Jean-Claude Trichet: European financial integration

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the 23. Internationales ZinsFORUM "Zinsen 2009", Frankfurt am Main, 11 December 2008.

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Ladies and Gentlemen,

I would like to thank the organisers for the invitation to speak about European financial integration here at the Zinsforum. The challenging times we are now experiencing provide an excellent opportunity to exchange thoughts on this topic that is of great interest to the ECB. More integrated financial markets are important for realising the full potential of the single market. But they also make the execution of the single monetary policy in the euro area more efficient, which is obviously of key importance to the ECB.

My speech today has two major themes. I will start by addressing the **current stage of the financial integration process** in Europe. The introduction of the euro as a single currency was a quantum leap for the integration process; but I believe that further efforts are still needed to make the objective of a competitive and safe single market in financial services come true. I am convinced that this process should be first and foremost market-driven. But I also believe that public authorities have a role in fostering financial integration in Europe. This is particularly true when it comes to supporting the private sector to coordinate their action and to reducing policy-related obstacles to cross-border activities.

The second theme I will address today against the backdrop of European financial integration are the **regulatory and supervisory initiatives** that have been taken recently in light of the ongoing financial crisis. These pertain both to managing the crisis and to preventing a recurrence in the future. I do believe that continued efforts are needed in this regard, in particular to enhance cooperation among the authorities.

The state of European financial integration

But before going into our assessment on the state of financial integration, I will briefly elaborate on the reasons behind our interest in this topic. For the ECB, financial integration is not an end in itself, but it is relevant for a number of issues that are important to us.

First, financial integration matters for the ECB as it contributes to the **efficient functioning of the monetary union**. Integrated financial markets support the effective transmission of the single monetary policy throughout the euro area and the smooth operation of the underlying payment systems. Financial integration also increases the depth and liquidity of financial markets, and consequently enhances the resilience of the European financial system. In addition, it offers more possibilities for geographical risk diversification. Obviously, a more resilient financial system is highly relevant for the ECB's task of contributing to the safeguarding of financial stability.

Second, and more generally, integrated financial markets help **to realise the full economic potential of the European Union**, as also recalled in the Lisbon strategy. Financial integration contributes to the development of the financial system by increasing competition and expanding markets, which results in lower intermediation costs and a more efficient allocation of capital. These effects, in turn, raise the potential for increased economic growth.[1]

[1] For example, a study by London Economics once estimated that the integration of the European bond and equity markets could result in an additional GDP growth of around 1% over a ten-year period, or

For the reasons I come to mention, the ECB has always been a very strong supporter of the European financial integration process. We therefore monitor developments in this area closely, and present our view in our annual report on Financial Integration in Europe.[2] As a matter of fact, we have now just started the work on our third report, which we intend to publish in Spring 2009.

Let me now give you an overview of our assessment on the current state of play in the various financial markets.

We have developed a number of quantitative indicators to track the integration of the money, bond, equity and banking markets in the euro area. These indicators show that, since the introduction of the single currency, integration has advanced significantly. However, progress has also been uneven across financial markets. Two main conclusions stand out in this regard: First, integration is typically more advanced in those markets that are **closer to the single monetary policy**. Second, it also depends on the degree of integration of the **related market infrastructures**.

In order to highlight the role of infrastructures, I would in particular like to mention **the long history and success of TARGET**, the Eurosystem real-time gross settlement facility for euro payments. This system has since 1999 enabled the safe and efficient euro-area wide handling of interbank payment transactions. The enhanced version of this system, **TARGET2**, provides since the completion of the migration of the national central banks in May 2008 a single shared platform for euro wholesale payments. As a result, we now have an even more integrated and efficient payments landscape. Indeed, TARGET2 is **the first market infrastructure to be completely integrated and harmonised** at the European level! TARGET2 processes a daily average of nearly 400,000 transactions, for a daily average value of 2.6 trillion euro. This positions TARGET2 as one of the largest payment systems in the world – together with Fedwire in the United States, and CLS, the international system for settling foreign exchange transactions.

This success of large-value payment systems integration has been instrumental in achieving and sustaining financial integration in the **money market**. The evolution towards a single market can be observed in terms of cross-country standard deviation of the unsecured interbank lending rates. These decreased to negligible levels of two to three basis points almost immediately after the introduction of the euro, indicating near-perfect integration.

Bond markets also show clear signs of integration. We observe that over the past ten years, bond yields are being increasingly driven by factors common to the euro area, rather than by purely local factors. At the same time, euro area investors are seen to be progressively diversifying their portfolios on a cross-border basis. Currently, euro area residents have almost 60% of their total bond portfolios in euro area cross-border bond holdings.

It is interesting to see how the recent **financial crisis** has affected the evolution of our financial integration indicators in the money and government bond markets. In both markets, spreads and standard deviations of rates across euro area countries increased in 2008. The turmoil in 2007 only seemed to affect the unsecured money market rates. The recent intensification, however, has led to a rise in the cross-country standard deviations of one- and twelve-month secured money market rates as well, from their usual level of 1.5 basis points to 5-6 basis points.

The key question is **how much of this recent divergence should be allocated to factors related to financial integration**, and how much of it has its origin in other factors. To be

approximately 100 billion euro. See 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.

more precise, higher spreads that result from higher counterparty risk or increased risk aversion do not necessarily point to a more segmented market, but are rather rooted in a general change in investor behaviour. Increased liquidity risk, on the other hand, could well indicate more market segmentation.

Our preliminary analysis confirms that, although these general factors have played a large role in the increased spreads and standard deviations, we also find some indication of increased liquidity risk. However, I would like to stress that **all assessments we can make at this juncture are still preliminary**. We are not yet out of the storm, and a more complete and thorough analysis will have to wait for some time to come. My message at this point of time is for us all to **remain committed to a continuous integration process** in the European financial markets, and resist the tendency to focus on national markets under tension. Let us therefore not lose the momentum in these uncertain times.

I now turn to the **equity markets**, where it is considerably harder to measure financial integration. This is not least because stock returns are less directly comparable across countries than returns in the money and government bond markets. Notwithstanding this difficulty, our assessment shows signs of continuously increasing integration, and currently, there is no indication that this trend has been affected by the financial crisis. For example, euro area residents doubled their share of euro area cross-border holdings over the past ten years to slightly below one third of their total equity holdings. Moreover, according to our indicators, integration here seems to advance faster at the European than at the global level. At the same time, country-specific factors still play a significant role in the equity markets, not least because of the continued fragmentation in the post-trading infrastructure. A pan-European infrastructure for securities clearing and settlement in the EU would therefore certainly provide new impetus for further integration.

Equity markets offer me a nice entry point to make you aware of a new type of indicators that we are currently developing. Financial integration is an important, but not the only factor that contributes to the efficiency of the financial system. There are indeed other relevant factors, such as the degree of financial development or the quality of the framework within which financial markets operate. In the ECB we are now in the process of extending our analysis from financial integration to the **development of financial markets**. We understand financial development broadly as a process of financial innovation and organisational improvements. This includes developments that reduce asymmetric information; increase the completeness of markets; add possibilities to engage in financial transactions through contracts; reduce transaction costs; and increase competition. The idea to extend our work from financial integration to financial development goes back to the ECOFIN Council's invitation in 2006 to "monitor and assess relevant institutional features that hinder the efficient functioning of the financial system".

One of these financial development indicators measures the level of **venture capital financing**. Venture capital is indeed an attractive additional source of corporate financing, as it provides financing to young and small, research-based firms, which typically face constraints in the more traditional markets. Our indicator shows a rise in venture capital financing in Europe in the recent years; however, the starting level is very low. More precisely, the euro area average for the last five years amounts to 0.02% of GDP, compared with 0.1% in the United States. Therefore, I see more room for investigating ways to promote the development of this type of markets as well.

The final market I want to include in my overview of the state of financial integration is the **banking market.** Again, banking markets offer a nice illustration of how important the underlying infrastructure is. The **wholesale and capital market-related segments** are supported by TARGET2 and, not surprisingly, are well integrated. For example, cross-border interbank loans account for a quarter of total interbank loans, and banks' intra euro area cross-border holdings of bank securities have almost tripled over the past decade. By contrast, the **corporate and retail banking** markets have remained more fragmented so far, also reflecting the multiplicity of existing payment systems. For instance, the euro area cross-border loans to non-banks have remained at low levels, currently at below 6% of the total. Similarly, the cross-country dispersion of banks' interest rates on loans to firms and households has remained relatively high, especially with regard to consumer loans.

Now, the ECB and the Eurosystem are working hard to **address the remaining gaps** in financial integration, in particular when it comes to **market infrastructures**. The year 2008 has marked the launches of two important projects in this regard: TARGET2-Securities and SEPA.

The Eurosystem's **TARGET2-Securities, or T2S**, initiative establishes a pan-European securities settlement platform, in which 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 than the cost of domestic transactions today. In addition to the pure settlement cost, banks and other users would also achieve back-office and collateral savings.

The T2S User Requirements are a result of intensive cooperation by hundreds of experts from market participants, service providers and central bankers. By July 2008, we had received support of all euro area central securities depositories to the continuation of the project, subject to certain conditions. Consequently, on 17 July the Governing Council of the ECB formally approved the T2S project. The pan-European settlement platform is scheduled to go live by 2013.

Importantly for the retail banking sector, the **Single Euro Payments Area, or SEPA**, was launched in January 2008. SEPA aims to achieve a fully integrated market for retail payment services in the euro area, with the means of harmonised technical standards and market practices. With SEPA, there is no distinction anymore between cross-border and domestic payments. The European Commission estimates that SEPA could bring substantial benefits over the next six years. Moreover, these benefits would be further very significantly increased if SEPA can be used for electronic invoicing!

The **main priority for all the stakeholders** is now to make every possible effort to implement SEPA timely and in full. The final hurdles – which by definition are the most difficult in a market integration project of this ambition, size and complexity – need to be overcome. Without going into too much detail, banks and competition authorities urgently need to come to an understanding with regard to the future inter-bank pricing models in the retail payments market. Finally, the studies by the ECB and the European Commission have clearly shown that a long parallel processing of the old national and the new SEPA instruments is costly for both banks and their customers. Consequently, the period of dual processing should be kept as short as possible. The Eurosystem therefore has voiced its support for setting a realistic but ambitious end-date for the SEPA migration.

Regulatory and supervisory initiatives

I now turn to the second major theme of my speech. These are the recent regulatory and supervisory initiatives in Europe that are closely related to financial integration and that are particularly relevant in light of the ongoing financial crisis.

As I mentioned earlier, financial integration presents large potential benefits for the European economy. At the same time, it also poses important **challenges to supervisory authorities and central banks**. Indeed, while more integrated markets increase the shock-absorbing capacity of the financial system, such shocks may propagate more quickly, thereby affecting a wider number and range of market participants. In the same way, a large, systemically relevant cross-border financial institution would clearly have implications for financial stability in the event that it runs into problems.

These challenges have become quite evident in the past months. The financial crisis has underscored **the importance of appropriate public policy** in both crisis prevention and crisis management.

I will start with **crisis prevention**. In the face of increased market integration, European supervisors are confronted with the long-standing challenge of ensuring that their actions are both effective and efficient. Or to put it differently: they have to balance the need that their actions contribute to preserving financial stability, while at the same time avoiding creating any unnecessary regulatory burden for the supervised entities.

A major step to achieve this was the introduction of the **Lamfalussy process,** which has promoted more efficient and effective regulation and supervision in the EU financial services sector in the past years. The Lamfalussy process was initially created with the purpose to accelerate the adoption of regulatory measures related to the Financial Services Action Plan in the securities sector. Over time it has in addition assumed a very important function in supervisory convergence and cooperation in the whole financial sector. The Eurosystem has from the outset fully supported the Lamfalussy process.

A **review of the Lamfalussy process** by the EU institutions led the ECOFIN to adopt a number of recommendations in December 2007 to better exploit the full potential of the approach. The implementation of these recommendations is currently well under way. To begin with, earlier this year the Level 3 committees of supervisors have introduced the possibility for qualified majority voting into their charters; the members that do not comply are obliged to explain their decision not to do so. This will improve the effectiveness of the committees' decision-making processes. Moreover, the committees have to submit their annual work programmes to the Commission, the European Council and the European Parliament, thereby enhancing accountability of their activities. Finally, the European Commission will include explicit references to specific tasks, such as mediation or facilitation of information exchange, into the Decisions establishing these committees.

A lot of emphasis has recently been placed on the creation and strengthening of **colleges of supervisors** for European cross-border banks. As you may know, the main task of these colleges is to organise cooperation and sharing of information between the home and host supervisory authorities of those Member States in which the cross-border banks have significant activities. In May 2008, the ECOFIN recommended to strengthen the role of the colleges and to extend their use to all banking groups with cross-border activities in the EU.

The establishment of the colleges of supervisors will be accompanied by a clarification of the legal framework. The Commission has proposed amendments to the Capital Requirements Directive (CRD) **to enhance the legal underpinnings** of the colleges. These amendments pertain in particular to the interplay between the consolidating supervisor, which is chairing the college, and the authorities that are responsible for the significant branches and subsidiaries of the cross-border group.

Now allow me to make some comments as regards the envisaged role of the colleges of supervisors and the Commission's proposal. In general, I believe that the colleges will **improve supervisory cooperation**, in particular as regards the effectiveness, efficiency and consistency of the supervisory action.

First, **in terms of effectiveness**, the colleges should facilitate the information exchange on a cross-border group and enable all the involved supervisors to have full knowledge of the overall risk profile of the group. Moreover, the colleges should improve the coordination of supervision and risk assessment, both as regards consolidated and solo supervision, and arrange for the division of tasks.

Second, the colleges should over time become the main supervisory interface for the banking groups. This would lead to **higher efficiency,** as any unnecessary duplication of supervisory requirements should be avoided.

Third, the common legal underpinnings for the colleges in the revised CRD will ensure **consistency** across colleges. In addition, the ECB supports the work by the CEBS on developing operational guidelines. These guidelines have the aim to further align the working procedures of the colleges, the efficacy of their decision-making bodies, and the coherence of the practices used across colleges.

However, it remains to be seen whether such a framework will suffice, or whether further improvements will be needed. **The key challenges now lie in its implementation**. Let me mention some examples in this regard.

First, the effectiveness of the colleges depends on their **ability to facilitate decision-making** for the banking group as a whole. The CRD is expected to introduce some rules on the decision-making process should the authorities disagree on essential decisions concerning supervision of cross-border banking groups. Recent events clearly underscore that swift decision-making is of the essence; we cannot afford to have a cumbersome decision-making process in case of disagreements.

Second, the coordination role of Level 3 committees would be of critical importance to ensure **consistency of supervisory actions across colleges**.

Finally, let me stress the importance of **effective information exchange**. First, communication between the home and host supervisors **within the colleges** is crucial for the full understanding of the risk profile of the group. Second, the financial turmoil has highlighted the importance of information sharing **between central banks and supervisors** for the identification and assessment of risks to financial stability.

Moving from crisis prevention to **crisis management**, I would like to stress that the well **coordinated action by public authorities** was instrumental in limiting possible cross-border spillovers in the recent crisis.

To illustrate this point, let me just quickly recall that the **Eurosystem and other central banks** have ensured adequate access to central bank funding to liquidity-constrained but solvent banks. **Governments,** on their part, in a concerted and coordinated manner granted guarantees on new issuances of bank debt. They in addition committed to providing banks with additional capital resources, and jointly decided to raise the level of protection of deposits.

The Eurosystem has contributed to this work by proposing **a set of recommendations** on the appropriate framework for both the granting of government guarantees and the recapitalisation measures for financially sound banks.

With regard to the **government guarantees**, the Eurosystem recommendations provided not only overarching objectives but also specific parameters for the pricing system. In these recommendations, we have stressed the importance of supporting solvent but liquidity constrained banks and preserving the level playing field. In addition, consistency with the Eurosystem's liquidity management should be ensured so as not to impair the implementation of the single monetary policy.

With regard to the **recapitalisation measures**, the Eurosystem, in collaboration with the European Commission, also contributed by elaborating a common framework for the pricing of different forms of capitalisation instruments. These measures aim to strengthen the capital position of fundamentally sound banks and to restore a smooth flow of credit to the economy. At the same time, they aim to preserve a level playing field and avoid undue distortions in competition. It is in addition important to ensure that the temporary nature of the government measures is preserved and that private investors are not being discouraged. The methodology of the Eurosystem has been incorporated in the Commission's communication on the recapitalisation of financial institutions.

Finally, coordinated action was very important in the granting of **state deposit guarantees**. We all saw how initially uncoordinated initiatives immediately led to spill-overs with potential detrimental effects for banks in other countries that did not enjoy a similar level of protection. Timely concerted action among Member States led to a joint decision to raise the level of protection of deposits. The action was accompanied by a prompt initiative by the Commission to amend the Deposit Guarantee Schemes Directive. This amendment had the full support of the ECB.

The recent events have shown how the Member States and the EU institutions can act in a rapid and coordinated manner when necessary. However, **there is no room for complacency**. Consideration of the lessons from the financial crisis and the introduction of improvements to the EU framework for supervision and crisis management has already started. In October, the European Commission set up an independent **High Level Group** to develop proposals to strengthen the supervision of European financial institutions and markets and financial stability arrangements. The Group shall present its report to the European Commission in view of the Spring European Council 2009. I will assure you that the ECB Governing council will examine very carefully all proposals which will be made by the high level group, as well as by the European Parliament and by the industry itself.

Conclusion

Ladies and gentlemen, continued financial integration is of key importance for Europe. The financial crisis that we are currently facing may have caused a freeze on this development in some markets; all the more I urge us all to keep the momentum in this important process.

The ECB remains firmly committed to fostering further financial integration. The successes of TARGET and TARGET2 demonstrate the importance of the work done in the field of market infrastructures. We will now continue working hard in order to address the still remaining gaps.

Finally, the financial crisis confirmed the importance of an appropriate public policy response, both in terms of crisis prevention and crisis management, to avoid cross-border spillovers in the single market. Stronger coordination among Member States and EU institutions for crisis prevention and crisis management is needed. The ECB will closely follow the debate and contribute to it where necessary.

I thank you for your attention.