Jean-Claude Trichet: European financial integration - the view of the ECB

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Eurofi conference entitled "Europe's single capital market: time to tackle the toughest challenges", Luxembourg, 10 March 2005.

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Introduction

Ladies and gentlemen,

It gave me great pleasure to accept the invitation to this conference, which addresses an issue of the highest importance to the ECB and the Eurosystem. With this in mind, I would like to express the ECB's views on European financial integration.

Let me start by reminding you that financial integration is achieved through an effective interplay of market forces in an environment of free competition, coordinated action by private actors and specific measures taken by public authorities. The ECB both supports and complements such steps. Our support for financial integration is not something we see as optional. On the contrary, we see it as an issue that is of great importance in the conduct of our own activities. Let me give the underlying reasons behind this stance.

First, a well integrated financial system is pivotal to the smooth and effective implementation of monetary policy throughout the euro area. In this regard, I would also like to mention the ECB's task of promoting the effective operation of payment systems, as well as its interest in the smooth running of securities settlement systems.

Second, a well integrated financial system helps to make the euro area economy more efficient through the reduction of financing costs and an improved allocation of financial resources. This is likely to be conducive to higher and more sustainable non-inflationary growth. A study sponsored by the European Commission concluded in 2002 that further integration in the European Union might generate additional gains of 1% in the overall level of real GDP over a decade or so.

Third, European financial integration is a priority that has been reiterated by the European Council on several occasions. The ECB's support for European financial integration is therefore in accordance with Article 105 of the Treaty, which states that "the ESCB [– European System of Central Banks –] shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community".

Finally, there is the interconnection between financial integration and financial stability. As deeper financial integration may, to some extent, change the interplay of vulnerabilities, the potential impact of these on financial stability – which is of natural interest to central banks – has to be taken into account.

The ECB uses all available channels in its efforts to foster European financial integration. We try to raise awareness of the need for integration and the means of achieving it. We also advise on the shaping of the legal framework. Furthermore, the ECB can act as a catalyst for collective initiatives from the private sector. Finally, where appropriate, the ECB can take direct action. I will later give several examples of these different roles.

I would like to discuss now the three major components of the financial system, namely the institutions, the markets and the infrastructure. I will address both the wholesale and retail aspects of these three components, and will touch upon developments that can be deemed a success, as well as areas where more effort is required.

Institutions

Following the adoption of the single currency, the Financial Services Action Plan (FSAP) represented the next major stage in the integration process. Now that the FSAP is nearing completion, I see the post-FSAP period as a "window of opportunity" for further enhancing financial integration. At the same time, I am convinced that further progress is inextricably linked to the improvement of the regulatory and supervisory framework and the financial stability arrangements. In particular, institutional arrangements must respond to the need for greater cross-border cooperation, with a view to both supporting further integration and at the same time preserving financial stability.

In the area of financial regulation and supervision, a key objective is to achieve a high degree of regulatory and supervisory convergence across countries. This will help reduce the compliance burden on financial institutions, thus addressing one of the largest remaining obstacles to enhanced cross-border activities. At the same time, well developed arrangements for the exchange of information and the cooperation among supervisory authorities have become a prerequisite for the effective supervision of cross-border entities.

In the area of financial stability, arrangements for financial stability monitoring and crisis management need to be tailored to the fact that liquidity and solvency problems at financial institutions are increasingly likely to affect more than one country.

The institutional framework for banks is especially important. Given its pivotal role in channelling funds into the EU economy, a well integrated banking sector is a prerequisite for achieving a truly single financial market. In recent years, we have witnessed an increase in cross-border banking. The considerable competitive pressures in the global markets and the increasing saturation of domestic markets should normally spur further cross-border banking. Policy-makers have already launched important initiatives to step up cross-border cooperation in line with the growth of cross-border banking. While some challenges for the coming period certainly remain, impressive progress has already been made.

In the area of financial regulation and supervision, the extension of the Lamfalussy approach to the banking sector and the establishment of the Committee of European Banking Supervisors (CEBS) are such milestones. Here, I would like to emphasise the crucial work performed by the CEBS, which develops common benchmarks and best practices for the consistent implementation of EU Banking Directives as well as agreed principles for cooperation between home and host supervisors. In addition, the forthcoming revision of the Codified Banking Directive will provide a robust underpinning for greater cross-border cooperation among authorities, especially for large banking groups. The revised Directive will tighten the requirements for the information exchange and coordination between the consolidating supervisor and host supervisors. It will also assign the consolidating supervisor a coordinating role in the gathering and dissemination of information about the group as well as the planning and coordination of supervisory activities. Following these two major reforms, efforts should now focus on their effective implementation.

As regards financial stability, there has been a significant increase in cross-border arrangements in response to the recommendations of the reports by the Economic and Financial Committee (EFC) on financial stability and crisis management. The important role of the Financial Services Committee (FSC), which was responsible for monitoring the implementation of the EFC recommendations, should be fully acknowledged at this point.

With regard to crisis management, the 2003 Memorandum of Understanding between EU banking supervisors and central banks, and to which the new EU Member States adhered in June 2004, was a great accomplishment. For the first time, principles for managing financial crises that may have a cross-border impact were agreed at EU level. Nevertheless, the Memorandum may be not sufficiently detailed to cover large cross-border banking groups comprising several authorities, where crisis management is particularly complex. Given the potential far-reaching implications of financial disturbances involving such groups, the development of group-specific agreements could be an important avenue to explore. Another important issue is the involvement of finance ministries in the crisis management framework. A High-Level Working Group, comprising representatives from the ministries of finance, central banks and banking supervisors, is working on concrete proposals for cooperation arrangements between the three authorities at EU level.

As regards financial stability monitoring, the EU framework has been enhanced considerably in recent years. In this context, I would like to highlight the stability assessment of the EU banking sector, performed by the ESCB's Banking Supervision Committee, and the comprehensive analysis of potential vulnerabilities in the euro area financial system as a whole, which was carried out as part of the ECB's Financial Stability Review. In addition, the CEBS is expected to improve its internal exchange of information on individual institutions and groups.

Markets

I now turn to the second component of the financial system, the financial markets. The introduction of the euro and the measures adopted under the FSAP have spurred the integration of the European financial markets. Nevertheless, there continue to be varying degrees of integration.

Wholesale money and bond markets tend to be relatively well integrated, but only the unsecured euro money market has reached a fully satisfactory level of integration.

The integration of the market of debt securities has been significantly increased, although not yet reaching the level of the United States. In the euro area, the amount of outstanding debt securities issued by non-financial corporations in their domestic currency represents around 5% of GDP, compared to a figure of more than 20% in the United States.

Integration is progressing in the government bond markets and, to a lesser extent, also in the corporate bond markets. The corporate bond markets have grown and deepened substantially in Europe over the past years, although a large gap with the United States still exists as regards the outstanding volume. But the new issuances in 2003, according to the best estimates, were of the same order of magnitude on both sides of the Atlantic. The business of underwriting corporate bonds in euro, on the other hand, is a wholesale banking area that has become largely pan-European and even international.

The short-term securities markets in Europe are slowly integrating. The market’s size for commercial paper in the EU represents about EUR 1000 billion, which is about two thirds of the size the US market for commercial paper. As I mentioned earlier, one of the ECB’s approaches to fostering financial integration is to act as a catalyst for initiatives from the private sector. One such example is the Short-Term European Paper (STEP) initiative, which was set up by the ACI – The Financial Markets Association. It aims to promote the convergence of the practices prevailing in the fragmented European short-term securities markets through market players’ voluntary compliance with the standards set out in the STEP Market Convention. The Governing Council of the ECB has decided to support, in principle, the activities pertaining to the introduction of a STEP label, which would acknowledge adoption of the standards, for the first two years after its launch. It has also decided to produce and publish STEP yield indices as well as statistics on volumes on an ongoing basis. The ECB would like to strongly encourage similar initiatives to promote financial integration in Europe.

Continuing my assessment of the wholesale markets, I will briefly discuss the equity market. Recent empirical evidence shows that the degree of integration has increased here. For example, the so-called “home bias” in the equity holdings of investment and pension funds has decreased substantially over the time. Overall, however, this market segment is still one of the least integrated.

As a final comment on the wholesale markets, I would like to say a few words on the development of new credit markets. Sometimes, these markets are set up in a pan-European context right from the start – we might say they are “born integrated”. One example of this is the European market for synthetic collateralised debt obligations.

This development is encouraging. However, the existence of cross-border activity, with its impact on prices and volumes, does not always signal the absence of hurdles and the achievement of full integration. Factors of segmentation may still exist, but can be overcome by innovative instruments. For example, in the securitisation market, originators need a two-layer structure to create pan-European transactions backed by well diversified multi-jurisdictional asset portfolios: first, assets must be securitised at the domestic level, and then, a pan-European vehicle backed by several domestic securitisation transactions must be set up. This is a complex procedure and incurs costs.

I now turn to an important retail market, namely the mortgage credit market which represents in the EU an outstanding volume of around EUR 4 trillion. The lack of integration manifests itself here in numerous ways. In no national market can borrowers access the full range of mortgage products. Moreover, only a negligible portion of European mortgage credit is granted across borders, and the techniques for loan origination and servicing differ substantially from country to country.

More than half of mortgage lending is still financed by retail deposits, although in recent years capital market instruments, such as covered bonds and residential mortgage backed securities, have gained in importance. These are important asset categories that can also be used as collateral in the Eurosystem’s monetary policy operations. Nevertheless, they still exhibit a high degree of heterogeneity across countries due to differences in their legal, tax and regulatory framework.

Given the size of the mortgage credit market, the costs incurred through the lack of integration cannot be ignored. In this regard, the ECB supports both private-sector and European Commission initiatives to encourage further integration, such as the follow-up to the report of the Commission's Forum Group on Mortgage Credit.

Infrastructure

Integration of financial markets cannot take place without an integrated payment, clearing and settlement infrastructure. This brings me to the third component of the financial system, the financial infrastructure, which also gives me the opportunity to illustrate some cases of where the ECB has taken direct action.

TARGET is one such example. Had TARGET not been operational from the first day of Monetary Union, there would have been no means of transferring liquidity from a country with a liquidity surplus to a country with a liquidity deficit. Consequently, we would not have had a single but several money markets, which would have made monetary policy far more difficult to implement. Over time, TARGET has continuously increased its market share in large value payments in euro. TARGET's market share is now around 90% of the total traffic value compared to 70% at the moment when the euro was launched. At the same time, the domestic component has remained at roughly three quarters of the total traffic value.

However, our ambitions did not stop in 1999. We are currently building TARGET2, which is due to go live in 2007 and will replace the current decentralised system with a single technical platform. By the way, with EUR 1.7 trillion settled every day, TARGET is already one of the two largest wholesale payment systems in the world, alongside Fedwire in the United States. With the functionalities that will be introduced in TARGET2, we also expect it to be one of the most, if not the most, sophisticated.

TARGET2 will further improve financial integration in several respects. Not only will it increase cost effectiveness, but it will also allow for the provision of a harmonised service level ensuring a level playing field for banks across Europe. This will be supported by the implementation of a single price structure for domestic and cross-border payments. Moreover, TARGET2 will offer new functionalities enabling banks to better integrate their euro liquidity management. For example, participants will be able to group some of their accounts and pool the available intraday liquidity for the benefit of all of the members of the group of accounts. In addition, TARGET2 will benefit its users in terms of consolidated information. Whereas in the past an institution's head office has not been able to see the information being held across its various branches, TARGET2 will enable it to monitor and process automatically all of its data from a single location.

The level of integration that TARGET had already achieved in 1999 can be considered higher than that of the securities infrastructure today. Owing to the single currency, a significant process of consolidation has also taken place in the securities infrastructure in the euro area. At the present moment, the current configuration remains complex, with a significant number of national exchanges, clearing houses and central securities depositories. Further consolidation of some of the European infrastructure is advisable.

The ECB has a particular interest in an integrated securities infrastructure because it uses it in the context of the collateralisation of its intraday credit operations for payment system purposes and its monetary policy. In addition, a major disruption in a securities settlement system could undermine the stability of financial markets.

There are numerous private and public-sector initiatives under way to promote the integration, efficiency, and security of the European securities infrastructure. The "Standards for Securities Clearing and Settlement in the European Union" that have been drawn up jointly by the ESCB and the Committee of European Securities Regulators (CESR) are an important initiative. In its communication on "Clearing and Settlement in the European Union", the European Commission recently outlined the actions it intends to undertake to improve clearing and settlement arrangements, which are welcomed by the ECB and the Eurosystem. In particular, we agree that the barriers as identified by the "Giovannini Group", must be eliminated. In addition, we concur that some parts of the clearing and settlement industry deserve careful attention from a competition policy point of view. Finally, in order to ensure the smooth operation of the markets and guarantee financial stability, we share the Commission's view that a sound regulatory framework is essential.

In principle, the ECB and the Eurosystem also support the adoption of a framework directive on clearing and settlement, for two main reasons. First, a directive would complement the market-led removal of the "Giovannini barriers", a necessary condition for competition to be able to fully play its role. Second, the implementation of the ESCB/CESR standards, as well as any other harmonisation measures, may require changes to the national legal framework that cannot be made by the national supervisory authorities. We do not expect this framework directive to duplicate the work of the ESCB/CESR. Rather, in line with the Lamfalussy approach, the directive should stipulate high-level principles to be further developed by implementing measures. We agree with the Commission that the ESCB/CESR standards might form the basis of such implementing measures. Last, but not least, in the light of our interest in the financial market infrastructure, the Commission is invited to recognise explicitly, the responsibilities and tasks of the ESCB and the Eurosystem, especially their role in the oversight of the securities clearing and settlement infrastructure.

Having covered the wholesale aspects of the financial infrastructure, I now turn to the retail aspects, which are very important. Take the example of the mortgage markets that I covered earlier. A pan-European mortgage market cannot develop if there are limitations on making payments from one bank to another within the euro area.

In this regard, the Eurosystem's initial objective is to have a Single Euro Payments Area – a SEPA – for citizens and enterprises in the euro area from 1 January 2008 onwards. According to the Commission's regulation, the price charged by banks for a cross-border transfer must be the same as that of a transfer within the same country. While prices to the end-customer have been homogenised through legislation, the level of service cannot be influenced by legislation. What is lacking is the possibility of using national instruments for pan-European business as well. A real SEPA will only be achieved when payments can be made throughout the whole area from a single bank account, using a single set of payment instruments, as easily and safely as in the national context today.

The ECB's second objective is to have a SEPA for the infrastructure by the end of 2010. Once national instruments, services and standards have been gradually phased out and replaced by pan-European ones, national infrastructures will be abolished or transformed into pan-European ones. Consequently, decisions related to the next generation of national systems should be made from a pan-European perspective to ensure compliance with the SEPA.

To encourage national implementation, the respective national banking communities should translate the SEPA objectives into national transformation plans, allowing each bank and infrastructure provider to tailor its strategies and solutions towards a SEPA. The ECB intends to monitor this progress with the assistance of the European Payments Council (EPC). National banking communities will be requested to provide national migration plans for a SEPA in the course of this year.

The EPC has the initiative and capability to define the pan-European schemes for credit transfers, direct debits and cards. However, since the EPC has no power to enforce, it would have to rely on the cooperation of the banking sector and infrastructures. The ECB, in cooperation with the Eurosystem NCBs, stands ready for facilitating the implementation of the SEPA objectives and for fostering the full adoption of the project which it considers key for achieving financial integration.

Concluding remarks

Ladies and gentlemen, I have explained why the ECB attaches utmost importance to progress in European financial integration and I have talked about the various channels we have at our disposal for fostering it. In describing the present state of affairs, I have also given the main examples where the ECB actively contributes to European financial integration. At the same time, I have made it clear that the ECB expects continued efforts from the private sector and I have mentioned the substantial opportunities of, but also the challenges to, the relevant public policy framework.

The ECB has demonstrated since the first days of its existence that it is a credible and solid anchor for monetary stability. Financial institutions and market participants know also that they can count on the ECB to be in the domain of financial integration a very strong pillar to sustain their efforts and to facilitate the success of this important European endeavour.

Thank you very much for your attention.