Jean-Claude Trichet: Integration of the European financial sector

Introductory remarks by Mr Jean-Claude Trichet, President of the European Central Bank, at the International Banking Event, Frankfurt am Main, 29 June 2004.

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Introductory remarks

Madam Lord Mayor, ladies and gentlemen, I am very glad to address this distinguished audience in the prestigious Römersaal, surrounded by this impressive series of German emperors' portraits amongst whom, you will not be surprised, I would particularly distinguish the first one, Karl der Grosse, Charlemagne, who also has the biggest portrait. These paintings highlight very well the major role Frankfurt played in history. Besides its political influence, Frankfurt developed a key role in European banking. A young man called Rothschild started his business here before expanding all over Europe. Today, the large presence of major German, European and international banks and the dynamism of the Stock Exchange demonstrate well the great importance of Frankfurt as a city of banking and finance at the heart of Europe.

I see therefore a great interest in addressing tonight the issue of European financial integration. Furthermore, now is also the appropriate timing to reflect on the best approach to further progress. The Financial Services Action Plan reaches completion and the gaps that remained in the core legislative framework have been filled. Market participants should now grasp the opportunity to reap the full benefits of the Single Market.

My talk today aims at providing some food for thought on financial integration. I would like to stress four points. First, giving an overview of what we should understand by financial integration, why it matters for the economy and for the ECB, and what key steps have been achieved. Second, underlining the progressive setting of the framework for a single financial market. Third, providing an overview of the progress made so far in banking. And fourth, setting out the actions that may and should be undertaken to optimise the benefits from financial integration.

The context of financial integration

What does it actually mean to have an integrated financial sector in Europe? An integrated market is perhaps easiest understood when it concerns goods, and where it refers to a situation where there are no barriers to trade across borders. The same reasoning can also be applied to the wider context of financial markets. Market participants should generally not be discriminated in their access to the market on the basis of their location, and cross-border transactions should be treated equally to domestic ones, notably in terms of rules and costs. Progressing towards such an ideal setting with regard to all the segments of the financial markets is the challenge before us.

Let me give you some examples of what integration means in practice in financial markets. Near perfect integration has already been achieved in the unsecured interbank money market. Almost immediately after the euro's introduction, the differences in rates across the euro area became so small that shifting funds across borders to exploit these differences became unprofitable. We also observe that banks only very rarely resort at the same time to the Eurosystem's credit and deposit facilities. This shows that geographical borders are not an obstacle anymore to shift liquidity in the banking system quickly and efficiently. Integration has also advanced in the repo-market, probably one of the most dynamic segments of the money market. Also the interest rate swap market, which is crucial for banks' interest rate risk management, has developed into one of the euro area's most liquid and integrated markets. Market participants are now using this market to define their interest rate benchmark rather than the market of government securities, where some national differences are still relevant. The European corporate bond market is still young but has grown strongly with the euro. Integration seems to be reasonably well, as demonstrated by the growing competition for fees between banks that arrange and underwrite issues. Finally, with regard to equity markets research conducted at the ECB shows that in the euro area local stock returns are more and more driven by common European news, rather than purely local events, which points to considerable integration. Large insurance companies, pension funds and investment funds also take a more pan-European view in their portfolio decisions.

Before such an audience I do not have to recall in detail that the benefits of financial integration are very numerous. But similar to many public goods, one might not always be directly aware of the benefits although they are very substantial. Financial integration results in deeper and more liquid markets, more efficiency and a better allocation of risk. It further facilitates the allocation of capital to the best investment opportunities, leads to lower prices for consumers and raises the economy's growth potential. A recent study, for example, quantified that the overall level of EU-wide real GDP may increase by more than 1% over a decade or so as a result of further integration, and that employment would also benefit. The cost of equity capital was estimated to fall across Europe by about 40 basis points, with a further reduction of 10 basis points arising from reduced clearance and settlement costs.

Apart from these more general benefits, there are also reasons why we at ECB in particular attach great importance to financial integration. Evidently, the financial system plays an essential role in the transmission of monetary policy and integrated European financial markets facilitate the implementation all over the euro area of the ECB monetary policy. This holds especially for markets that are directly involved in our operations: the money market, but also the bond market since the vast majority of the assets we take as collateral are bonds. Another reason for our interest relates to our responsibility for the promotion of a smooth operation of payment systems. Integration, particularly at the level of infrastructure, facilitates this. Lastly, integration also contributes to financial stability, another key issue of interest for central banks, since a larger and more diversified financial system is better able to absorb economic shocks.

A robust public policy framework as a precondition for integration

Ladies and gentlemen, European and national authorities have worked hard to establish a sound public policy framework for the single financial market. I believe that the main pillars of such framework are now in place for financial integration to progress even further. Let me address its core elements, namely regulation, supervision and financial infrastructure.

Regulation

First, the regulatory component. Here, I have to mention foremost the impressive achievement of the Financial Services Action Plan. Set out in 1999, the Plan has led to the adoption of 39 Community measures - the result up to now - for the legislative framework of the single financial market. Of course, the impact of the FSAP on financial markets will take some time to manifest itself fully, but I am convinced that the expected benefits of a modernised regulatory framework are very substantial. I will illustrate this with the new EU rules for the capital adequacy of banks and the accounting reform that is now underway in the EU.

A robust capital adequacy framework for banks is a key condition for a single financial market. Indeed, an efficient and stable European financial system requires that regulatory capital requirements are sufficiently aligned with banks' underlying risks. The authorities in the different countries should also implement the rules consistently. The need to revise the requirements is the result of an important gap that exists between the present rules and banks' risk management practices. The average bank of 1988, when the Basel Accord was adopted, is a very different animal compared with the average bank today. Globalisation, the shift towards market-based financing and the speed of financial innovation have all significantly changed banks' risk profile. The current Accord, which is based on a simple scheme of very broad risk categories, hence needed to be revised. Moreover, the current Accord applies in a uniform way to all types of credit institutions, from the smallest local savings banks to the largest global players, regardless of the quality of their risk management.

The new framework, which I presented as Chairman of the G10 together with Jaime Caruana, Chairman of the Basel Committee, last Saturday in Basel, addresses these concerns. Basel II is based on three pillars, namely minimum capital requirements, a review process by supervisors and market discipline. It also introduces more comprehensive and risk-sensitive rules. For example, in addition to the already existing capital requirements for credit risk, banks will for the first time have to set aside capital for their operational risk. Basel II also allows for different ways to calculate the minimum requirements and the institutions that opt for the most advanced methods get a capital advantage. In this way, institutions have an incentive to further develop their risk management capabilities. The ECB strongly supports the new framework and considers that its incorporation in the European rules will be another milestone for the Single Market. But the consistent implementation of the new rules remains an important area to watch. Close co-operation between supervisors will be of utmost importance to achieve effective convergence, both within the EU and on a world-wide basis.

I now turn to the current endeavours in developing an internationally harmonised accounting framework. This reform is especially important for the EU because of its contribution to financial integration. I recall that from 1 January 2005 onwards, all listed companies in the EU will be required to publish their consolidated accounts in accordance with international accounting standards. A first step in this direction was the adoption of a Regulation endorsing all International Accounting Standards, with the exception of two controversial standards concerning the recognition, measurement and disclosure of financial instruments, IAS 32 and 39. These standards are particularly important for the banking industry. It is therefore no surprise that they have triggered an extensive debate among the industry, supervisors and standard-setters. The ECB has a keen interest in these new rules because of their impact on banks. We therefore carried out work in this area, mainly from a financial stability angle. Our concerns relate in particular to the reliability of calculated fair values, the comparability across institutions, and the impact of changes in a bank's own credit risk on its capital position. We conveyed our concerns to the IASB, which triggered additional discussions. We will follow with extreme attention the developments to come.

Supervision

Supervision is the second pillar I see of a framework for integration. The timely finalisation of the FSAP is a very impressive achievement. Its full benefits will now be reaped if the rules are implemented and enforced consistently among Member States. In this process I see a crucial role for the Lamfalussy approach to financial regulation and supervision. This new framework provides for the establishment of sectoral committees of national authorities to pursue a consistent implementation of European rules. The new arrangement will be very valuable for the FSAP, but also for the EU regulatory provisions in general.

The Lamfalussy approach addresses the supervisory challenges arising in more integrated financial markets. Banking groups that perform a lot of their business in other Member States rightfully expect to face similar attitudes and procedures of national supervisors. This is crucial for alleviating their compliance costs and also to ensure that no major competitive distortions are introduced through widely diverging supervisory practices. It is also a precondition for further cross-border activity. Regulatory convergence, which applies to high-level principles, has therefore to be complemented by supervisory convergence. In other words, in the day-to-day practice the high-level principles have to be consistently implemented by supervisors. National authorities must therefore step up their information exchange and identify best work practices. Moreover, closer co-ordination of supervisory actions is needed, especially for the major EU financial groups.

The Lamfalussy approach will not only foster financial integration, but also help to preserve financial stability. In integrated financial markets, risks can more easily spread from one institution to another and from one country to another. The so-called 'systemic risk' is therefore no longer confined to one Member State but has to be looked at from an EU-wide perspective. The role of the Committee of European Banking Supervisors to enhance the cross-border exchange on individual institutions is therefore certainly important. At the same time, the CEBS's work is complemented by that of the ESCB's Banking Supervision Committee. The BSC closely monitors developments in the European financial system from a macro-prudential perspective. It has also been working successfully on arrangements of co-operation in the area of financial crisis management, another important dimension of financial stability.

Financial infrastructure

I now come to the third important element of a robust framework for financial integration and that is often unknown to the general public, namely clearing and settlement. This particular infrastructure lies at the core of all financial markets and is indispensable for their proper functioning. Integration here means that the place where securities are issued do not affect investors' clearing and settlement costs. It also means that the conditions at which banks obtain central bank money is not affected by the location of the securities they use as collateral. Purely domestic retail payments as well as clearing and settlement activities in the EU are relatively cost effective and safe, but there is still progress to be made as regards cross-border arrangements.

We at the ECB have a particular interest in the clearing and settlement infrastructure because of its role in the implementation of monetary policy. Moreover, a major malfunctioning in this area might have important implications for the financial system at large and threaten financial stability.

The ECB is active in this field in various ways. First, through the development of TARGET 2. Integration in payment systems and the euro money markets was achieved very quickly after the introduction of the euro because of the existence of TARGET, the large-value payment system operated by the Eurosystem. This will soon be replaced by TARGET 2, which will reinforce the benefits from a common infrastructure. It will also provide for a harmonised level of services and a single price structure. TARGET 2 is a clear illustration of how public authorities can contribute to financial integration by providing a common technical infrastructure.

The second way the ECB is active in this area is through the removal of the remaining obstacles to integration. The report prepared by the Group headed by Alberto Giovannini identified three types of barriers to efficient and competitive markets: differences in technical requirements and market practice; tax differences; and issues relating to legal certainty. For its part, the ECB contributes to removing these obstacles mainly by acting as a catalyst for improvement and by encouraging discussion among the relevant players. We also try to harmonise our central bank procedures and operations, which is beneficial to integration.

Finally, we also contribute to an integrated regulatory and oversight framework for clearing and settlement. We set risk management standards for the securities settlement systems that are used for our credit operations. We also regularly assess the systems that hold collateral for our operations. In a broader perspective, given the potential effects of the failure of a major clearing and settlement system, we think that public standards for risk management are essential. The ESCB, in co-operation with the Committee of European Securities Regulators, is currently developing such standards for EU clearing and settlement systems.

Assessment of the progress that has been made in cross-border banking

I remain very much convinced that the framework to foster financial integration in Europe is now largely in place. My perception is supported by the many indications that we have seen over the past years that integration has advanced rapidly and has now reached a very significant level. I already gave you a number of illustrations in the financial markets. I will like now to say a few words on the banking sector.

Let me start with the structure that European banking groups use for their cross-border business. The Banking Supervision Committee has done some background work on this. It appears that a major European banking group is on average present in five to six of the, former 15, EU Member States. Often, such groups have spread out to neighbouring countries through branches and subsidiaries. As we all know, regional financial groups have for example developed in the Benelux and Scandinavian countries. But groups that are present in almost every EU Member State are still a very rare phenomenon. I do not interpret these results as some kind of indication that integration would have failed in Europe. In that respect, I find it very instructive to look at what happened in the US over the past decade or so. In the mid nineties, the restrictions on interstate banking were significantly loosened in the US. But banks did not rush to set up branches all over the country; on the contrary, they preferred to expand in neighbouring states. US banks that choose to operate on a national basis also continue to be rare. Then we should not necessarily interpret the absence of truly pan-European banking groups as an indication of low integration, bearing in mind the US example.

Another relevant point we have to look at is the mode through which banks prefer to enter other EU markets; they can provide their services directly across borders, or prefer to set-up a local branch or a subsidiary. In that respect it is important to bear in mind that the single passport applies to the direct provision of services and branches. But contrary to what one would perhaps expect, banks prefer to offer their services across the EU mainly through subsidiaries. Again, this is sometimes interpreted as a lack of integration, but I think the answer is more complex. It continues to be a fact that having a local establishment in a country is still an important factor to gain local business. A Spanish family or family-owned business will probably continue to have a preference for a local Spanish bank that has a clear local identity and that is aware of the needs of the local community. And this can be more easily achieved through a local subsidiary rather than a branch.

We therefore see that at least until now the preferred way of banks to gain a foothold in another EU Member State is through mergers and acquisitions. Over time, domestic banking consolidation has been consistently higher than cross-border consolidation. If one looks at deals with a significant value, then the total value of domestic transactions in the EU sum up to around EUR 280 billion for the period 1999-2003 compared to EUR 50 billion for cross-border deals in the EU. However, domestic consolidation might be a prelude to cross-border consolidation as banks seek to reinforce their domestic position before expanding abroad. In addition, the relative importance of cross-border deals has increased over time. For example for every EUR 100 of domestic consolidation in the five years preceding the euro, there were cross-border deals of EUR 6; in the five years after the euro's introduction the figure had tripled to EUR 18.

As a result of cross-border M&As, and to a lesser extent also the expansion of branches, the share of banks from other EU Member States is in some national banking systems already very significant. This is foremost the case in the new Member States, where such shares often range between 70 and 90%.

I have concentrated here on the restructuring and reshaping of the pan-European commercial banking sector, particularly the retail banking. As regards investment banking the situation is already pretty different, with a relatively small number of pan-European institutions and a number of non European institutions being very active.

Challenges for the future

Ladies and gentlemen, let us turn now to the challenges ahead.

The first challenge ahead is that the single financial market should be equipped with a consistent regulatory process. This is echoed by the financial industry in the current debate on the post-FSAP strategy. In particular, the private sector advises that further integration also depends on the extent to which regulation and supervision converge among national authorities. In this respect, I consider that the Lamfalussy process will allow for more flexible and uniform technical rules across Member States and lead to convergence in national supervisory practices. It will therefore be paramount to exploit the process to the maximum. I would urge all national banking supervisory authorities in the context of the newly established Committee of European Banking Supervisors to deliver concrete results in a reasonable period of time in the area of convergence of supervisory tools and practices. This should include supervisory reporting in order for the industry not to see any difference all over Europe when submitting data to supervisors.

Second, the financial industry has the decisive role to play in the development of the single financial market. Laws and regulations alone cannot extend the boundaries of marketplaces or define new products. On the contrary, market forces should ultimately drive the integration progress. Collective action by market participants, perhaps with the support of public authorities, has therefore to be organised at the EU level to overcome possible co-ordination problems in this process. The integration of money markets is a clear example of how actions by market players themselves may underpin integration. The EONIA, the reference rate for overnight unsecured interbank deposits, was developed by market participants with the facilitating role of the ECB. This example also illustrates how public authorities may also play the role of catalysts of collective action.

And third, European financial integration is a process which calls for a very attentive monitoring as regards its impact in terms of financial stability. A large number of complex processes are at stake: better allocation of capital resources all over a vast continental economy of 450 million inhabitants; better assessment of risks through enhanced quality of management of financial institutions; enhanced market discipline; concentration of investments in a fewer number of institutions; globalisation of the European financial institutions ; introduction of new non European institutions as major European players; regional regroupings, etc, etc… Together with the flexibilisation of the financial system fostered by the combination of market innovation, technological improvements and globalisation, the previously listed forces should, by and large, foster the resilience of the financial sector and its capacity to weather shocks.

That being said, it is not, in any respect, time for complacency. The exceptional chances and opportunities of the present times have their necessary counterparts in potential risks that have to be identified, analysed and appropriately weathered if materialising. I consider that improving tirelessly the resilience of the European financial system and paving the conditions for enhanced financial stability in an ever changing environment is a fundamental responsibility of the ECB and the Eurosystem.

I thank you for your attention.