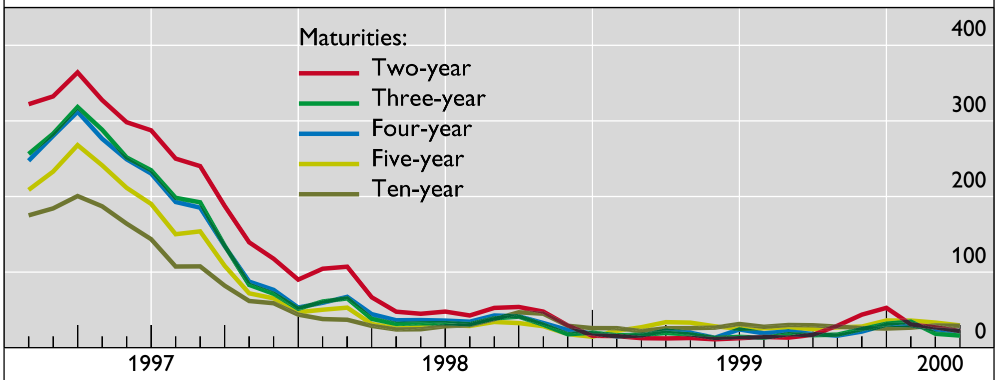
… is not fully harmonised

The economic convergence process in the run-up to EMU went hand in hand with an impressive narrowing of interest rate differentials across the 11 participating economies. Current yield spreads are typically contained within 40 basis points or less at any point on the yield curve (Graph VII.2). Closer inspection suggests that a significant portion of these yield differentials reflects technical and liquidity considerations rather than economic risk. Yield differentials in the vicinity of 20 basis points for similarly rated borrowers, such as the German, French and Dutch governments, are too large to be justified by market perceptions of differential credit risk, especially in view of the fact that the spread between French and Dutch bonds and the lower-rated Italian and Belgian bonds is narrower. Moreover, differences in issuers' creditworthiness are unlikely to exhibit the required term structure to account for the fact that national yield curves often cross each other at different points on the maturity spectrum (Graph VII.3).

Liquidity, security design and issuance policies are key in explaining the interchange between German and French bonds in the highest-priced position at different points along the maturity spectrum. German bonds enjoy benchmark status at the short end of the yield curve and then again in the 10-year maturity range, where they are complemented by the most heavily traded futures contract worldwide. Over the intermediate maturity range, the French Treasury has managed to carve a niche for its securities through an innovative, transparent and investor-friendly issuance policy.

Convergence of yields[1]

In basis points

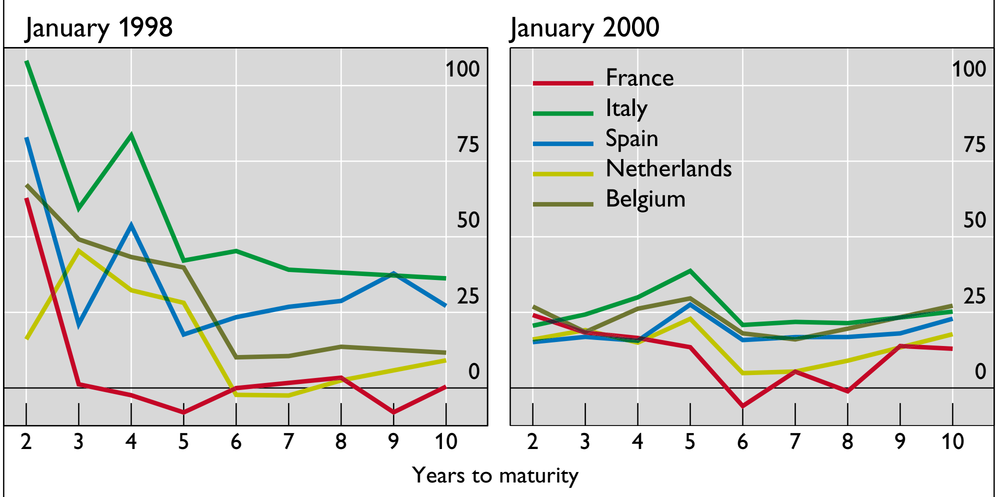


[1] Calculated as monthly averages of the difference between the highest and lowest yield of a given maturity of government bonds in Germany, France, Italy, Spain, the Netherlands and Belgium.

Source: Bloomberg. Graph VII.2

Yield spreads at different maturities[1]

Monthly averages, in basis points



[1] Over German government bonds.
Source: Bloomberg. Graph VII.3

Greater coordination between issuers has economic benefits …

Idiosyncratic national debt management policies and differences in market conventions are not without costs. No single government bond market is sufficiently large and deep to become the benchmark for the whole euro area, let alone challenge the US market in its leading role. Moreover, different structures and conventions in national bond issuance translate into inefficiencies in other market segments. One example is the repo market where, as noted, development is hampered by imperfect harmonisation of conventions. The corporate bond market could also benefit from a well defined reference government yield curve off which it could be priced in a consistent way. Greater coordination among euro area treasuries with respect to the calendar of issuance, coupon, maturity and other more technical characteristics of the bonds issued could lead to greater fungibility and larger pools of bonds across the maturity spectrum which would be likely to carry a liquidity premium. Bonds issued by the governments of the smaller economies would arguably be the main beneficiaries of such a boost in prices.

… but poses a political dilemma

Given the potential benefits in promoting market structure and reducing debt servicing costs, calls have been made for greater cooperation among EMU governments in this area. The issue, however, is much more complex than a harmonisation of market structure and conventions. It goes to the heart of the debate on how far national discretion could or should be surrendered in the name of achieving benefits that are unevenly distributed across the euro area. For some of the more formal proposed schemes, it is also a question of the extent to which cooperation would imply, or be perceived as implying, shared fiscal responsibilities, which are explicitly ruled out by the Maastricht Treaty. Any argument based on the economic benefits of greater coordination has to be carefully weighed against the further erosion of national independence. This debate is familiar from the process that led to Maastricht and it shows that closer economic integration is likely to continue to raise similar issues.

Corporate bonds

The euro has been particularly attractive to private sector borrowers both within and outside the euro area. Between July 1998 and December 1999, euro 11 private sector borrowers issued 76% of their debt in euros, compared to an average of 50% in the predecessor currencies between January 1990 and June 1998. Over the same period, private borrowers residing outside the euro area issued a fifth of their international debt in euros, nearly a twofold increase over the total share of the legacy currencies before July 1998 (Graph VII.4).

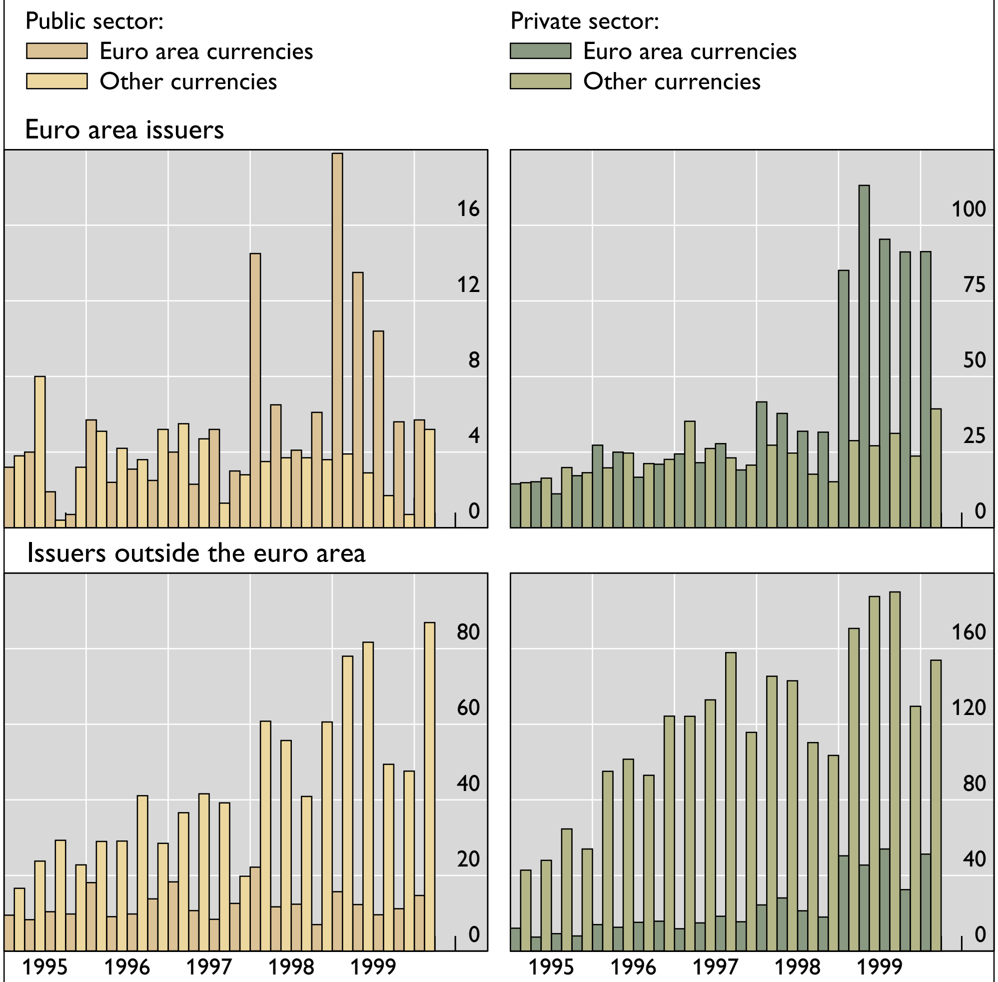
Private issuance surged …

While it could be argued that low interest rates and a weakening currency may have played some role in stimulating borrowers' interest in the euro, structural factors have clearly also contributed to the increase in issuance. Chief among these factors has been a significant expansion of the investor base. The single currency has effectively relaxed regulatory currency matching requirements for assets and liabilities imposed on many institutional investors that had led to a strong national bias in their portfolio allocation. Insurance

… helped by strong euro area demand

International bonds and notes: announced issues

In billions of US dollars



Sources: Bank of England; Capital DATA; Euroclear; International Securities Market Association; Thomson Financial Securities Data; BIS.

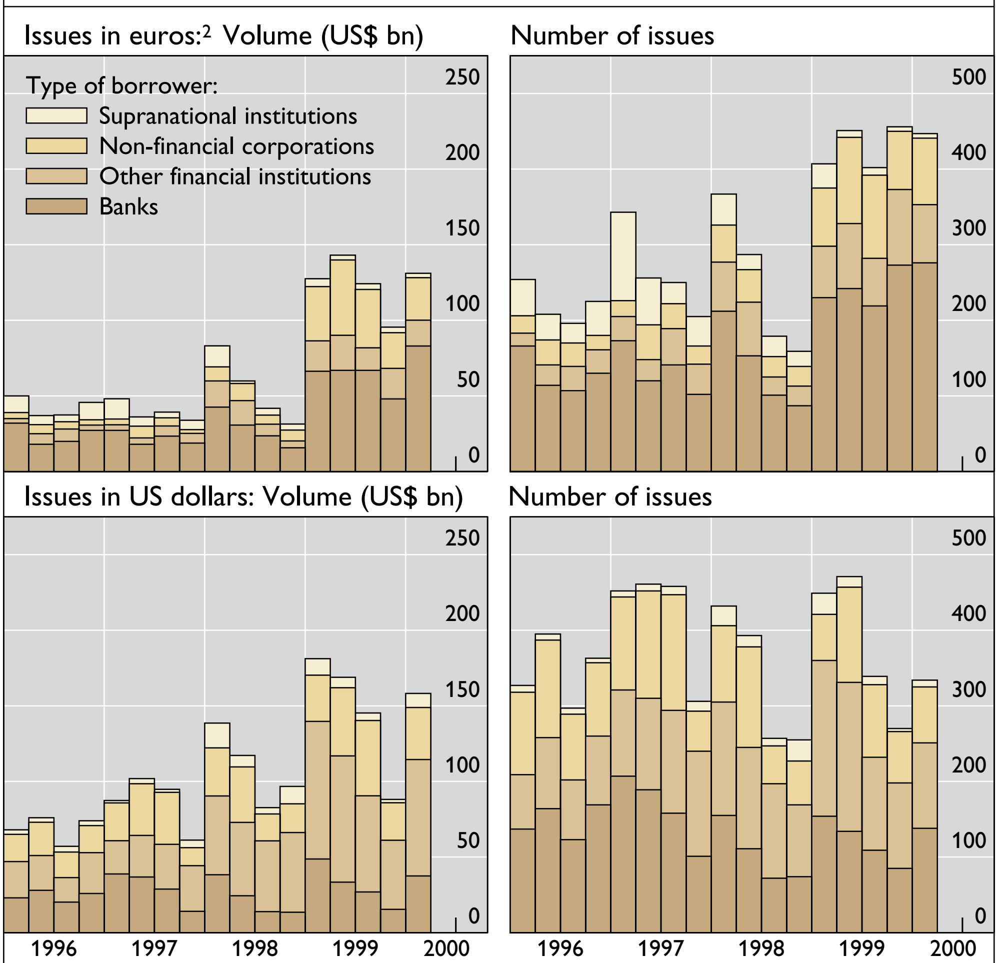
Graph VII.4

companies and pension funds have thus been able to take advantage of the elimination of exchange rate risk while at the same time achieving a greater degree of portfolio diversification by investing across the single currency area. German investors, for instance, had already sharply increased their purchases of euro-denominated foreign assets ahead of the introduction of the new currency. These purchases actually intensified thereafter, with euro area assets accounting for roughly two thirds of the total gross outward portfolio investment from Germany in 1999.

High concentration on bank and …

The composition of borrowers that have tapped the euro bond market partly reflects the traditional structure of European finance, but partly also its changing profile. The largest issuers, in terms of both the number of issues and the volume of funds raised, have been European banks (Graph VII.5). German banks' sales of securitised assets in the form of Pfandbriefe account for a large part of this segment. Indeed, the success of the Pfandbrief market has prompted a number of European countries to introduce legislation that replicates its institutional features in an effort to facilitate the development of bank asset securitisation. Such recent innovations in France, Spain and Luxembourg have yet to mature and achieve the liquidity and investor

International bond issues by type of borrower[1]



[1] By announcement date. [2] Prior to 1999, including deals in the legacy currencies and ECUs.
Sources: Capital DATA; BIS. Graph VII.5

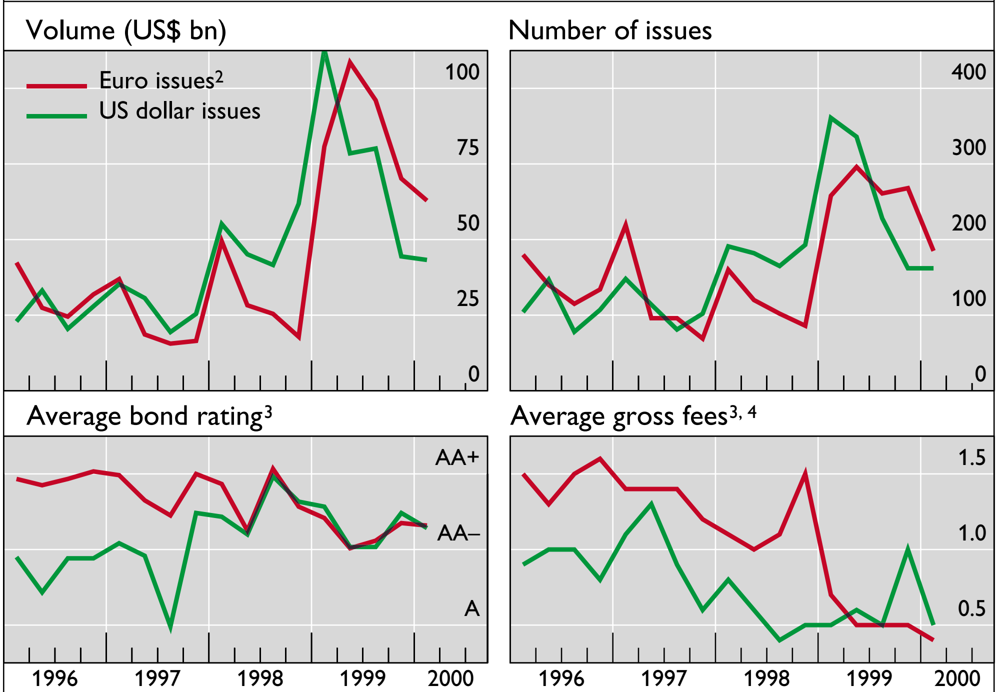
acceptance enjoyed by their German counterpart. A smaller but growing share of bonds has been issued by non-financial corporations, which have capitalised on the increasing appetite for credit risk among European investors. Within this group, there is a high concentration of telecommunications companies that have made extensive use of bond markets to finance the flurry of merger and acquisition activity in this sector. Large-scale borrowers, such as supranational institutions and other US dollar-based agencies and finance companies, remain under-represented in the euro-denominated bond market, relative to their size and global presence. An often cited explanation for this phenomenon is the unfavourable conditions in the swap market, which raise the effective US dollar financing costs for these borrowers accustomed to sub-Libor rates.

… telecommunications issues

The advent of the euro has rendered investment strategies based on cross-currency yield arbitrage and directional bets on national interest rates obsolete, encouraging investors to focus more closely on credit risk. European institutional portfolio managers have begun to educate themselves in the evaluation and management of credit risk, and have gradually developed an appetite for it. The progressive expansion of the market towards lower credits bears witness to this process. What used to be a market only for borrowers rated AA or higher has been able to accommodate a broadening array of credits (Graph VII.6). The sub-investment grade segment, while still much smaller and less diversified than its US dollar counterpart, has regained momentum after suffering a severe setback in the aftermath of the 1998 financial market turmoil.

Investors more receptive to credit risk

International bond issues by the private sector[1]



[1] Corporations, banks, other financial institutions and supranational institutions. Rated issues only. [2] Prior to 1999, including issues in the legacy currencies and ECUs. [3] Weighted by the issue volume. [4] As a percentage of the nominal amount.

Sources: Capital DATA; BIS. Graph VII.6

Currency of issue versus business relationship in the choice of bond bookrunner					
Borrower's nationality		Currency of issue			
		Euro legacy currencies	Euro	US dollar	All currencies
Market share of bookrunners whose nationality matches the issue currency (in %)[1]					
Euro area	1996–98	59.0	63.1	41.1	53.8
	1999–2000[2]	56.3	60.0	39.6	55.1
United States	1996–98	34.6	28.6	81.7	71.9
	1999–2000[2]	–	26.9	79.4	71.1
All	1996–98	53.2	58.2	64.2	57.8
	1999–2000[2]	50.5	53.0	69.3	58.2
Market share of bookrunners with the same nationality as the borrower (in %)[3]					
Euro area	1996–98	39.7	35.4	19.2	28.1
	1999–2000[2]	18.1	42.1	22.3	36.6
United States	1996–98	52.6	44.5	81.7	74.2
	1999–2000[2]	–	53.5	79.4	75.2
All	1996–98	28.2	27.7	38.6	32.1
	1999–2000[2]	19.2	36.3	51.2	41.5

[1] Percentage share of the volume of bonds issued by borrowers of a specific nationality (rows) won by bookrunners of the same nationality as the specified currency of issue (columns). For example, in 1996–98, US banks ran the books of 41.1% of all US dollar bond issues by euro area borrowers. [2] Up to mid-March. [3] Percentage share of the volume of bonds issued by borrowers of a specific nationality (rows) and denominated in the specified currency (columns) won by bookrunners of the same nationality as the borrower. For example, in 1996–98, the books of 19.2% of all US dollar bond issues by euro area borrowers were run by banks from the same country as the borrower.

Sources: Capital DATA; BIS calculations. Table VII.2

Intensified competition in bond underwriting

The introduction of the single currency has played a critical role in increasing the contestability of the market for the provision of corporate financial services. Table VII.2 shows that historically the nationality of the underwriter of an international bond has been more closely associated with the currency in which the bond is issued than with the nationality of the borrower. This suggests that any established relationship between corporations and their investment bankers is not as important a factor in the selection of underwriters as the ability of the latter to correctly price and place the issue in a market they know well. The advent of the euro has diminished any local advantage European bankers had derived by virtue of their familiarity with investors with a strong national currency bias. While the effect of this change has failed to alter the strength of the stylised facts, the lower right-hand panel of Graph VII.6 suggests that fees for the euro-denominated segment of the market have rapidly converged towards the level of its US dollar counterpart over the last two years. Together with the growing similarity in the average credit quality of the borrowers and the close relationship between issuance levels in the two segments, this convergence in fees is a clear indication of the progressive integration of the international bond market.

The blossoming of the euro-denominated corporate bond market will have a lasting impact on the European financial structure, traditionally characterised by the predominance of bank-intermediated forms of finance. A broader and more receptive investor base is likely to encourage more classes of private borrowers to substitute debt securities for bank loans. At the same time, banking institutions are themselves likely to use the market as a source of funding that will support their portfolios of less liquid assets. Clearly such developments, by expanding the range of available funding channels, will also enhance the efficiency of the mechanism for the allocation of savings, thereby benefiting the entire European economy. However, by increasing the sensitivity of corporate and bank balance sheets to capital market conditions, this trend is also likely to pose new challenges for financial stability in the area.

Equity markets

Healthy supply

Two of the most significant developments in Europe's equity markets during the past year are only tangentially linked to the introduction of the new currency: healthy issuance and further maturation of Europe's specialised exchanges for young and growing company stocks. Issuance has been supported by generally buoyant stock prices as well as by the continuing trend of government withdrawal from commercial activities. Gross issuance of international equity by euro area companies grew in 1999 by almost 70% over its average level for the previous two years. Declining bond yields in much of the euro area, a result of the economic convergence, have contributed to intensified interest by retail investors in riskier but potentially more rewarding equity investments. In fact, record inflows into equity mutual funds have supported valuations across most of the area's equity markets.

New types of issuer

A new, more capital market-friendly breed of European entrepreneurs has brought increasing numbers of small and medium-sized companies into the public equity markets. This trend has been underscored by the success of the network of "new markets", which have been created in many European countries with the objective of providing access to equity finance for small, dynamic companies with a high growth potential. After a period of strong growth in early 1999, the market was unsettled by an excess supply of new equity for much of last year. Conditions improved again in November, influenced by the global rally in "new economy" stocks (see Chapter VI). This time, strong initial public offering activity was met by a more diverse group of investors showing greater commitment to the sector.

Old pricing paradigm persists

The advent of the euro was widely expected to mark the beginning of a new paradigm in the valuation of equity for companies in the EMU area. The importance of diverging macroeconomic factors affecting share prices was expected to diminish because of the elimination of exchange rate risk, the fully unified monetary policy stance and the greater cohesion of fiscal policy across the EMU economies. In addition, the expansion of cross-border commercial activity, boosted by progress towards a single market in the European Union, was expected to increase the importance of sector-specific factors at the expense of country-specific factors in influencing individual company valuations. Evidence from company valuations so far, however, has failed to detect a major shift. Individual company stock continues to co-move more closely with that of other companies in the same country than with that of similar companies elsewhere in the euro area, an indication that prices continue to be driven principally by local investors with a considerable geographical portfolio bias.

Gradual progress towards a pan-European stock exchange

One factor that is likely to have contributed to this segmentation of equity markets is the absence to date of an integrated trading infrastructure covering the entire EMU area. There have been many attempts to establish a unified platform that would allow investors from inside as well as outside the common currency zone to trade seamlessly in equities of European companies, through bilateral or multilateral agreements among the existing national bourses. The most ambitious such plan is for an alliance among six of the largest stock exchanges in the euro area, together with the London and Zurich exchanges, aimed at creating a pan-European market for the largest and most heavily traded stocks. The intention is to start with simple steps such as the harmonisation of opening hours and to progressively establish a common trading infrastructure, as well as uniform settlement and clearing facilities. By improving market liquidity and reducing trade processing costs, such a development would help the European equity markets to realise their full potential and grow to a size commensurate with the area's economy (Table VII.3). Progress in this project, however, has been slower than initially expected. Agreement on a common architecture has been hampered by the ambitions of

Stock market indicators

	Market capitalisation[1]				Turnover[2]			Number of listed stocks[1]		
	in billions of US dollars			*1999 in % of GDP*	in billions of US dollars					
	1990	1995	1999		1990	1995	1999	1990	1995	1999
Euro area	1,169	2,119	5,526	*85*	737	1,237	4,342	2,485	2,592	3,893
Germany	355	577	1,432	*68*	509	594	1,551	413	678	1,043
France	314	522	1,503	*105*	121	213	770	578	450	968
Italy	149	210	728	*62*	42	87	539	220	250	264
Spain[3]	111	198	432	*72*	…	163	739	427	362	723
Netherlands	120	356	694	*176*	41	124	471	260	217	233
Belgium	65	105	184	*74*	9	18	59	182	143	159
Austria	11	33	33	*16*	11	13	13	97	109	97
Portugal	9	18	67	*62*	…	4	40	181	169	125
Finland	23	44	349	*272*	4	19	110	73	73	147
Ireland	…	26	69	*75*	…	…	48	…	80	84
Luxembourg	10	30	34	*192*	–	–	1	54	61	50
United States[4]	3,059	6,858	16,773	*181*	1,778	5,481	19,412	6,599	7,671	7,297
Japan[5]	2,918	3,667	4,455	*102*	1,288	884	1,676	2,071	2,263	1,889
United Kingdom	849	1,408	2,955	*206*	543	1,153	3,399	1,701	2,078	2,292
Canada[6]	242	366	789	*124*	71	185	389	1,144	1,196	1,406
Switzerland	160	434	678	*262*	65	340	562	182	233	239

[1] Listed domestic stocks. [2] Value of share trading; total domestic and foreign listed companies. Due to different reporting rules and calculation methods, turnover figures are not entirely comparable. [3] For turnover, Madrid Stock Exchange only; otherwise, also including the stock exchanges of Barcelona, Bilbao and Valencia. [4] For turnover, New York Stock Exchange and Nasdaq; otherwise, also including AMEX. [5] For turnover, Tokyo Stock Exchange only; otherwise, also including Osaka Stock Exchange. [6] Stock exchanges of Toronto, Montreal and Vancouver.

Sources: International Federation of Stock Exchanges (FIBV); International Finance Corporation; Swiss Exchange. Table VII.3

individual alliance members and a reluctance to change established practices and rules. Disappointment with the lack of progress and increasing competitive pressure from a number of newly created electronic trading systems have prompted some exchanges to seek closer cooperation on a smaller scale. The most prominent examples are the announced mergers between the London Stock Exchange and Deutsche Börse, on the one hand and between the Paris, Amsterdam and Brussels exchanges, on the other. The first deal will create the second largest stock exchange in the world by market capitalisation, while the second will be a significant competitor within Europe. Other European exchanges are expected to join these two alliances at a later stage.

Consolidation in the financial sector

The euro has catalysed consolidation …

The euro has played a central role in reshaping financial intermediation in the EMU area and its periphery by reinforcing the factors that have been driving the consolidation process in the banking and non-bank intermediary sectors for some time. The euro lifted the economic barriers to the cross-border supply of financial services within the single currency area and thus expanded the scope for growth and diversification for the area's banks. Its influence has strengthened the trend towards larger institutions that would be able to reap the full benefits of greater economies of scale brought by technological progress. At the same time, it has intensified competition, at least at the wholesale level, reinforcing the incentive to create institutions capable of competing effectively on a pan-European scale for corporate banking business.

The pace of financial sector consolidation in Europe accelerated in anticipation of the introduction of the new currency and has continued

Merger and acquisition activity in the euro area financial industry[1]

	Same country		Other euro country		Other non-euro country		Total		*As a percentage*[2]	
	Number	Value[3]	Number	Value[3]	Number	Value[3]	Number	Value[3]	*Number*	*Value*[3]
Banks – banks										
1998	7	8,445	1	147	12	13,787	20	22,379	*12.7*	*13.0*
1999	9	41,242	4	9,465	15	7,495	28	58,202	*15.9*	*34.2*
2000[4]	3	4,528	0	0	5	11,654	8	16,182	*26.7*	*62.0*
Banks – non-bank financial										
1998	4	28,604	1	646	3	897	8	31,147	*24.2*	*37.9*
1999	3	20,816	1	800	12	4,130	16	25,746	*20.8*	*56.4*
2000[4]	8	4,768	1	1,631	4	653	13	7,052	*48.1*	*39.1*
Non-bank financial – non-bank financial										
1998	6	7,299	2	7,974	7	1,201	15	16,474	*11.8*	*13.8*
1999	11	15,508	4	378	19	21,888	34	37,774	*15.7*	*40.7*
2000[4]	4	5,071	1	9	5	454	10	5,534	*23.3*	*18.8*

[1] Either acquirer or target company is resident in the euro area. Only completed or pending deals; announcement date volumes. [2] Of mergers and acquisitions in all countries. [3] In millions of US dollars. [4] 1 January to 10 April.
Source: Bloomberg. Table VII.4

Cost structure in the banking sector						
	Number of branches per 1,000 inhabitants			Employment per $1,000 assets		
	1990	1995	1998	1990	1995	1998
United States	0.29	0.28	0.29	0.40	0.32	0.29
Japan[1]	0.18	0.19	0.19	0.07	0.06	0.06
Euro area[2]	0.56	0.55	0.55	0.21	0.15	0.15[3]

[1] For the employment ratio, commercial banks only. [2] For the employment ratio, Germany, France, Italy, Belgium, the Netherlands and Spain only. [3] 1997.

Source: National data. Table VII.5

unabated. The merger wave has also spilled over to the periphery of the euro zone, partly in sympathy with the consolidation taking place within the area, and partly in anticipation of future EMU entry. However, while financial sector mergers and acquisitions often cross industry lines, they remain largely confined within national borders. Current cross-border activity mostly takes the form of strategic alliances, often reinforced by the acquisition of minority, non-controlling stakes.

… largely at a national level

There are several factors that might explain this preference for national transactions. One is that domestic mergers offer clearer opportunities for reducing costs by trimming overlapping branch networks and excess capacity. Another factor is that such transactions present, in principle, fewer complications in terms of conflicts of corporate and managerial cultures between the two merging organisations, one of the commonest reasons for lack of success. A third factor is that a strong domestic presence is seen as a prerequisite for successful cross-border alliances as it gives the institution a stronger bargaining position. Finally, there is evidence that economies of scale are more prevalent in the wholesale business, which is arguably easier to centralise, than in the retail sector, where a local presence is crucial. In this sense, what has been observed so far is likely to be only the first stage in this consolidation process, with later stages focusing more on the international dimension.

Supervisory and regulatory structure

A framework blending harmonisation with decentralisation …

The objective of creating a single market for financial services in the European Union dates back to the 1957 Treaty of Rome. Market forces alone, however, were unable to overcome legal, regulatory and practical impediments to the cross-border provision of services. Recognising the inherent difficulties in fully harmonising all national standards, the European Union adopted an approach based on the principles of mutual recognition of regulatory frameworks, subject to minimum essential harmonisation, and home country control. This approach has been successful in facilitating the introduction of key legislation. At the same time, it has given rise to a regulatory framework in which common elements coexist with others that remain under national control and thus potentially differ across countries. This mixture of harmonisation and decentralisation has been extended under EMU, where the conduct of monetary policy is fully centralised, while responsibility for financial stability remains largely with national authorities.

… has implications for competition …

In a market free of competitive distortions, similar institutions must have the same opportunities for access and face the same costs stemming from the supervisory and regulatory framework and the approaches to dealing with financial distress. The continued reliance on an approach that maintains decentralised control over important components of this framework raises the issue of potential implications for the "levelness of the playing field" within the European Union. By further integrating the economic environment in which EU financial institutions operate, the advent of the euro has highlighted the possible competitive distortions that may arise from differences in the elements that remain decentralised.

… and financial stability

The decision to leave the responsibility for financial stability largely with national authorities has also raised questions concerning the appropriate mechanisms for achieving this objective in the euro area as a whole. The main issues relate to the implications of decentralisation for the balance between the incentives that influence decision-making by the relevant authorities and the adequacy of the means at their disposal to secure stability in an increasingly international business environment. These questions have gained salience in the light of the role of the euro in furthering economic integration.

The relationship between these two goals – a level playing field and financial stability – is more intimate and complex than might appear at first sight. Experience suggests that competitive distortions may undermine stability by leading to excessive risk-taking. Conversely, there may be circumstances in which constraints on the provision of assistance to institutions in distress on the grounds of unequal treatment could complicate the effective management of financial strain.

Current arrangements

Reliance on home country control …

Since the "home country control" principle was first adopted in the Second Banking Co-ordination Directive, it has been an integral part of the major legislative initiatives to promote the single financial market. The same principle is also an important element of the design of the EMU framework. It assigns responsibility for the worldwide consolidated supervision of an EU credit institution to the "competent authority" of the member state in which the institution has its head office, subject to the harmonisation of minimum prudential standards. Host country supervisors are expected to provide all necessary information to the home country authorities. In contrast, conduct of business rules are the responsibility of the host country where the services are actually provided.

… puts emphasis on coordination

Even prior to the introduction of the euro, this basic principle was the foundation for the development of a complex web of cooperation among regulatory and supervisory authorities. Cross-border cooperation and information exchange were implemented partly bilaterally, through memoranda of understanding, and partly at the EU level, through the Banking Advisory Committee and the Groupe de Contact. Parallel coordinating structures were established for EU insurance and securities market supervisors. National organisational arrangements for financial sector supervision vary considerably across countries, ranging from a single agency to multiple agencies for separate sectors and with different degrees of central bank involvement. Consequently, each committee, though organised along sectoral lines, interfaced with agencies with multi-business supervisory responsibilities. However, the formal structures that bring together supervisors from all three sectors have been created only recently and their character is better described as consultative than rule-making, in line with current practice in many member countries.

EMU brings the Eurosystem into the picture

The creation of the euro, besides bringing about the centralisation of the conduct of monetary policy, has so far not altered the fundamental features of this picture. The Maastricht Treaty assigned to the Eurosystem the role of contributing "to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system". Supervisory powers, therefore, have remained at the national level, under an arrangement that accommodates the considerable variation in practices and powers allotted to different agencies under national frameworks and forgoes further harmonisation. While the text of the Treaty does not preclude the assignment of certain responsibilities in this field to the ECB, it has been decided not to make use of this option at the present stage. The Treaty has also given the Eurosystem responsibility for the oversight of payment systems, thereby strengthening the statutory backing for some national central banks' policies in this field. Finally, in line with the need for greater coordination, the Banking Supervision Committee of the ESCB now brings together the authorities responsible for financial stability and payment systems oversight in the system with national banking supervisors.

Minimum harmonisation of deposit insurance

In the area of deposit insurance, the 1994 Directive on deposit guarantee schemes has partly harmonised arrangements by making such schemes mandatory in all member states and setting a uniform *minimum* coverage of €20,000 per depositor. National schemes, however, have the option of offering higher protection levels, and the Directive contains no provisions on several other aspects of the arrangements, including administration and funding.

Winding-up procedures …

As regards policies for dealing with problem institutions, the harmonisation of procedures and rules for reorganisation and winding-up is not very far advanced. The home country control principle and national laws remain the rule. Takeover and securities legislation, which can materially affect the effectiveness of private market solutions to problem institutions, differs considerably across countries. The result is a lack of uniformity in the rights attached to shares as well as in the powers of boards of directors and shareholders. National authorities retain discretion in scrutinising bank takeovers as part of their responsibility for safeguarding financial stability, although this is limited by the EU rules on the free movement of capital.

… and liquidity assistance …

The use of public funds in a bank rescue is governed by the EU rules on state aid. While acknowledging the special nature of the banking sector, the European Commission is of the opinion that Community law clearly sets a criterion of "equal competitive conditions", hence subjecting state financial support to the Commission's scrutiny. The use of central bank funds in crisis management is part of the Emergency Liquidity Assistance function (ELA).

Neither the Maastricht Treaty nor the Statute of the ESCB gives the ECB an explicit mandate for providing emergency liquidity support directly to individual financial institutions. However, by assigning the responsibility for financial stability to national authorities, the Treaty implicitly charges national central banks with this task. Subsequent agreements have crystallised this basic principle (see below).

… under national control

Levelling the playing field

Similarities with the US framework …

In assessing how far the current arrangements for ensuring financial stability in the European Union might be a source of competitive inequalities, it is useful to compare them with those established in the United States. The latter in fact presents another example of a framework based on the coexistence of multiple regulatory and supervisory agencies for the financial system. Indeed, because of the historically stricter functional differentiation between securities and banking business in the United States, the banking regulators' purview is narrower than in Europe, where securities firms normally operate with a banking licence. This US feature tends to emphasise the differences in regulatory and supervisory approaches in the two fields. Even so, at least in the banking area, there are a number of countervailing elements in the US system which tend to promote greater uniformity of treatment. The prompt corrective action scheme effectively obliges the supervisory agencies to align their actions in response to the deterioration of a bank's financial condition. The centralisation of the lender of last resort function at the Federal Reserve guarantees harmonisation of the conditions under which banks can access liquidity support. National rules require banks to offer the same nominal deposit insurance coverage, and the centralisation of insurance provision for bank deposits under the Federal Deposit Insurance Corporation ensures that it is available on uniform terms.

… but also important differences …

Such mechanisms are largely absent from the current EU framework. The Directive on deposit insurance has institutionalised only a minimum insurance coverage, thereby permitting a significant dispersion in protection levels (Table VII.6), without constraining other elements that could have compensated for this dispersion, such as insurance premiums and funding mechanisms. There is no formal equivalent to the prompt corrective action scheme that would closely prescribe the intervention by supervisory agencies when confronted with a distressed institution, nor is there harmonisation of the conditions of access to liquidity support from central banks. Admittedly, the restrictions on state aid limit the discretion of national authorities in the scrutiny of mergers and acquisitions or the resolution of insolvent institutions. Nonetheless, the effective room for manoeuvre in response to national considerations remains considerable within the existing framework.

… with a potentially distorting impact

It is of course difficult to assess the extent to which these national differences impinge on competitive conditions. One reason is that their effect should not just be considered in a piecemeal fashion, but should be evaluated in terms of the overall architecture of the arrangements and actual practices. Even so, the actions already taken or being taken by the European Commission in the area of state aid to the banking sector indicate a heightened sensitivity

Coverage of deposit protection schemes[1]

	Coverage per depositor		Funding	Administration[2]
	in euros	relative to GDP per capita, in %		
Germany	20,000[3]	85.4	yes[4]	private[3]
France	60,980	276.6	no	private
Italy	103,291[5]	559.5	no[6]	private
Spain	15,000[7]	113.5	yes	joint
Netherlands	20,000	90.1	no	joint
Belgium	15,000[7]	68.4	yes[8]	joint
Austria	18,895	80.6	no[9]	private
Portugal	15,000[10]	156.1	yes[11]	government
Finland	25,228	113.4	yes	private
Ireland	15,000[12]	73.3	yes	government
Luxembourg	15,000[7]	40.6	no	private
United Kingdom	22,222[13]	105.0	yes[14]	government
Sweden	26,349	109.9	yes	government
Denmark	42,000	143.5	yes	government
Greece	20,000	193.8	yes	joint
EU[15]	20,000[16]	99.1	.[17]	.[18]
United States	85,708	296.6	yes	government
Japan	60,853[19]	226.0	yes	joint
Canada	33,220	186.5	yes	government
Switzerland	20,000	56.8	no	private

[1] Prevailing at end-1998. [2] Of the system: either by the government, by industry (private) or both (joint). [3] For almost all banks, 100% up to a limit of 30% of the bank's liable capital. Official coinsurance 90% up to €20,000. [4] Additional assessments may be made if necessary to discharge the fund's responsibilities. These contributions are limited to twice the annual contribution. [5] 100% of first Lit 200 million (€103,291). [6] Banks commit ex ante; however, contributions are ex post. [7] Until December 1999; €20,000 thereafter. [8] In case of insufficient reserves, banks may be asked to pay, each year if necessary, an exceptional additional contribution up to 0.04%. [9] System is organised as an incident-related guarantee facility. [10] 100% up to €15,000; 75% from €15,000 to €30,000; 50% from €30,000 to €40,000. [11] The payment of the annual contributions may be partly replaced, with a legal maximum of 75%, by the commitment to deliver the amount due to the fund, at any moment it proves necessary. [12] 90% up to €15,000. [13] 90% of protected deposits, with the maximum amount of deposits protected for each depositor being £20,000 (unless the sterling equivalent of €22,222 is greater). [14] Banks make initial contributions of £10,000 when a bank is first authorised, further contributions if the fund falls below £3 million, not exceeding £300,000 per bank based on the insured deposit base of the banks involved, and special contributions, again based on the insured deposit base of the banks involved, but with no contribution limit. [15] EC Directive on Deposit Guarantee Schemes. [16] The minimum coverage was originally specified as ECU 20,000 and the conversion rate was set to ECU 1 = €1 at end-December 1998. [17] Determined within each member state. [18] Only directs that each member state shall ensure within its territory one or more deposit guarantee schemes are introduced and officially recognised. [19] Full coverage until March 2001.

Sources: J R Barth, D E Nolle and T N Rice (1997) and IMF, as quoted in A Prati and G J Schinasi, "Financial stability in European economic and monetary union", *Princeton Studies in International Finance No 86*, Princeton University, August 1999; national data; BIS calculations. Table VII.6

to their potential impact. Looking forward, that impact is likely to grow. This is in part due to the introduction of the euro, which has increased transparency and given further impetus to the integration of markets. But more generally, as further elements of the EU regulatory framework are harmonised, the competitive advantage that may arise from differences in those aspects that remain under national control is bound to become relatively more significant.

Clear examples include the considerable diversity in the powers and practices of national supervisory agencies as well as the architecture of safety nets.

Safeguarding financial stability

The issues that have been raised with respect to the current arrangements for safeguarding financial stability in the euro area relate primarily to the allocation of responsibilities and the exchange of information among the relevant authorities.

Ambiguities regarding the responsibility for ELA …

Initial criticism of the arrangements regarding emergency liquidity assistance focused on the ambiguities in the Treaty concerning the mechanisms for providing liquidity support, if and when required, and the corresponding allocation of responsibilities. Steps taken by the authorities in the period under review, however, have clarified that responsibility for emergency liquidity assistance to individual institutions has been assigned to competent national authorities, as defined in the national framework, while the Eurosystem retains responsibility for managing overall liquidity conditions through monetary operations. Specific technical characteristics of the arrangements have facilitated the drawing of this distinction. First, under EMU there is a well defined dividing line between ELA, on the one hand, and monetary operations, on the other, as a result of the existence of standing facilities available on demand and a prespecified set of acceptable collateral. ELA begins where normal operations stop. This contrasts with arrangements in some other countries, such as the United States, where end-of-day credit is granted at the discretion of the authorities through the same facility used to provide emergency liquidity support. Moreover, the comparatively ample supply of collateral and wide access to the standing facilities in the Eurosystem mean that the available cushion before ELA is technically activated is larger than elsewhere. Second, the fact that operating objectives for monetary policy are effectively set in terms of short-term interest rates rather than specific quantities of reserves provides national central banks with somewhat greater freedom. In particular, if financial distress is associated with changes in the demand for reserves at the local, or even aggregate, level, these could be accommodated by the Eurosystem without modifying the stance of policy as long as the key interest rates remained under control. Mechanisms for the timely exchange of information with the Governing Council of the ECB, which is ultimately responsible for monetary policy decisions, ensure that the consequences of national actions for monetary policy implementation can be duly taken into account.

… have been clarified

Decentralisation can be cumbersome …

ELA is but one instrument in the wider set of tools available to deal with institutions in distress, which may range from pure liquidity shortage to insolvency. The more general question is whether allocating this broader function to national authorities with respect to "home" institutions might in some circumstances create difficulties. Conceivably, in certain situations this might result in incentives not fully in line with the stability needs of the area as a whole. Cases in point might be those of institutions that were systemically relevant only outside their home market or that, in effect, had more than one "home" market in view of the geographical scope of their operations and, perhaps, ownership structure. In the absence of appropriate burden-sharing

… in cases of intense cross-border activity mechanisms, such situations could complicate the timely elaboration of a policy response and might even lead to a certain bias towards inaction. Even so, scenarios such as these are predicated on a degree of financial integration that, arguably, goes beyond what has so far been achieved within the euro area.

Harmonisation of legal framework …

Progress towards the elimination of existing differences in important aspects of the national legal framework is likely to boost the effectiveness of market-based mechanisms in dealing with cases of financial distress. A liquid repo market could usefully complement the uncollateralised interbank market, especially during periods of financial strain when market participants are particularly sensitive to credit risk. The establishment of a common legal and market infrastructure, the absence of which has so far hindered the development of the cross-border repo market in the euro area, would minimise the likelihood that emergency central bank assistance will be necessary. Similarly, further harmonisation in national securities and bankruptcy legislation as well as in the framework for merger and acquisition approvals could facilitate the resolution of financial distress through cross-border "private money" solutions.

… and closer supervisory cooperation are key

In any case, there is little doubt that the greater financial integration promoted by a single currency puts a premium on mechanisms for the exchange of information between the relevant authorities in charge of safeguarding financial stability. Access to accurate and timely information is necessary both for the early detection of potential vulnerabilities, thereby permitting preventive action, and for assessing the extent and intensity of strains once they arise. The establishment of the Eurosystem has provided an opportunity for streamlining and strengthening existing mechanisms. There is, however, scope for improving the practical functioning of current arrangements, especially with regard to communication and cooperation between supervisory authorities of different sectors at an international level, cooperation between these authorities and central banks, and the convergence of supervisory practices.

Looking ahead, it is difficult to foresee how the framework for safeguarding financial stability will evolve. Much will depend on the pace of further financial integration, on how the arrangements perform if and when put to the test, and on developments in the broader political environment. The current balance between centralisation and decentralisation is unique. Nonetheless, as the elusive objective of a true single market comes within closer reach, the underlying forces at work should tend to shift the balance towards further centralisation or harmonisation, even though the precise modalities and timing of this shift remain hard to predict.