# Jean-Claude Trichet: Fostering sound financial globalisation – the role of Europe

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Paris Europlace Financial Forum "The Paris Marketplace Contribution to the Global Economy", Paris, 2-3 July 2008.

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Ladies and Gentlemen,

Mesdames et Messieurs,

Je suis très heureux d'intervenir aujourd'hui à l'occasion du Forum financier de Paris Europlace. En premier lieu, permettez-moi de préciser que mon discours intervient durant la « purdah period » précédant une réunion du Conseil des gouverneurs. En conséquence, aucun de mes propos ne saurait être interprété en termes d'intentions du Conseil des gouverneurs sur l'orientation de la politique monétaire et le niveau des taux directeurs. Je me concentrerai aujourd'hui sur le rôle de l'Europe dans les marchés financiers globalisés. Il est en effet particulièrement opportun de procéder à une évaluation de la contribution, au sein de l'économie mondiale, des marchés de capitaux européens. Les événements observés sur les marchés de capitaux depuis plusieurs mois nous ont rappelé à quel point le système financier mondial était devenu étroitement intégré. La mondialisation financière est un facteur important du dynamisme économique mondial et de la stabilité, car elle favorise une allocation efficace du capital et accroît les possibilités de partage et de diversification des risques. Il convient toutefois que son développement se déroule dans un environnement caractérisé par l'efficacité et la discipline. Pour cela, il nous appartient à tous d'assumer notre part de responsabilité pour garantir un fonctionnement sûr et efficace du système financier mondial.

Europe is one of the major building blocks of the global economy and, as such, needs to play a very active role in fostering sound financial globalisation. I would like to highlight two main priorities in this respect.

*First, we should further step up our efforts to build a truly integrated, safe and highly competitive European financial market*. The tenth anniversary of the ECB one month ago gave us the occasion to take stock of the achievements in European financial integration over the past decade. We were proud to find that significant progress has been achieved and that the introduction of the single currency has acted as a major driving force in this regard. However, as I would like to underline today, further efforts are necessary to make the single financial market a reality.

While financial integration is first and foremost a market-driven process, authorities can play an important supportive role in a number of ways, for instance by acting as catalysts for private sector initiatives and by reducing policy-related obstacles to cross-border finance. The Eurosystem can also provide central banking services that support the financial integration process. I will highlight a few areas, which, in my view, particularly merit further public sector action.

*Second, Europe should also contribute actively to safeguarding the resilience of the global financial system*. At the present juncture, the main priority in this regard is to address, from a systemic point of view, the global financial system weaknesses which have been identified during the ongoing financial market correction. At the same time, greater global interconnectedness will continue to necessitate substantial efforts towards enhanced international cooperation. I will mention a number of priority issues in this context.

## The state of European financial integration

Let me begin with a brief review of the current state of European financial integration. Completing the single financial market is a key priority on the European economic agenda for a number of reasons. First, an integrated financial market is a prerequisite for realising the full economic potential of Europe, as highlighted in the Lisbon strategy. A study by London Economics estimates that the integration of the European bond and equity markets could result in additional GDP growth of around 1% over a ten-year period, or approximately 100 billion euro.[1] Second, financial integration is also a crucial element in the safe and efficient functioning of the monetary union. In particular, financial markets that are more integrated provide strong support for the effective transmission of the single monetary policy and the smooth operation of the underlying payment systems. By enhancing the depth and liquidity of financial markets, integration also enhances the resilience of the European financial system.

The ECB has, therefore, always been a strong supporter of the European financial integration process and we have monitored the respective developments very closely. Based on a set of quantitative indicators, we review the state of financial integration in the money, bond, equity and banking markets in our annual report on Financial Integration in Europe. The second issue of this report was published last April.[2]

Our findings show that European financial integration has advanced significantly since the introduction of the single currency. However, the progress made differs across financial market segments. In particular, integration is more advanced in those segments that are closer to the single monetary policy and it also depends on the integration of the underlying market infrastructures.

The euro area unsecured *money markets* score well in both of these respects. It is therefore not surprising that these markets reached a stage of near-perfect integration almost immediately after the introduction of the euro, when the cross-country standard deviation of the unsecured interbank lending rates rapidly decreased to an almost negligible level of two to three basis points. The collateralised money markets are also well integrated. Although there was a slight increase in the standard deviation of unsecured rates during the financial market correction, the fact that collateralised rates have not reacted in a similar way suggests that the reason lies in an increased variability of credit risk among banks rather than in growing cross-border market segmentation.

The close integration of large-value payment systems has been instrumental in achieving and sustaining money market integration. TARGET, the Eurosystem's real-time gross settlement facility for euro payments, became operational in January 1999 and since then has enabled the safe and efficient euro-area wide handling of interbank payment transactions. The move to a single shared platform with TARGET2, which on 19 May 2008 fully replaced the former TARGET system, will render wholesale euro payments even more integrated and efficient.

*Bond and equity markets* also show clear signs of integration, especially the government bond markets. Progress has also been achieved in the corporate bond markets and, to a lesser extent, in equity markets. Both bond yields and equity returns are increasingly driven by common factors and the cross-border shares of bond and equity holdings have been growing to 60% and one third of total holdings, respectively. This suggests that euro area investors are progressively diversifying their portfolios on a cross-border basis. At the same time, country-specific factors still play an important role, especially in corporate bond and

[1] London Economics (2002), "Quantification of the macroeconomic impact of integration of EU financial markets", Report to the European Commission.

[2] See the Report on Financial Integration in Europe at http://www.ecb.europa.eu/pub/pdf/other/financialintegrationineurope200804en.pdf.

equity markets. A key obstacle to greater bond and equity market integration is the lack of a sufficiently integrated infrastructure for securities clearing and settlement in the EU.

Substantial progress has also been made on the integration of *banking markets*, namely in the wholesale and capital market-related segments. Cross-border interbank loans have increased to almost a quarter of total interbank loans and euro area banks' holdings of securities issued by banks in other euro area countries have almost tripled over the past decade. By contrast, retail banking markets have remained fragmented so far. For instance, the cross-border share of loans to non-banks has more or less stagnated at a very low level, below 5%. Similarly, the cross-country dispersion of banks' interest rates on loans to non-financial corporations and households has remained relatively high, especially with regard to consumer loans.

**Public sector action to foster financial integration**

Further efforts are needed to complete the single financial market, particularly in those areas where integration is currently lagging behind, namely in the corporate bond, equity and retail banking markets. While I would like to highlight again the primary role of market-led action in this respect, public authorities should nevertheless strive to facilitate progress. I see three main priorities at the current juncture, namely to: (i) further enhance the EU institutional setting for financial regulation and supervision; (ii) remove obstacles to cross-border securities clearing and settlement; and (iii) enhance the EU regulatory framework and market infrastructure for retail banking.

The European financial integration process presents a twin challenge for the *EU regulatory and supervisory architecture*. *First*, closer convergence of prudential rules and supervisory practices is needed in order to facilitate the efficient operation of cross-border financial institutions and to safeguard an effective pan-European level playing field. *Second*, while financial integration increases the overall shock-absorbing capacity of the financial system it also increases the likelihood that financial risks may be cross-border in origin or nature. Against this background closer cross-border cooperation in monitoring and addressing financial risks is of the essence.

The EU has already taken important steps to foster regulatory and supervisory convergence and cooperation in recent years. The introduction of an enhanced institutional setting for financial regulation and supervision with the Lamfalussy framework has been a milestone in this respect, coupled with improvements to the EU legislative framework for financial services, including in particular the adoption of the Financial Services Action Plan and the respective follow-up policy for the period 2005-2010.

However, the first full review of the Lamfalussy framework by ECOFIN in December 2007 demonstrated that the new institutional setting has not yet reached its full potential. While the review confirmed the widely shared assessment that the Lamfalussy framework has greatly enhanced the EU regulatory and supervisory process in recent years, it also underlined that the optimal level of cross-border convergence and cooperation has not yet been attained.

In order to move forward, the December 2007 ECOFIN pointed to the need to: (i) strengthen the roles, tools and decision-making procedures of the EU committees of supervisors; (ii) enhance the supervisory arrangements for cross-border financial groups by improving the functioning of the supervisory colleges formed by the competent home and host supervisors; and (iii) consider introducing a reference to the EU in the mandates of national supervisors. The ECOFIN Council set out a specific roadmap for achieving progress on these issues by the end of 2008.

The Eurosystem strongly supports these initiatives. Indeed, from the inception of the Lamfalussy framework we have argued that this innovative institutional approach provides an appropriate basis for achieving the heightened degree of cross-border convergence and cooperation which is required. One of the key advantages of the Lamfalussy approach is the combination of a decentralised set-up with cross-border coordination at EU level. A decentralised approach is in line with the national responsibilities for safeguarding financial stability – relating not only to financial regulation and supervision, but also to financial stability monitoring and assessment, crisis management, and deposit insurance – while also allowing for the benefits of geographical proximity and the established experience and knowledge of local authorities to be drawn upon. At the same time, it is clear that the accompanying coordinating mechanisms need to be sufficiently strong, and this has not been the case so far. Therefore, a key priority on the EU financial services policy agenda is the effective and timely implementation of the measures that will allow the full benefits of the Lamfalussy framework to be reaped.

Let me now turn to the work underway on *enhancing securities clearing and settlement* that is underway in Europe. Given the existing fragmentation of the securities market infrastructure the post-trading costs of cross-border securities transactions in the EU are excessively high and this constitutes an important impediment to the enhanced integration of European bond and equity markets. A number of initiatives have been launched to achieve progress in this field, relating in particular to the implementation of the industry's Code of Conduct and the removal of the so-called Giovannini barriers. A crucial complementary step towards an integrated European securities market infrastructure would be to establish a common securities settlement platform. This is the objective of the Eurosystem's TARGET2-Securities (T2S) initiative.

Under T2S, cross-border transactions will be settled at the same price and as efficiently as domestic transactions. Moreover, the T2S settlement cost will be significantly lower even than the cost today of domestic transactions. If T2S existed now, the average settlement cost could be reduced very substantially. If the geographical scope of T2S were extended beyond the euro area, substantial further cost savings would be achieved. In addition to the pure settlement cost, banks and other users would also enjoy substantial back office and collateral savings.

The details of the economic impact analysis of T2S are set out in the proposal by the ECB's Governing Council's proposal for all European central securities depositories to join the T2S project. This proposal also includes the user requirements that have been developed in close co-operation with hundreds of experts from central securities depositories (CSDs), banks and central banks. The entire documentation, which was sent to the CSDs on 23 May 2008, is available on the ECB's website. The Governing Council has invited all European CSDs to express their views with regard to their participation in T2S by 4 July 2008 and will subsequently decide whether to proceed with the project.

While the Code of Conduct, the removal of the Giovannini barriers and T2S are different lines of work, they all aim at enhancing the efficiency of post-trading services in Europe. They are complemented by the ESCB-CESR recommendations, which aim to ensure the safety and soundness of EU post-trading activities.

Finally, I would like to make a few remarks on further steps to *promote retail banking integration*. Again, a multi-pronged approach is most promising in this regard. For instance, the European Commission, as part of its financial services policy for the years 2005-2010, is pursuing a number of initiatives to overcome both regulatory and market-based barriers in this field. In addition, it is expected that the above mentioned initiatives to streamline the regulatory and supervisory interface for cross-border financial institutions will foster an enhanced cross-border provision of banking services, including in the retail segment.

Furthermore, in January 2008 the market-led initiative to establish a Single Euro Payments Area (SEPA) was launched, which aims at achieving a fully integrated market for retail payment services in the euro area via harmonised technical standards and market practices, with no distinction between cross-border and national payments. The main priority at the current juncture is for all stakeholders to make every possible effort to achieve the full and timely implementation of SEPA in order to ensure that a critical mass of retail payments will be made on the basis of SEPA instruments by end 2010.

As ECOFIN concluded in January this year, public authorities have an important catalytic function in driving the migration process to SEPA forward, namely by supporting and explaining SEPA in their communication with their national constituencies. In addition to this political task, they also have an operational role to play in becoming early users of SEPA products and services. As initiators and receivers of high volumes of payment transactions, public authorities – such as national and local administrations, tax authorities, social security agencies and pension funds – are key stakeholders which can make SEPA a success.

We have noted that there is still a lack of information and awareness about SEPA among the public at large. Greater effort should be made to communicate the benefits of SEPA to corporate enterprises and private customers at European and national levels.

While we expect that the critical mass of retail payments will have moved to SEPA payments by the end of 2010 on a voluntary basis, an official end-date for the migration period may need to be set, by which time the use of national credit transfers and direct debits should have been phased out. Recent studies by the ECB and the European Commission have clearly shown that a lengthy period of processing the old national and the new SEPA instruments in parallel will be costly for both banks and their customers. Therefore, this period of dual processing should be kept as short as possible.

**Responding to the global financial market correction**

Financial integration is proceeding not only within Europe, but also at the global level. Financial globalisation enables the international community to share significant benefits in terms of enhanced financial efficiency and economic growth, but it also makes the safeguarding of financial stability a more interdependent endeavour. Effectively coordinated international action aimed at addressing financial system vulnerabilities has therefore become very important, as highlighted during the ongoing financial market correction.

Against this background, the major collective effort undertaken by both the public and the private sector to cope with the financial market turbulences has been encouraging. Hard work has been done in terms of restoring the orderly functioning of financial markets in the short term and identifying proper measures to strengthen the resilience of the financial system in the longer term in order to avoid the recurrence of similar events in the future. The report of the Financial Stability Forum (FSF) on "Enhancing Market and Institutional Resilience"[3] has been fully endorsed by the international community and provides the main reference point for the necessary improvements. In this context, let me briefly point out that enhancements will be required in a number of areas, with particular focus on (i) aspects of the prudential framework, relating to capital and liquidity risk as well as to banks' liquidity risk management practices; (ii) transparency, including full disclosure of banks' exposures on structured products and off-balance sheet vehicles; (iii) valuation standards, especially as regards marking-to-market illiquid assets; (iv) market functioning, including possible conflicts of interest of credit rating agencies and their role in rating structured finance instruments; and (v) authorities' responsiveness to risks and arrangements for crisis management.

At the present juncture, the key priority is to ensure the expeditious and effective implementation of the respective recommendations set out in the FSF report. There is a strong consensus among the international community to act with determination in this regard. In addition, it is fortunate that many of the recommendations were developed by the authorities that now have the mandate to apply them. Nevertheless, the competent national,

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[3] The report was published on 11 April 2008. It is available at http://www.fsforum.org/home/home.html.

regional and international authorities and bodies will need to make every possible effort to ensure adequate progress. This relates especially to those actions which were agreed to be implemented within 100 days or by the end of this year. In addition, it will be crucial to continuously monitor the progress made in order to keep up the momentum for reform and, possibly, to identify elements that may require further follow-up action. The FSF will play an instrumental role in monitoring the efficacy of the implementation of its recommendations.

I would like to point out that some of the financial system weaknesses exhibited during the recent financial market correction present more structural, longer-term challenges and will require our continued attention in the coming years. Let me draw your attention to four important issues in this regard.

*First, it will be crucial to ensure adequate transparency regarding financial markets, institutions and financial instruments*. The availability of adequate information is the basic prerequisite for sound investment decisions, effective risk management and market discipline. In this way, transparency not only contributes to a more efficient allocation of capital, but is also the best insurance against irrational herd behaviour and the propagation of financial turbulence. Various episodes of financial stress, including the most recent one, have clearly demonstrated that the lack of reliable financial information is a key element in the excessive building up and unwinding of financial imbalances. The continuous enhancement of financial disclosure requirements, accounting rules and valuation practices in line with market developments will therefore be indispensable.

*Second, pro-cyclical features of the regulatory framework need to be identified and addressed*. While to some extent procyclicality is inherent in the financial system because risk is by its own nature cyclical, it is important to ensure that the regulatory framework does not amplify these fluctuations. Instead, the public sector should play an active role in mitigating procyclical behaviour as far as possible by enhancing the forward-looking nature of the regulatory framework. Concrete areas for attention that have been identified include certain elements of the fair value accounting rules and the implementation of the new capital requirements for banks and insurance companies. In the future, public authorities will need to be continuously aware of the importance of applying sufficiently long-term horizons for financial rules and prudential practices.

*Third, it will be necessary to pay closer attention to the growing importance and complexity of liquidity risk in the more market-based financial system.* In this context it will be essential to ensure that prudent liquidity risk management of financial institutions provides an effective line of defence, also to pre-empt the moral hazard risk associated with a possible undue reliance of market participants on central bank actions. The experience gained from the financial market correction has indicated that the liquidity risk management of a number of financial institutions was not commensurate with their increasing exposure to liquidity risk from both the assets and liabilities side. To ensure progress towards best practices in this field as well as to respond to the increasing need for the effective cross-border mobilisation of liquidity, closer coherence of supervisory requirements and approaches with respect to liquidity risk is also warranted. The recently published consultation paper by the Basel Committee on “Principles for Sound Liquidity Risk Management and Supervision” constitutes an important starting point in that direction.

*Finally, the institutional arrangements for cross-border cooperation among authorities should be further enhanced,* both during situations of financial distress and in normal times. As regards crisis management arrangements, one priority in my view will be to clarify responsibilities and procedures to support timely and well-targeted public sector action. The recently agreed EU-wide Memorandum of Understanding between supervisory authorities, central banks and finance ministries on cooperation in cross-border financial crisis situations could also serve as a basis for improvements at the international level.

With regard to ongoing supervision, I fully support the FSF’s proposal to set up colleges of supervisory authorities for the largest globally active institutions by the end of this year. In the

EU, such informal institutional infrastructures of supervisors to support greater information-sharing and coordination in the supervision of cross-border groups are already in place. Our experience in Europe points to a number of elements that are crucial for ensuring the effective functioning of supervisory colleges, which may also be relevant for further developing the international arrangements in this field. These include especially the adequate involvement of all relevant host authorities; a coordinating role for the home country supervisor, with due respect to the responsibilities of host authorities; and arrangements – to be devised by the EU committees of supervisors established under the Lamfalussy approach – to foster consistent procedures and policies across different supervisory colleges.

Lastly, closer ongoing cooperation should be pursued not only between supervisors, but also between supervisors and central banks. Such joint work, to be pursued at all levels (nationally, regionally and globally), would in particular aim to enhance the integration of supervisors' micro-prudential functions and central banks' macro-prudential functions in the assessment of possible financial risks and vulnerabilities. This would make a significant contribution to raising awareness of emerging financial system imbalances at an earlier stage and devising effectively coordinated public sector action to address them. Furthermore, given the growing role of correspondent and custodian banks in payment and settlement systems, closer cooperation between supervisors and central banks, in their role as overseers, is increasingly important to ensure a comprehensive and consistent treatment of the respective financial risks.

## Conclusion

Mesdames et Messieurs, permettez-moi de conclure mon intervention. La mise en place d'un marché des capitaux européen sûr, efficient et totalement intégré est une contribution essentielle que l'Europe peut apporter dans le cadre d'un processus harmonieux de mondialisation financière. Des progrès significatifs ont déjà été réalisés dans ce domaine, mais de nouvelles avancées doivent être réalisées. Il importe que le secteur public soutienne le processus d'intégration financière, notamment à travers l'amélioration de la structure réglementaire et de surveillance au sein de l'Union européenne, la levée des obstacles dans le domaine des systèmes de compensation et de règlement-livraison de titres et le renforcement du cadre réglementaire et de l'infrastructure de marché pour les services bancaires aux particuliers.

L'Europe doit aussi s'impliquer fortement dans la sauvegarde de la résilience du système financier mondial, en voie d'intégration complète. La coopération mondiale face à la correction observée récemment sur les marchés de capitaux a été efficace jusqu'à présent, mais il ne faut céder à aucun excès de confiance. De nombreux défis sont en effet encore devant nous. La mise en œuvre en temps opportun et de façon cohérente des recommandations formulées par le Forum de la stabilité financière réclamera des efforts soutenus de la part de chacun d'entre nous, à la mesure de nos responsabilités. De même, un engagement constant en faveur d'une étroite coopération transfrontière demeurera essentiel, non seulement pour surmonter les turbulences actuelles mais, plus généralement, pour assurer une stabilité financière mondiale satisfaisante dans le contexte d'un système financier international de plus en plus intégré et complexe. Le renforcement de la transparence, l'atténuation de la procyclicité du système financier, une gestion efficace des risques de liquidité et la consolidation des dispositifs institutionnels de coopération entre les différentes autorités responsables constituent les grands axes des réformes nécessaires.

Je vous remercie de votre attention. I thank you for your attention.