Eva Srejber: Sweden and European integration

Speech by Ms Eva Srejber, Deputy Governor of Sveriges Riksbank, at the IBC Euroforum: Nordic Banking, Stockholm, 3 June 2002.

* * *

Let me begin at once by stating the limits I intend to set for this subject in my speech: I intend to focus on *financial* integration within the EU and to discuss how companies and individuals can benefit from the advantages created by integration in this field. My starting point is, thus, that greater integration in the financial area mainly brings advantages, but there is cause to seek to analyse the forces behind such a development. As different public rules and regulations play an important role for developments in the financial sector, there is also reason to discuss a number of questions of a policy nature that are already on the agenda for a strengthened co-operation within the EU. This is largely a matter of achieving a balance between providing scope for product development and efficiency in the production of financial services in Europe, and creating the right conditions for stability and predictability in the financial system.

From white paper to financial action plan

Ten years ago, 1992, was the final date for realising the common market in the EU on the basis of the programme in the white paper presented by the European Commission in 1985. In this paper the commission described a total of almost 300 different directives that should be adopted in order to realise full mobility for goods, services, capital and persons within the European Community. Twenty-four of these directives concerned financial activities, including the liberalisation of capital movements. Almost all of these directives also came to be decided within the set time period, and a number of favourable conditions were created for bringing about more vigorous competition between the different EU member states.

A lot has also happened in this field and contributed to strengthening developments within the EU with regard to both supply and demand for financial services. The most important driving force behind this development relates to the general internationalisation process, the new communication technology and the deregulation of parts of the government rules and regulations. When the euro was later introduced as the single currency in twelve EU member states, it provided the ‘finishing touch’ that abolished uncertainty over exchange rate developments in a large part of Europe. At the same time, there is some disappointment that it has not been possible to create a market completely without borders for all types of financial activities within the EU *even more* quickly, and that some obstacles still remain. These obstacles are partly linked to the rules and regulations governing financial activities - and it is therefore in principle possible to influence them. The EU is now working on implementing a financial services action plan, which should be implemented by 2005. It includes 42 new or amended directives which have a bearing on the financial sector.

Disappearing exchange rate risks …

It is easy to conclude that there has been a dramatic decline in interest rate spreads between the countries that have introduced the euro, in the region of from around 5 down to 0.3 percentage points for government bonds. Some of this decline is, of course, connected with the consolidation of government finances in the EU member states, but as long as the national currencies remained, investors often also demanded a premium for managing exchange rate risk. The remaining interest rate spread can be largely explained by different credit ratings of member states in the euro area, which are carrying different baggage weights from debt previously incurred, as well as by differences in liquidity between different bond issues. The introduction of the euro has also contributed to increasing the breadth and depth of European capital markets and in any case led to almost complete integration of the part of the money market trading that is closely connected with the Eurosystem’s monetary policy transactions. To be sure, it is the quintessence of a common monetary policy that there should be uniform interest rate conditions for the liquidity supply across the entire monetary union. This has also led to an integration of deposit markets, i.e. short-term financing without formal collateral.

… but remaining deficiencies in the infrastructure

On the other hand, things have moved rather more slowly with regard to integration of cross-border money market trading against collateral. This is because it is more difficult to equate the value of these different types of collateral when they fall under different national legal systems. Securities trading between different countries is on the whole made more difficult by the fact that the infrastructure has still not been adapted to making transactions between buyers and sellers in different countries as simply and cheaply as within individual countries. One of the most cited examples of obstacles to cross-border financial transactions is the cost of making payments from one country to another. Now there is an EC regulation that prescribes that the price of making payments in euro between countries should not be higher than the same payments within a country, but the underlying infrastructure has involved de facto higher costs for making payments across borders. Other examples of national differences concern provisions aimed at establishing good consumer protection, but which make it more expensive and difficult in practice to create an efficient competition across borders, as the suppliers of financial products must adapt their marketing strategies to each individual country. One might have believed that the Internet would break this national fragmentation and open up the way for a demand-based international market for traditional bank services, but so far electronic banking services have mainly been used on a national basis. There are also numerous examples of tax systems discriminating between domestic and international financial transactions, which of course impedes the customers' incentives to use foreign suppliers, even if they offer more favourable terms for the actual service.

Integration contributes to greater welfare

Despite the difficulties in moving ahead more quickly with financial integration in the EU, there are estimates that it may be extensive enough in the future to make a contribution of more than one half of a per cent to GDP on an annual basis.[1] The actual figure should perhaps not be seen as exact, but there is reason to expect an unequivocally positive connection between financial integration and real growth on the basis of the development trends observed so far. A larger market makes it possible to benefit from economies of scale and economies of scope. This means increased economic welfare for the financial system's customers, provided that a sufficient degree of competition is maintained on the market and that there are efficient systems for supervision and oversight to ensure the stability of the system is upheld. If, for instance, European securities funds could operate under the same market conditions as American ones, they could become much larger than they are now. According to the same source as above, this could entail annual savings for European fund savers of 5 billion euro - close to 50 billion kronor![2]

More diversified demand

A more efficient supply also presupposes changes on the demand side. If the element of national thinking in financial investments were reduced, more savers would also be able to benefit from a broader supply of products. At the same time, it is essential that increased financial exposures towards companies and financial operators in other countries occur in controlled forms, i.e. with a high degree of transparency with regard to the risks attached to them. This is particularly important with regard to financial commitments of normally very long duration, e.g. investments in connection with life insurance.

There is reason to believe that the demand for financial services will continue to be a driving force behind the integration process and give a basis for further structural changes in the financial markets. Increased corporate financing through securities is one trend that will undoubtedly be further reinforced. Similarly, households' saving in funds will probably show a rapid increase in the future, particularly in order to secure future pensions, and this will call for a capacity to diversify investments, where geographical spread in particular is an important aspect.

In these two latter aspects, however, Europe is a long way behind the United States. One obvious difference between the US and Europe is that the banking system plays a much bigger role here. This

---

1 Heinemann, F & M Jopp (2002): *The Benefits of a Working European Retail Market for Financial Services*, Report to the European Financial Services Round Table.

2 *idem*.

has largely historical reasons, but it also has importance for the continued structural development of the financial system, since it has proved to be much more difficult to integrate financial institutions than financial markets. The most obvious trend in the banking system in Europe is the consolidation within individual countries into larger units. On the other hand, very few banks have established themselves in other countries, and the - relatively modest - consolidation that has occurred through cross-border mergers and acquisitions has not in general led to any radical change in the market within the EU for the services traditionally offered by the banks to households and small companies. Within this area of the banking sector there is still a substantial over-capacity in the EU, which seems to be taking some time to phase out. However, a number of banks in western Europe have expanded into eastern Europe and contributed to a modernisation of the banking systems in the former planned economies.

Internationalisation is a driving force

My point thus far is that most of the driving forces behind the developments in the financial sector are connected with increased international competition and an increased awareness of international opportunities, and that regulatory systems are also becoming more international. Within the legal community constituted by the EU, the financial legislation applies to all 15 member states, and the financial services action plan that is now on the agenda for implementation by 2005 will also affect the conditions for the operations of the financial sector in Sweden. In addition, the single currency creates a further dimension in the opportunities for bringing about a truly integrated financial market in the countries that have adopted the euro, in that it is more efficient to build up systems that can be used on a larger market than within smaller, individual currency areas. In order to benefit fully from this dimension, it is necessary to strengthen the incentives for making the infrastructure more efficient, in order to conduct cross-border trading in financial services, e.g. with regard to payments, clearing and settlement between operators in different countries.

Less detailed government rules and regulations for financial services

The political system, which has power over the rules and regulations for the financial sector, thus has important tasks with regard to ensuring that effective competition can be maintained and to reducing uncertainty regarding financial transactions. A number of initiatives are also being taken to strengthen financial integration. This involves the delicate task of prioritising between removing obstacles to cross-border operations and ensuring a fundamental consumer protection that does not have a discriminating effect.

Ten years after the white paper on the single market was to be realised, there are new action plans within the EU with the aim of removing the remaining obstacles to borderless trading in financial services. This should not necessarily be seen as a failure with regard to the initial ambitions, but is also a result of new trends in the financial system making new demands of the regulatory systems, which it is to be welcomed that the political system embraces. And there has also emerged a partially new view on the purposes of government rules and regulations, which has been a process that has taken some time as it is based on a long tradition of fairly detailed provisions regarding which transactions were allowed or forbidden and who should do what. This has applied at least to financial services primarily aimed at the household sector, which has made it difficult to continuously adapt the financial sector to changing market conditions and has entailed considerable costs for the consumers. Now the emphasis is on ensuring that those who produce the services are clear in showing what they have to offer and what risks may be involved in different financial commitments, which gives the customers greater scope to decide for themselves how they want to make their arrangements.

Continued pressure for political initiatives

The EU has high ambitions to make the European economies more efficient. At the summit meeting in Lisbon two years ago the heads of state and government adopted a strategy aimed at making the EU the most competitive, knowledge-based economic area in the world by the year 2010! Financial integration plays an important role in realising this strategy. Prior to the most recent informal meeting of the finance ministers and central bank governors in the EU, which took place in Oviedo in Spain, a working group had studied the conditions for speeding up financial integration. This group made a review of the important welfare functions of the financial system and referred to the profits that an efficient financial sector can generate. They also illustrated some of the obstacles that remain within the EU and which I have just mentioned. On the basis of its analysis, the group drew conclusions on what measures from the public sector could contribute to realising the political ambitions within the EU.

The finance ministers and central bank governors of the EU member states endorsed the group's conclusions. They thus emphasise once again that the 42 measures in the financial services action plan must indeed be implemented in the member states no later than 2005, in a way that opens up markets but does not create new obstacles to integration. Public supervision of financial activities needs to become more uniform within the EU, to enable operators with financial activities in several countries to be covered by similar conditions and to facilitate co-operation between the national supervisory authorities. Competition within the financial sector should be intensified, and in particular different financial operators should be afforded equal access to clearing and settlement systems. Furthermore, existing elements of tax discrimination should be identified and removed. The position of consumers should be strengthened by making it easier for them to obtain information on the financial services they wish to use. They may also need better support from consumer complaints boards in the EU member states, to fight for their rights, where needed.

General principles for regulation

In this list of measures I would personally like to draw attention to the principle that the regulations necessary for the financial sector should be more general in nature and be based on aspects such as transparency and openness in access to different markets. This creates the right conditions for active competition and for market forces to efficiently adapt to new trends in the supply of and demand for financial services. More general principles for prudential regulation also improves the scope for higher efficiency in the supervision of financial institutions - for the institutions which are obliged today to report to many different authorities, as well as for the authorities themselves who can follow the same principles in all countries.

Within the framework of clear rules that promote competition, there should be a general minimum protection for smaller consumers so that they do not risk being victims in the event of financial failures, e.g. in the form of a deposit guarantee for normal bank savings, and codes of conduct for operators on the financial markets to avoid abuse in the form of insider trading, etc. It is important to maintain a high level of confidence that institutions and markets will function in the way that the customers expect them to function. It is quite possible to combine a good general consumer protection with flexibility in the range of products which could make production more efficient. On the other hand, a far-reaching harmonisation of detailed conduct of business rules would probably involve greater costs for consumers than what they would stand to gain from completely harmonised services.

The principles that form the basis of the EU's regulatory framework for the financial sector are to a great extent based on this general orientation. The directives generally establish criteria of minimum harmonisation in order to enable financial operators to be active throughout the entire union. On this basis, authorisation and supervision should in principle be performed by the authorities within *one* member state, normally the home country of the institution in question. This "licence" to conduct financial operations should thus be recognised by the authorities in the other member states and financial institutions should be able to operate there from their establishments in their respective home country. In the same way, the EC directives on securities markets have led to some minimum harmonisation of the conditions for trade in financial instruments, e.g. what the issue prospectuses should contain and how insider trading could be limited.

Limitations in practice

The problem is that it is difficult to apply this model for rules and regulations fully when there are many different national peculiarities which are hard to do away with. This has therefore provided some scope for the authorities also in the host countries to apply supplementary provisions, which have in practice impeded cross-border competition. Such provisions are often attributed to some form of general good, which can be hard to define - and for which it is even harder to disclose a hidden protectionist background.

Another problem with the legislative work within the EU is that it has been so difficult to continuously modernise the rules and regulations and adapt them to new market conditions. The legislators have in several cases been one step behind the market, which has meant on the one hand that new products and operations may not have been encompassed by the new freedom of movement on the single market, and on the other hand that the protection the legislation aims to provide has been undermined. This problem came under particular focus last year, with regard to the securities markets within the EU, and a Committee of Wise Men headed by former EMI head Alexandre Lamfalussy proposed a simplified procedure for the entire legislation process. As you know, directives are adopted by the Council of Ministers and the European Parliament in a co-decision procedure, which is in itself a complex process and even more so when the directives include detailed provisions on what is to be regulated. A more efficient method would be to limit the directives to fundamental principles and to delegate the detailed design and further development to a special committee. Furthermore, by involving the national supervisory authorities closer in the legislation process, the idea is to make it easier and quicker to adapt the rules and regulations to new market trends and behaviour. Since the Lamfalussy Group's proposals touched on the delicate division of responsibilities between the Council of Ministers, the European Commission and the European Parliament, difficult negotiations have been needed to gain acceptance of the new model, but it is now being applied to the proposals for a directive presented most recently for the securities markets in the EU. Perhaps there are more pitfalls ahead in the work on making EU legislation on financial services more efficient, but ambitions for achieving results in this field have now clearly been raised.

Efficiency and stability must - and can - go hand in hand

So far I have talked a lot about the importance of efficient financial markets and effective means of adapting legislation to new conditions. However, measures to ensure the stability of the financial systems are at least as important. An economic policy aimed at macroeconomic stability is a fundamental precondition for a stable financial system. However, this is not sufficient in itself - special measures aimed directly at the financial system are also required. Regulations should ideally be worked out in consultation between the legislators and the supervisory authorities and the central banks in order to facilitate the different roles played by the authorities in promoting financial stability. I would like to emphasise that there is no contradiction between an increased significance for financial transactions and stable financial systems, provided that there are good opportunities to assess the realism and risks in financial commitments. The review of the capital adequacy rules for banks now being prepared is a good example of how the overall purposes or rules to maintain financial stability can be combined with good scope for individual banks to apply the regulations in a way that is effective for them. As the banks are enjoined to better monitor their own risks, a capital requirement that is adapted to their risk exposure is achieved de facto, without a need for detailed provisions in individual cases. This also builds into the system an assurance that fundamental stability can be maintained within the system without unnecessary encroachment on the efficiency of the financial sector.

An efficient monitoring of institutions and markets is central to being able to assess the risk of tensions that can nevertheless arise if over-investment financed by loans leads to financial bubbles and if regulations are abused. In particular, when the regulatory framework is made more general in character, great demands will be put on having sufficient resources and good competence at the authorities concerned in order to carry out the monitoring in a well-informed way. Here, it is also necessary to have an interplay between the central banks and supervisory authorities to implement existing regulations in a good manner. And the more integrated the financial sector becomes within the EU, the larger the number of people who will potentially be affected by such tensions or crises, which will make further demands for well-oiled channels for monitoring between different countries and concerning different types of financial activities. This involves not merely having good systems for mutually providing information on what is happening when things are going smoothly, but also maintaining a readiness to identify problems and intervene in acute crises that might arise and that could threaten the stability of the system. It is complicated to build up this kind of readiness when it comes to authorities in different countries with different traditions, different principals, responsibility for different parts of the financial system, etc., but it is nevertheless extremely important that the network co-operation in this field be developed further.

New requirements for co-ordination in supervision and oversight

The basic model for financial supervision within the EU is that it shall be carried out by national authorities and this is, in my opinion, the most natural and efficient means of keeping a watch over financial operators and markets. However, this requires that the supervision of other operations and markets that can affect financial conglomerates is also sufficiently co-ordinated.

Within the EU a discussion has come up as to which type of authority is best suited to exercise supervision of the financial system: the central banks with their overall responsibility for the safe and efficient functioning of the payment system, or independent financial supervisory authorities, which are not involved in monetary policy decisions that can have consequences for individual institutions. In Sweden we apply the latter model, which I consider to work well in our environment. On the one hand, the risk of a conflict of interests between monetary policy decisions and supervisory decisions will thereby be avoided, and on the other hand it provides scope for a co-ordinated supervision between financial operations pursued in different institutional forms, e.g. banking and insurance, within financial conglomerates. Other EU countries have other models and there are also ambitions from some quarters to change the division of responsibilities.

In my opinion, there is no reason to settle for a particular institutional solution for the supervisory work; it is more important to ensure the good functioning of the arrangements that apply. A larger issue that might have institutional consequences is whether it is sufficient in a more integrated EU to rely on co-operation and co-ordination between national authorities or whether a controlling authority is needed that can take on a leader role as required to ensure that the co-operation functions well. A discussion on this has recently been intensified within the EU and has also involved the question of what type of institution should in that case be the responsible authority at European level. Here I believe that it would be best to wait and see and to build upon the only path that there is currently political scope to realise, namely to ensure that the co-operation between the existing authorities functions efficiently.

Some conclusions

Financial integration is an ongoing process throughout the world and has positive welfare effects in all countries that accept it and ensure to adapt their regulatory framework to make it possible. International co-operation takes place within several bodies in order to develop the regulatory framework, and Sweden is affected in particular by the legislation within the EU. When designing the rules and regulations for the financial sector, it is most important to identify the essential elements for counteracting stability problems without making product development and efficiency more difficult. There are distinct advantages to focusing on an overall framework legislation without too many details, which would obscure the view and hamper continued adaptation.

When it comes to the implementation of the rules and regulations, co-operation is required between central banks and supervisory authorities in order to enable the financial system to develop effectively without risks to the overall stability. A general framework legislation does not make supervision simpler, but instead makes greater demands for competent analysis of operational conditions in the financial sector. At the Riksbank we have therefore invested in developing competence within our field of responsibility for the oversight of the payment system, which plays a central role with regard to the functioning of the whole financial sector.