Jean-Claude Trichet: Financial integration in Europe and important financial sector issues

Keynote speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Second Symposium of the ECB-CFS research network on "Capital Markets and Financial Integration in Europe", Frankfurt am Main, 13 February 2008.

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Ladies and Gentlemen,

It is a great pleasure for me to address such a distinguished audience of researchers, market participants and policy makers here at the Second Symposium of the ECB-CFS research network on "Capital Markets and Financial Integration in Europe". As you will probably all appreciate, we are living in challenging times right now. And many, although not all, of the main challenges relate to financial sectors. So, for my remarks today I have made a selection of important financial sector issues, some more structural and others more related to recent developments.

My presentation is divided into two broad parts. In the first part, I would like to broadly address the importance of financial integration in Europe, review the current state of integration and tell you about our activities in this area. In the second part I would like to look at one specific part of the European regulatory set-up that has been less often discussed in the past in relation to financial integration, namely the structure of deposit insurance schemes. I will conclude by some remarks on the present very significant market corrections and financial turbulences that we experienced in the international financial system since the summer last year.

Financial integration

Financial integration is an important part of the Lisbon Agenda and the European Union's Single Market Program. In particular, among industrial countries the free flow of capital across borders unleashes competitive pressures that reduce the cost of capital and allows for better sharing of risk for consumers and firms. It is therefore the long-standing view of the Eurosystem that financial integration is an important process for the general well-functioning of the European economy.

Since its creation in 2002, the ECB-CFS network has featured important pieces of research that further substantiated our conviction in this regard. We have seen more of this since this morning in the present Symposium. One paper adds that the benefits of financial openness through the corporate sector arise particularly from improvements in total factor productivity, rather than through capital accumulation.[1] Another illustrates how cultural factors, such as mutual trust and confidence, matter for the degree of risk sharing even among European regions within the same country.[2] While we have certainly made a lot of important progress in European financial integration over the last decades, not the least through the introduction of the euro, available research also suggests that a lot of benefits in terms of cross-country risk sharing are still to be reaped and therefore further efforts are necessary.

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1 Bonfiglioli (2006), International financial integration, productivity and capital accumulation, mimeo., Institut d'Analisi Economica CSIC, July.

2 Ecinci, Kalemli-Ozcan and Sorensen (2007), Financial integration within the EU countries: the role of institutions, confidence and trust, NBER working paper.

Research presented this afternoon also threw a positive light on the role of financial integration with respect to Central and Eastern European countries. In fact, this contrasts a bit with some previous literature that argued that developing and emerging market countries are less able to reap the benefits of financial integration. One paper argued that foreign banks appear to allocate credit more efficiently than domestic banks in this region.[3] And, accordingly, another finds that financial integration has helped convergence and economic growth in Central and Eastern European countries.[4]

Financial integration is also of key importance for the performance of the tasks of the Eurosystem. First, a well-integrated financial system enhances the smooth and effective transmission of monetary policy throughout the euro area. Second, financial integration is relevant for our task of contributing to the safeguarding of financial stability. Integrated markets reinforce the shock-absorption capacity of the system, as they are more liquid and offer better opportunities for financing and risk distribution. Finally, without prejudice to the main objective of price stability, we support the general economic policies of the European Union.

What is the current state of European financial integration? Here I will be very brief today, as I have characterised this already at various occasions in the past and as financial integration is not a fast-moving process. The degree of integration in the euro area varies considerably across different market segments. The euro money market is already highly integrated, as it is closest to the single monetary policy and supported by area-wide large-value payment systems, such as TARGET or EURO 1. An important exception is the market segment for short-term debt securities, which shows some fragmentation owing to the prevailing differences in market standards and practices. The bond markets are also relatively well integrated. For instance, the cross-border holdings already constitute around 40% of the total of the long-term debt securities held by monetary financial institutions. Equity markets are less advanced than bond markets but show signs of increasing integration. For example, the proportion of variance of equity returns explained by euro area shock is around 38% when measured over the period of 1999-2007. Still relatively fragmented securities clearing and settlement systems continue to constitute obstacles to the further integration of securities markets in Europe.

In general, wholesale and capital market-related activities of banks show solid signs of increasing integration, while retail banking and the underlying retail payment systems have remained more fragmented, as has been the case for mortgage markets. Finally, as was discussed in detail in an ECB staff presentation earlier during this Symposium, financial markets in the member states that joined the European Union in 2004 are significantly less integrated than those in the euro area.[5] In sum, a lot has been achieved in the past, not the least through the introduction of the euro, but more needs to be done in the future to reap the full benefits of the Single Market for Financial Services.

Let me now mention some examples where we have focused our efforts to contribute – within the realm of our competencies – to improving financial integration and where we plan further work. We tend to group our efforts relating to financial integration in four types of activities: (i) giving advice on the legislative and regulatory framework; (ii) acting as a catalyst for collective private sector initiatives; (iii) enhancing knowledge and raising awareness; and (iv) providing central bank services. I select examples from each group.

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[3] Giannetti and Ongena (2007), Lending by example: direct and indirect effects of foreign bank entry in emerging markets, mimeo., Tilburg University.

[4] Abiad, Leigh and Mody (2007), International finance and income divergence: Europe is different, IMF working paper, WP/07/64, March.

[5] Baltzer, Cappiello, De Santis and Manganelli (2007), Measuring financial integration in the new EU member states, mimeo., ECB.

As regards legislative and regulatory advice, the Eurosystem was fully involved in the review of the Lamfalussy framework that took place at the end of last year and published a contribution to the assessment regarding the banking sector. We generally share the broad agreement among EU bodies that the Lamfalussy framework has significantly increased the efficiency and effectiveness of financial regulation and supervision in the EU.

At the same time, however, a number of further improvements seem warranted to reap all the benefits. First, increased regulatory convergence is called for, in particular for reducing national options and discretions in EU directives. Indeed, the inconsistent implementation as well as the "gold plating" of EU rules at the national level give rise to significant compliance costs for financial institutions operating across borders. Second, we need to strengthen the basis and decision powers of the "level 3" committees of supervisory authorities pursuing supervisory convergence and cooperation Third, further improvements in the arrangements for the supervision of cross-border financial groups should be achieved. All authorities need to be adequately informed to effectively perform the ongoing supervision of cross-border institutions as well as to be fully prepared to address potential cross-border situations of financial distress. Given the increased scope and intensity of the cross-border activities of EU banking groups, the need for effective information-sharing and cooperation in their supervision is now more important than ever. In this respect, the Eurosystem underscores in particular the importance of strengthening information sharing also between supervisory authorities and central banks without supervisory responsibilities with respect to the major EU banking groups.

Next, I am turning to our role as catalyst for market activities fostering financial integration. The example I choose here is the Single Euro Payments Area, in short SEPA initiative, led by the European Payments Council, which has started officially last month. It is a market-led initiative aiming at removing technical, legal and commercial barriers against smooth cashless cross-border payments in euro. The objective is to make cashless paying with euro as easy, efficient and safe as it is today within one country. This has genuine benefits for consumers, firms and public administrations having to conduct cross-border payments. The launch included both the roll-outs of the SEPA credit transfer system and the SEPA cards framework. The SEPA direct debit system will follow before the end of 2009. The ECB has supported the European Payments Council in a variety of ways. For example, the ECB regularly organised meetings with stakeholders such as end-users, infrastructures providers and card schemes. We have also published a study of SEPA's potential economic impact, which highlighted, among other things, the room for cost reductions for banks.[6]

The ECB is also very active in enhancing knowledge about financial integration. Our research network on "Capital Markets and Financial Integration in Europe" with the Center for Financial Studies at the University of Frankfurt and whose Second Symposium you are currently attending is one good example. A major task of the ECB in this area is also the "Report on Financial Integration in Europe". This report was published for the first time last year and it displays, among other things, our most important indicators to assess the degree of financial integration in different parts of the financial system. The second report will come out next month, and will again feature a number of interesting analyses and conclusions.

I would like to mention yet another example in this group of activities, namely our contribution to the possible extension of the market transparency provisions in the Market in Financial Instruments Directive, in short MiFID, to financial instruments other than equities. The interest of the ECB in this issue follows in particular from the great importance of well-functioning markets for the transmission of monetary policy impulses. We explained our view at a public hearing held by the European Commission in September 2007. Focusing on post-

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6 Schmiedel (2007), The economic impact of the Single Euro Payments Area, ECB occasional paper, no. 71, August.

trade transparency in retail and wholesale bond markets, we proposed a market-led controlled experiment about the trade-off between transparency and liquidity. In such an experiment, post-trade transparency could be gradually introduced, starting for example with the most liquid bond market segment, in order to assess its effects on market liquidity. The ECB stands ready to support such an experiment. In the present time, the importance of transparency in financial markets to allow for an efficient processing of information has of course become particularly evident.

Finally, we provide central banking services that also foster financial integration. For example, most recently we successfully launched TARGET2, the second generation of our large-value payment system. By moving from a system composed of mutually interconnected national real-time gross settlement systems to a common system with a single shared platform for payments, we achieve further harmonisation for users in different countries and realise considerable scale economies. We achieved a single price structure for both domestic and cross-border transactions, the possibility of consolidated liquidity management for cross-border financial institutions and a harmonised set of cash settlement services for a variety of connected systems. The new system started in November last year with the first wave of countries. More countries will join in a few days and the last wave will follow in May this year.

With a view to maximising the benefits from TARGET2, the Eurosystem is currently also exploring the possibility of providing settlement services in central bank money for euro-denominated securities transactions. The objective of this project, called TARGET2-Securities, is to concentrate securities and cash settlements within Europe on an efficient, single platform. The user requirements of the system are currently the subject of a public consultation. The Governing Council will take into consideration the views of the stakeholders as well as the relevant public authorities prior to making a decision, by mid-2008, on whether to launch the project.

Deposit insurance

Let me move to an area that has received relatively scarce attention in relation to financial integration, which is the design of deposit insurance schemes. Although I look at it today primarily from an integration perspective, we should keep in mind that deposit insurance plays also an important role in crisis prevention and resolution. Deposit insurance serves two different but interrelated purposes. Its consumer protection purpose is to protect small and unsophisticated bank depositors against loosing a potentially important part of their wealth. Its financial stability purpose is to avoid bank depositor runs.

While it is nowadays hardly challenged any more that deposit insurance is a necessary element of the regulatory set-up, there is also awareness that an ill-designed deposit insurance scheme can have important adverse effects. On the one hand, a too generous coverage – protecting also large sophisticated depositors – could reduce market discipline for banks and therefore create distortions in the allocation of risks, including potential incentives for excessive risk taking by banks. This, in turn, could contribute to instability and related costs. On the other hand, unclear arrangements or only partial coverage for retail depositors could open the way again for bank runs.

In order to illustrate the relevance of deposit insurance schemes for financial integration, let me recall the definition of financial integration we are using for our work. According to this definition, a market for a given set of financial instruments or services is fully integrated when all potential participants in that market (i) are subject to a single set of rules when they decide to deal with those financial instruments or services, (ii) have equal access to this set of financial instruments or services, and (iii) are treated equally when they operate in the market. The instrument in question here is the basic bank deposit. Differences of rules and regulations across countries about how deposits are guaranteed could therefore affect the degree of integration achieved. Given that small depositors tend to be immobile, and therefore cross-border retail deposit holdings are rather limited in the EU at present, the main issues arise with respect to the compliance costs for cross-border banks and the competition between banks that are subject to differing rules and regulations governing deposit insurance schemes.

Let me compare some main features of deposit insurance schemes across European countries, starting with coverage.[7] In EU countries, the amount of fully insured deposits per depositor varies between 20,000 euros, the minimum threshold prescribed by the Directive on Deposit Guarantee Schemes, and about 103,000 euros. Everything else equal, depositors that possess as much as 100,000 euro in a bank account are more likely to be sophisticated and therefore less needing protection than small depositors. And without such insurance, large and sophisticated depositors may exert some market discipline on banks. In other words, banks with a large share of their deposits in a country with high coverage may have different incentives and access to deposit finance compared to banks in lower coverage countries. A related point could be made about the different types of deposits that are covered by the respective schemes.

A second important parameter of a deposit insurance scheme is the funding structure. In the EU some schemes are pre-funded, i.e. they collect the means for being able to pay out in case of a bank failure beforehand, others are only funded ex post, i.e. in case of a bank failure the necessary amounts are collected from other banks, and again other schemes use a combination of the two. For the pre-funded schemes the premium structure is of relevance. Some schemes use flat rates in proportion to banks' deposits and others take some aspects of bank risk in the pricing into account. All this leads to greatly varying "coverage ratios" across the EU, defined as the size of funds divided by the total amount of deposits covered. The differences in funding structures can lead to differences in the costs of deposit insurance for banks headquartered in different countries.

As the views of stakeholders tend to be divided, an important issue for further analysis and research is whether differences in coverage and funding structures have a significant impact on the competition among banks originating from different countries.

In addition, cross-border banks with subsidiary structures have to obey to the rules of the deposit insurance scheme in each country where they are represented. This is complicated and costly for them. Once they have become a member of a scheme and paid into it, it is often impossible to recover the funds in case they would like to streamline the group by moving to a branch structure, e.g. by becoming a Societas Europea. This might discourage cross-border groups from streamlining their company structure, which could become a factor limiting financial integration. In this area as well, I a missing a study providing answers that take all benefits and costs of different options into account.

All these observations raise the issue as to whether the mechanisms for coordination at the level of the EU should be used to achieve more convergence in the various aspects of deposit insurance schemes in the context of the presently decentralised approach to financial regulation and stability. This convergence could go in the following directions. First, in addition to setting a lower bound, also the maximum amount covered could be limited and the specification which deposits are included and which not better harmonised. Partial insurance, or the so-called co-insurance, for smaller deposits could be removed where it still exists, as recent experience seems to suggest that it may reintroduce incentives for retail depositors to run a bank. Second, it may be advisable to move towards pre-funded schemes, which are financed through risk-sensitive premia. This would bring bank incentives better in line. Obviously, it would also mean significant transitional costs for the countries that

[7] For a comprehensive comparison of EU deposit insurance schemes, see European Commission (2007), Scenario analysis: estimating the effects of changing the funding mechanisms of EU deposit guarantee schemes, Joint Research Centre, February.

presently operate schemes funded ex post. Pre-funded schemes would also permit to mobilise very rapidly the guarantee which might be a decisive advantage to avoid bank runs. Such European convergence of deposit insurance practices would, however, not solve the problem that at least as important differences exist between European and non-European countries.

Deposit insurance is naturally not only relevant for financial integration but also, very much, for the handling of financial crises. Clearly the cross-country differences I mentioned above (and several others more) are at least as much an issue for crisis prevention, management and resolution as they are for financial integration. Convergence in deposit insurance arrangements across European countries should not advance in a way that neglects either the financial stability or the financial integration aspect of it. Both need to be well aligned. Overall, we agree with the Commission's "bifurcated" approach, according to which further progress at a shorter time horizon should first be achieved using the available non-legislative mechanisms and more fundamental reforms requiring legislation should be based on a deeper analysis, particularly considering the results of the debates on the financial stability set-up and burden sharing that are presently under way in Europe.[8]

Let me conclude with some remarks on the ongoing process of significant market correction that global finance is experiencing since several months, with its episodes of high market volatility and financial turbulences.

The last G7 meeting in Tokyo was a good occasion to exchange views on the underlying causes of the recent turbulences and on the areas where significant improvements will have to be brought about in global finance. The communiqué of the G7 that Ministers and Governors signed captures pretty well the large consensus we have at present on both the methodology and the six domains where we agree action will be necessary. This large consensus is very important because the challenges that we have to cope with are global and the solutions themselves can be nothing but global and very closely harmonised between the economies that are making up the global economy. I think particularly of the two vast continental economies that are on both sides of the Atlantic.

On top of stressing the absolute necessity to work very actively, and very united together, to draw the right lessons from the present market correction – which, according to our agreed methodology, we will do when receiving the definitive report of the Financial Stability Forum on the occasion of the next spring meetings of the Bretton Woods Institutions in Washington – I will make three remarks.

First, the international community is able to produce a right and pertinent diagnosis of the global finance's situation. As chairman of the Global Economy Meeting which takes place every two months in Basel, under the auspices of the BIS, I mentioned regularly in 2006 as well as in the first months of 2007 that my colleagues and I were judging that there was a significant underpricing of risks in global finance. This situation was substantiated by a very low level of spreads, a very low level of risk premia, an abnormally low level of volatility in a large number of markets. We had explicitly and publicly called for institutions and markets to prepare themselves for a correction that was both unavoidable and necessary to pave the way for more sustainable path of global finance. Such analysis and diagnosis were reflected pretty well in most Financial Stability Reviews published by central banks, not the least in the ECB publication a long time before the market correction. The BIS publications were themselves equally clear in this respect.

Second, a good analysis and a pertinent diagnosis are a necessary condition for future necessary market corrections to be as smooth and as orderly as possible. But it is not a

[8] See European Commission (2006), Financial services: Commission proposes self-regulatory improvements to deposit guarantee schemes, Brussels, 28 November.

sufficient condition per se as is clearly demonstrated in the present episode of turbulence and as was regularly observed in the previous periods of sharp and abrupt market corrections. And that is the reason why it is so important, so decisive that we draw all the lessons from the present episode, across the board, without any prejudices, without giving any privilege of untouchability to any part and parcel of global finance. From that standpoint I think the work of the Financial Stability Forum – scrutinizing liquidity risk management as well as credit rating agencies, analysing without complacency the weakness in the structure of incentives of the "originate to distribute" model as well as the monitoring of the off-balance sheet vehicles, examining the implementation of the Basel II agreement as well as the arrangement for dealing with in particular weak cross-border financial institutions – is of the essence.

Third, even with a right and pertinent diagnosis, and appropriate significant improvements in benchmark voluntary principles and codes of conduct for the private sector as well as substantial progress in rules and regulations, in cooperation and coordination between authorities where needed, my understanding is that we could not be ensured that the "unavoidable and necessary market corrections" of the future will be reasonably "smooth and orderly".

For a higher likelihood of that to happen we need probably simultaneously what I would call a further significant change of culture at national as well as at global level. I would sum up this change in our overall approach with these words: Transparency, Holism and Anti cyclicality. Transparency because enhanced public information on institutions as well as on financial instruments is the only way we have to avoid contagion and herd behaviour in times of difficulty. Holism because, technology and globalisation helping, we have progressively built global finance on the basis of the very close interconnections of all markets, all institutions, all economies. We must continue to improve our full understanding of the functioning of the financial system as a whole. The Financial Stability Forum gathering banking, insurance and market surveillance authorities, central banks, international financial institutions, treasuries etc., was the first major illustration of this necessity to address the global financial system as a whole. We have to reinforce considerably this holistic approach. And Anticyclicality because a number of rules and regulations, on the one hand, and of behaviours of public and private institutions as well as of markets, on the other hand, have a tendency to be largely procyclical, amplifying the booms as well as the busts in the cycle. We must look at all parts and parcels of global finance with a view to diminishing progressively their procyclical components which implies, in particular but certainly not exclusively, eliminating as much as possible asymmetry in the treatment of booms and busts and extending as much as possible, where needed, the time horizon adopted by all the institutions concerned.

Many thanks for your kind attention.