Lucas Papademos: Financial integration in Europe – March 2007

Introductory remarks by Mr Lucas Papademos, Vice President of the European Central Bank, at the ECB press conference on the occasion of the first publication of the report, Frankfurt am Main, 28 March 2007.

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I. Introduction

On behalf of the Executive Board of the European Central Bank (ECB), I would like to welcome you to this press conference on the occasion of the publication by the ECB of a new yearly report, entitled "Financial Integration in Europe".

The main purpose of this report, which we expect to publish towards the end of March every year, is to contribute towards the advancement of European financial integration and to raise public awareness of the Eurosystem's role in supporting the financial integration process.

Before I focus on the content of the report, let me first explain why we decided to regularly prepare and publish this report.

The Eurosystem has a keen interest in the integration and the efficient functioning of the financial system in Europe, particularly in the euro area, given their relevance to the fulfilment of our core tasks.

In particular, financial integration is of key importance for the conduct of the single monetary policy, as a well-integrated financial system enhances the smooth and effective transmission of monetary policy impulses throughout the euro area. Furthermore, financial integration is highly relevant to the Eurosystem's task of contributing to safeguarding financial stability. It is also fundamental to the Eurosystem's task of promoting the smooth operation of payment systems which also relate to the safe and efficient functioning of securities clearing and settlement systems. Finally, in accordance with the Treaty establishing the European Community, the Eurosystem supports, when this can be done without prejudice to the objective of price stability, the general economic policies of the Community which aim, inter alia, at "sustainable and non-inflationary growth". Financial integration, which increases the efficiency and fosters the development of the financial system, helps to raise the economy's potential for stronger non-inflationary economic growth.

The ECB and the entire Eurosystem fully support the efforts of the private sector as well as those of the European Commission, the European Parliament and the Council of Ministers to enhance the integration and development of the European financial system.

In this respect, let me emphasise that in the area of financial integration the ECB works in very close and effective co-operation with the European Commission which has a primary responsibility in this field. As such, the new ECB report complements, the work of the Commission aimed at enhancing European financial integration.

II. Summary of the content of the report

Let me now turn to the content of the report and draw your attention to some of the principal findings.

Our report is structured into three chapters. The first sets out the ECB's assessment of "The state of financial integration in the euro area". This assessment is based on a set of quantitative indicators developed by the ECB.[1] The second chapter, entitled "Special Features", contains in-depth analyses of selected issues relating to financial integration. The third chapter, "Eurosystem activities for financial integration" provides, an overview of the contribution of the Eurosystem towards a more integrated and developed financial market in Europe.

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1 From now on, this report will contain the indicators that previously appeared in the ECB report on "Indicators of financial integration in the euro area". The most recent edition of that report was released in September 2006. The indicators will continue to be updated bi-annually on the ECB's website.

II.1 Indicators in the state of financial integration

The ECB's assessment of the state of financial integration in the euro area covers the money, bond, equity and banking markets, as well as market infrastructures. The evidence confirms that the degree of integration varies by the market segment and that it is generally more advanced in those market segments that are closer to the single monetary policy, especially the money market. The unsecured money market has been fully integrated since the introduction of the euro, and the repo market is also highly integrated. The full integration of the large-value payment systems has been instrumental in achieving this result. Government bond markets have become considerably integrated and similarly the corporate bond market received a major boost with the introduction of the euro and has subsequently achieved a high degree of integration.

Progress has also been made in the integration of euro area equity markets, where equity returns are increasingly determined by factors that are common to the euro area countries rather than country-specific ones.

However, in other areas, financial integration needs to be enhanced. For example, the euro area securities infrastructure that underpins both bond and equity markets is not yet sufficiently integrated. Similarly, retail banking markets continue to be less integrated than other banking market segments. This situation is also reflected in the fragmented European retail payment systems and is addressed in more detail in one of the special features.

II.2 Special features

The second chapter, "Special Features", comprises in-depth assessments of selected issues relating to financial integration. In each edition of the report, these special features will typically address major policy issues, but may also contain analytical articles on the subject of financial integration. The topics are mainly selected on the basis of their importance to the EU's financial integration agenda and their relevance to the pursuit of the ECB's tasks.

This first report covers the following three topics: "Monetary Policy and financial integration", "Strengthening the EU framework for cross-border banks", and "The SEPA initiative and its implications for financial integration".

The first special feature, *"Monetary policy and financial integration"*, focuses on the impact of financial integration on the monetary policy transmission mechanism.

Deeper integration broadens the range of financing sources and investment opportunities and it creates economies of scale. It allows economic agents to share risks more effectively, thus improving their ability to mitigate or even offset the consequences of idiosyncratic shocks that might affect the individual economies within the euro area. A well integrated financial system is, therefore, crucial for the conduct of the single monetary policy, as it enhances the smooth and effective transmission of monetary policy impulses throughout the euro area.

For example, in a well-integrated financial sector, cross-country differences in the way banks adjust their interest rates to changes in policy rates should be very limited. Indeed, thanks to increased financial integration, such differences have diminished over time, and this has contributed to the fact that the transmission mechanism operates in a broadly similar way across euro area countries. However, some discrepancies in the interest rate pass-through across countries seem to persist, which may reflect, in addition to the different structures of financial institutions and markets, a lack of sufficient financial integration.

Similarly, the level and the type of indebtedness of households and non-financial corporations both play a role in the transmission of monetary policy. Our analysis shows that some of the differences across countries could be related to the degree of integration and development of the respective financial systems. It should be emphasised, however, that the significant changes that have occurred in the financial sector since the start of Monetary Union have increased the choice of financial products and available finance, generating tangible benefits for households and non-financial enterprises.

Overall, we can conclude that the process of financial market integration that is underway, while not yet complete, is conducive to the smooth transmission of monetary policy across the euro area. Nevertheless, greater financial market integration could eliminate some of the remaining differences and therefore facilitate further the transmission of the single monetary policy within the euro area.

The second special feature, *"Strengthening the EU framework for cross-border banks"*, focuses on the importance of cross-border banking in fostering integration in the banking sector. While cross-border banking is first and foremost a market-driven process, the public sector can play an significant role by providing a policy framework that is adequate to support cross-border activities. This special feature provides an overview of recent developments in cross-border banking in the euro area and reviews the related EU policy framework.

A number of indicators point to an increased degree of cross-border banking activities in the euro area, such as the growing cross-border share in the financial holdings of banks, the increasing cross-border mergers & acquisitions, and the rising market share of major cross-border banking groups.

In this context, it is also important that the EU policy framework ensures equal market access and supports the efficient operation of banks across countries.

Various prudential, legal and fiscal measures to strengthen the EU framework for cross-border banking have already been adopted or are currently under preparation. The special feature briefly reviews these measures and provides an overview of the efforts to enhance convergence and cooperation in the supervision of cross-border banks. According to our assessment the EU supervisory arrangements have already been substantially enhanced by two significant measures: the introduction of the Lamfalussy approach in the banking sector and the adoption of the revised regulatory framework for home-host country interaction under the Capital Requirements Directive. Additionally, several initiatives are underway to ensure that the benefits of this improved institutional setting can be fully reaped and various EU fora monitor the progress made in this field. At the same time, some discussion has emerged on whether or not it may be beneficial to move over time towards more integrated supervisory arrangements.

Our analysis concludes that the findings of the broad-based review of the EU supervisory framework by the end of this year will permit the evaluation of the overall functioning of the institutional arrangements and an assessment of whether there is a need for further action.

The third special feature, *"The Single Euro Payments Area (SEPA) and its implications for financial integration"*, considers the European banking industry's initiative to enhance the integration of retail payment systems in Europe. The Eurosystem supports this initiative and acts as a catalyst. The introduction of a single retail payment system is the natural complement to the introduction of the euro banknotes and coins and it is a necessary step towards the further integration of the retail payment market.

The aim of the SEPA project is to enable customers to make more efficient cashless payments throughout the euro area from a single account, irrespective of their location. SEPA will, in particular, define the technical standards and access conditions to the market. By creating a level playing-field, SEPA will ensure that participants are treated equally.

This special feature concludes that, while the banking industry has made substantial progress towards a more integrated retail payment market, committing itself to introducing SEPA instruments and procedures from January 2008 and to migrating a critical mass of its customer payments by end-2010, some issues, such as transparency and interoperability, still need to be finalised.

II.3 Eurosystem activities for financial integration

The report's third chapter, "Eurosystem activities for financial integration", provides an overview of the main Eurosystem activities in 2006. This chapter shows that the ECB and the whole Eurosystem contribute in a number of ways to financial integration and development, building on their expertise and special nature as public institutions which are both active in the market and have intense relationships with market participants.

We generally distinguish four activities in this contribution: (i) giving advice on the legislative and regulatory framework for the financial system and direct rule-making; (ii) acting as a catalyst for private sector activities; (iii) enhancing knowledge, raising awareness and monitoring the state of European financial integration; and (iv) providing central bank services that also foster European financial integration.

I will now provide an example of each of these four activities.

With respect to the shaping of the financial system's legislative and regulatory framework, I would like to mention, as an example, the EU securities clearing and settlement infrastructure. Its current fragmentation represents a major obstacle to the further integration of European securities markets. Greater integration of securities clearing and settlement systems will be crucial to lowering the post-trading costs of cross-border securities transactions, to exploiting the potential economies of scale and to establishing a European level playing-field. Moreover, the clearing and settlement infrastructure directly affects the performance of the major tasks of the ECB, pertaining to the implementation of its monetary policy via the framework for the collateralisation of monetary policy (and intraday credit) operations, the safeguarding of financial stability and the promotion of the smooth operation of payment systems.

Several public sector initiatives aim to achieve an efficient, safe and integrated post-trading market infrastructure in the European Union. The ECB is closely involved in this work through its participation in the Clearing and Settlement Advisory and Monitoring Expert Group (CESAME) and in the Legal Certainty Group. Let me also mention here – as an important development in 2006 – that, at the European Commission's request, the European industry associations for exchanges and post-trading infrastructures and their members signed a "European Code of Conduct for Clearing and Settlement" last November. The ECB also participates in the related Monitoring Group that is chaired by the Commission.

I now turn to the function that we describe as "acting as a catalyst for private sector activities". By this we mean that in areas such as standard-setting and the establishment of common infrastructures, cooperation between private agents of the financial sector is as necessary as competition. However, cooperation may fail to materialise without the support of a catalyst. The ECB and the entire Eurosystem can play such a role, on account of the competence and objectivity and the numerous contacts with market participants.

The Short-Term European Paper (STEP) initiative promotes the development of a pan-European short-term paper market through market players' voluntary compliance with a core set of standards encompassed in the STEP Market Convention. This Convention was signed on 9 June 2006. Since then, 32 STEP-compliant programmes, amounting to EUR 166 billion, have been launched under the STEP label.

The ECB has supported the STEP initiative since its inception in 2001. During the preparatory phase, the ECB facilitated coordination among market players, contributed to the STEP Task Force of the Financial Markets Association ACI and provided legal assistance.

The Eurosystem's ongoing contribution to the STEP market focuses on two main activities. First, until June 2008, the ECB and nine of the Eurosystem's NCBs will provide technical assistance to the STEP Secretariat concerning the STEP labelling process, whereby the ultimate responsibility for granting and withdrawing the STEP label fully rests with the STEP Secretariat. Second, the ECB regularly produces statistics on yields and volumes in the STEP market and publishes them on its website. From next week onwards, daily statistics will be made available. Following the publication of these yield statistics, the STEP market will be accepted as a non-regulated market for collateral purposes in Eurosystem credit operations.

Turning to research and monitoring activities, I would like to mention the ECB-CFS Research Network on "Capital Markets and Financial Integration in Europe", which was set up in 2002 by the ECB and the Centre for Financial Studies in Frankfurt. The current research focuses on three areas: (i) the relationship between financial integration and financial stability; (ii) EU accession, financial development and financial integration; and (iii) financial system modernisation and economic growth in Europe. The network has organised a series of conferences attended by academics, market participants and policymakers, such as the one hosted in September 2006 by the Deutsche Bundesbank entitled "Financial System Modernisation and Economic Growth". Furthermore, I would like to mention that, every year, the network awards five "Lamfalussy fellowships" to promising young researchers who undertake projects in the field of financial integration.

Finally, with respect to the provision of central banking services that are also conducive to financial integration, as an example I choose our wholesale payment system, TARGET and its further development into TARGET2. After the rapid integration of the euro area money markets, which was closely related to the establishment of the TARGET system, the planned launch of the single technical platform, TARGET2, later this year will promote further integration in the financial markets affected. This will be achieved, in particular, through a harmonised service level, a single price structure, and a harmonised set of cash settlement services in central bank money for all "ancillary" systems, such as retail payment systems, clearing houses and securities settlement systems.

In November 2006 the Eurosystem published its third progress report on TARGET2, informing market participants about the Eurosystem's decisions on pricing and legal issues, contingency procedures, and testing and migration activities. The report also confirmed that 19 November 2007 would be the starting date for TARGET2.

With a view to maximising the benefits from the establishment of TARGET2, the Eurosystem started in 2006 to explore the possibility of providing settlement services in central bank money for securities transactions in euro. The objective of the new service – the so-called TARGET2-Securities (T2S) project – is to harmonise the settlement of securities transactions and, ultimately, to process both securities and cash settlements on a single platform through common procedures. In early March of this year, the Governing Council concluded that it is feasible to implement TARGET2-Securities on the basis of a detailed feasibility study and a blueprint – both of which have since been published on our website. We therefore decided to go ahead with the next phase of the project, namely the definition of user requirements on the basis of market contributions. The scope of the project will be determined by taking into account the results of a public consultation. The Governing Council will then decide on the subsequent development phase by early 2008.

III. Conclusion

This brings me to the end of my presentation and I would like to conclude with the following remarks.

From my presentation, you may have noticed the many different facets that, together, contribute to financial integration and shape the European financial system. Since central banks are at the core of financial systems, they closely follow developments which can foster their integration. The ECB and the entire Eurosystem devote a substantial amount of resources to this task because we are convinced that this is an important area of progress for the European economy, within the framework established by the Lisbon agenda. Indeed the progress made so far towards the integration and development of the European financial system is a European achievement, and the creation of the euro has made a decisive contribution.

Finally, I should also like to stress that, while financial integration is an important driver for increasing the efficiency of a financial system, financial efficiency also depends on other factors. Among those are the degree of financial development and the quality of the fundamental determinants of the framework conditions of the financial market, such as the efficiency of the legal system. To capture more aspects of financial efficiency, we envisage widening the report's scope over time in order to encompass such factors as well.

I am now at your disposal for questions.