Jean-Claude Trichet: Completing the creation of a fully integrated European capital market

Speech by Mr Jean-Claude Trichet, Governor of the Bank of France, at the Finance Foundation, Venice, 19 June 2003.

* * *

Ladies and gentlemen,

It's a great pleasure to be here with you today. Let me start by expressing my thanks to the Finance Foundation for inviting me to speak at this conference in Venice. I would like to take this opportunity to share with you some thoughts on the creation and the completion of an integrated European capital market.

One may first recall all the rewards of this march towards a truly integrated European capital market. The creation of this market is indeed the third layer of a process that began at the end of the eighties, with the Single European Act which formed the basis for the establishment of the internal single market for persons, goods, services and capital. The second layer was obviously the creation of the euro and the launch of the Monetary Union. And it is not a coincidence that the ambitious Financial Services Action Plan, which serves as the framework for conducting this integration, was launched precisely in 1999. Clearly, achieving a full integration of financial markets will allow our countries to reap the full benefits of these initial steps through a reduction in the cost of capital for businesses, a wider range of investment opportunities, an increasingly efficient allocation of capital. Ultimately, the positive contribution to economic growth can be hardly disputed. An independent study carried out for the European Commission concluded in November 2002 to a significant macroeconomic positive impact in the long run of a full integration of European financial markets, not only in terms of GDP, but also in terms of business investment and employment.

Needless to say, as a central banker, I attach great importance to financial markets integration: the implementation of the single monetary policy would not have been possible without an efficient and fully integrated money market. A high degree of integration of the securities market is also required because central banks' credit operations are fully collateralised and rely heavily on the smooth transfer of securities. Moreover, efficient and integrated markets favour a homogenous transmission of monetary policy actions across the euro area.

So where do we stand today? I think it is fair to recognise that significant progress has been made already in the integration of European Capital Markets. At the same time, one has to acknowledge that integration is an on-going process, that faces renewed challenges in a constantly evolving environment. Let me elaborate on these two aspects successively.

1. European capital markets already exhibit a high degree of integration

If one stands back and compares the organisation, functioning and structure of European financial markets today with the situation that prevailed five years ago, the magnitude of the changes that already took place is striking, not only in the various market segments but also in their infrastructures: indeed, the euro area already benefits from highly-integrated capital markets.

1.1 Naturally, it is on the **euro money market** that the highest degree of integration can be found, as a result of the unification of monetary policy, and thanks to the efficiency of the cross-country large-value payment system that support it, i.e. the TARGET system. Interest rates differentials between what are nowadays regional deposit markets have quickly vanished following the advent of the euro and the "law of one price" applies to the transactions conducted within a deep and highly liquid euro-area wide market. The recognition granted to **money market reference rates such as EONIA and Euribor**, the sheer development of derivatives markets based on these references - the **OIS-based swap market and Euribor futures and options contracts**, the impressive increase in **cross-border transactions** are illustrations of this already well-advanced, if not already completed unification. On the inter-bank market, cross-border transactions conducted with EU counterparties represent more than 50% of the whole inter-bank euro deposit business. Similar developments are recorded in the

repo market: the increasing share of non-domestic euro area collateral in transactions combined with the growing use of tri-party agreements, as well as the share of cross-border transactions - which is more than 50% - provide clear evidences of an increasingly integrated market.

1.2 Changes have also been impressive, albeit more contrasted, on the securities markets. The euro had clearly stimulated the rapid development of the **corporate bond markets**. The main reason is that the single currency has made corporate debt financing more attractive by creating a much larger home-currency investor base than it was the case for any single country of the area before EMU and encouraged international underwriting business for euro-denominated corporate bonds, driving down issuing costs. In 2002, corporate issuance represented about half of the overall bond issuance in the euro area, that is four times more than its share in 1998. In 2002, the gross issuance of euro-denominated bonds accounted for more than a third (38%) of all bond issues (US dollar issues: 47%). Not only have the size of the bond market grown, but also did its liquidity, transparency and standardisation. An increasingly competitive environment, and the development of electronic trading systems, contemporary to the launch of the euro, are among the factors that contributed to these improvements, on the secondary market for government debt initially, and increasingly nowadays on the corporate segment. In that regard, it is worth reminding the success story of the MTS group, an original Italian concept which has translated over a few years into a true pan European electronic platform for fixed-income products with offshoots throughout the continent.

Developments witnessed on the **short term securities market** may appear somewhat uneven and less dynamic. And indeed, efforts remain to be done as regards for instance products characteristics, issuers' information *memoranda* settlement practices in order for cross border activity to effectively develop and market integration to gather momentum. Reasons for optimism abound however: intensive discussions are currently going on between market participants and Eurosystem/ESCB experts on the range of actions that are needed to achieve the highest desirable level of standardisation. In that regard, an harmonised and consistent implementation across member states of the recently amended European directive on UCITS (Undertakings for Collective Investments in Transferable Securities) that extends the range of money market instruments available to mutual funds would certainly represent a major step towards the creation of a pan-European market for short term securities. Still, it is worth recalling that this situation has not prevented this market segment from experiencing a significant growth in issuance as well as in turnover. As illustrated by the developments on the French component of this market, the largest one in the euro zone, this trend has been fostered on the one hand by an increase in large issuance programs, notably by non-resident issuers, and on the other hand, by the development of the euro Asset Backed Commercial Paper (ABCP) market segment (19% of total outstanding amounts).

1.3 The implications of the launch of the euro have also been highly visible on the **equity markets**. The disappearance of currency risk within the euro area has led investors to shift from a domestic focus to a more international, sector-related one, and asset managers to develop European oriented investment funds to complement their originally domestic-focused funds. The successful introduction of a broad range of pan European and sector-based indexes, and the subsequent launch of derivatives and new investment vehicles such as Exchange Traded Funds (or "trackers") based on these new indices, highlights this change in investors' approach. Empirical evidence suggests indeed that sector-related factors are playing an increasing role in price dynamics. As integration enlarges the range of potential investors, it also fosters the development of private equity and the financing of young and innovative firms, a trend that is obviously welcomed.

1.4 Behind the scene, supporting the evolutions that I just touched upon, market infrastructures have undergone radical changes. As an example, as regards **trading infrastructures**, the creation and expansion of EURONEXT is a striking illustration of the on-going consolidation process: the EURONEXT group now links the French, Belgian, Dutch and Portuguese stock markets, and has concluded co-operation agreements with several other European markets. The group also significantly increased its presence on interest rates derivatives markets. This ongoing movement of consolidation **affects securities clearing, settlement and depository infrastructures**, as providers aim to propose an integrated transaction service covering the entire securities processing cycle. In the field of post-market infrastructures, CLEARNET is pursuing its pan-European expansion by completing its operational integration throughout the EURONEXT area. The clearing house also reached an agreement with its Italian counterpart, enabling it to offer central counterparty services for transactions executed on the Italian government securities market.

A similar consolidation process is taking place in the Central Securities Depositaries (CSD) area, paving the way for a more efficient functioning of Delivery Versus Payment (DVP) procedures, and easier and safer settlement of cross-border securities transactions. This latter aspect is of particular interest for the Eurosystem, as a smooth functioning of securities settlement infrastructures is key for an efficient implementation of monetary policy. Structural changes, such as the setting up of Euroclear's Single Settlement Engine, are of great interest in that regard: the so called Single Settlement Engine (SSE) by 2005 will enable participants to settle securities transactions on a delivery-versus-payment basis between the group's different depositories, more effectively than today and at a lower cost, without changing their interface or procedure. Moreover, the central banks of the five countries concerned are discussing mechanisms that would allow Euroclear participants to settle all their transactions in central bank money and on a real-time gross settlement basis with the central bank of their choice.

1.5 All these developments highlight the necessity to harmonise operational practices, to define common standards and to adopt new procedures for co-operation between supervisory authorities. To function properly, markets require a well designed legal and regulatory infrastructure. Since the institutional reforms advocated by the Lamfalussy Report were set in train in 2001, European integration has made significant headway. Let me emphasise how the Lamfalussy works were of utmost interest and greatly efficient.

Indeed, the "Lamfalussy" process has proved to be effective with a readjustment of the content of the texts between the legislative and regulatory levels and a shortening of the timeframe for the adoption of directives. The four-level regulatory approach of the Lamfalussy procedure is now fully operational, with the two bodies in charge of "comitology" - the European Securities Committee (ESC) and the Committee of European Securities Regulators (CESR) - working on the preparation of measures to implement directives, sometimes in parallel with the political negotiations.

As I have mentioned it earlier, the Financial Services Action Plan (FSAP) has endowed Europe with a coherent and market responsive regulatory framework. Up to now, 34 out of the 42 initially proposed measures have already been finalised, and I would like to remind you how impressive were the progress made in implementing the Financial Services Action Plan over the last six months: in addition to the directive on market abuse, adopted in January 2003, the directive updating the accounting provisions of the fourth and seventh Company Law directives and the directive on pension funds were adopted at the beginning of May 2003. Moreover, in February 2003, the European Council and Parliament agreed on a common position on the draft directive on prospectuses, which is expected to be adopted during the course of the year, as will probably be also the directive on taxation of savings income and even the new directive on take over bids. The majority of the key measures relating to securities market in the Action Plan are expected to be adopted before the end of this year or the spring 2004. Discussions and consultations continued in several crucial areas such as the overhaul of the Investment Services Directive - a cornerstone of the FSAP and a key area in terms of European financial integration and investors protection, post trading activities (clearing and settlement), the review of the capital requirements that apply to financial institutions and a framework for the supervision of the reinsurance sector.

2. Financial integration is an ongoing process with renewed challenges in a constantly changing environment

We can easily measure the significant progress that have already been made in terms of financial integration. However, and this is the second topic I wanted to touch upon, in a constantly changing environment, and as the integration process deepens, new challenges arise that need to be addressed and taken duly into account in our reflection on the integration of European financial markets. Preserving **financial stability** is obviously among those challenges. In that regard, there are two specific and crucial issues on which we need to concentrate our efforts: the deepening of **co-ordination among financial supervisors** and the **restoration of public confidence** in financial markets.

2.1 Central banks, as well as public authorities and market participants, have a collective responsibility to find the ways to ensure that market globalisation goes along with **financial stability**. Financial stability is a complex concept. Financial stability is a situation in which the various components of the financial system - financial markets, payment and securities settlement systems, clearing systems and financial institutions - function smoothly and without interruption, with each component proving resilient to potential shocks. It would certainly be excessive to consider that an increasing risk of financial instability is the price to pay to benefit from the increasing sophistication, interconnection and integration of the world's financial markets. This assumption remains to be borne out. But I would definitively advocate that the greater the interdependence, the greater the risks of contagion, the more we need to methodically and collectively search for ways and means to preclude the risks of financial instability, and prevent crises from spilling over at the global level.

By their very nature and position at the heart of the financial system, central banks attach great importance to financial stability: they are responsible for price stability which contributes to financial stability. In turn, a stable financial environment makes it easier to ensure price stability. The involvement of central banks in financial stability is hence rooted in their role as issuers of money. Central banks are also responsible for the smooth functioning and fluidity of financing and settlement channels: this is the reason for their responsibility in the oversight of payment and securities settlement systems, as well as for the responsibility they often have as regards prudential supervision of credit institutions. The creation of the Monetary Union hasn't altered these responsibilities. But it has clearly had an impact on the way their are conducted: the Eurosystem is by nature a teamwork, with built-in co-ordination mechanisms ensuring that appropriate answers are given to specific situations should they occur. The management of the 9/11 crisis offered, if need be, a good illustration of the responsiveness of the structure.

Let me now turn briefly to the two specific issues that I mentioned previously.

2.2 As the integration of our Capital markets deepens, it is of utmost importance, from a financial stability viewpoint, to rely on an efficient **financial and banking supervision framework**. Let me offer a few remarks on this question:

The success of the "Lamfalussy" process for financial markets has prompted EU authorities and Member States, through the Economic and Financial Committee and the ECOFIN, to propose its extension, inter alia, to the field of banking regulation and supervision. As a matter of principle, such an approach is welcomed, should it translate into a more flexible regulatory process and a more consistent implementation of EU regulation in Member States, and foster the convergence of supervisory practices. However, in this exercise, we must keep in mind the specificity of banking supervision and build on the accumulated experience of the relevant authorities: first, in this area, co-ordination structures have been already set up that work effectively as underlined for instance in the Brouwer reports. Second, in this area particularly, co-ordination between supervisors and Central Banks is key. An illustration of this can be found for instance in the Memorandum of Understanding on high-level principles of co-operation in crisis management situations that have been agreed on, in March 2003, between the EU banking supervisory authorities and central banks. Third, because banking supervision ultimately ends up into the surveillance of individual institutions, supervision at the national level and the role of domestic supervisors remain strategic. The specificity of this domain calls for the preservation of two major principles: the participation of supervisors and central banks to the drafting of regulation on the one hand, the permanent improvement of an efficient decentralised and highly co-operative supervisory approach on the other hand. Again, Memoranda of Understanding (MOU) currently organise the bilateral exchange of supervisory information, for instance covering the special information needs in case of financial troubles.

2.3 Second, I would like to focus on the necessary restoration **of public confidence in financial markets**. Over the past year, in both the United States and Europe, reforms have been undertaken in the area of corporate governance and financial disclosure with a view to restoring investor confidence in listed companies. These legal and regulatory reforms mainly concerns three areas: External and internal audit, financial transparency.

Both in the United States, through the Sarbanes-Oxley Act, and in Europe, at the level of the Commission as well as in Member States (I will only mention here the French Financial Security bill which is to adopted soon), a lot of work is being undertaken to address the problems that surfaced during the last three years in this field. I will limit myself to two comments that both evolve around the simple idea that co-ordination is crucial on these questions:

- Financial services are increasingly delivered on a global scale. The regulation and oversight of financial markets can no longer ignore the reality that measures taken by any country may have consequences outside that jurisdiction. Hence the necessity for a reinforced dialogue between regulators, central banks and market participants as a means for managing regulatory spill-overs or frictions that otherwise could occur in highly interdependent and increasingly integrated financial markets, and more generally addressing global financial stability issues. Let me recall that structures such as the Financial Stability Forum already play a widely recognised role in fostering these exchanges and promoting co-ordination. Such a dialogue is all the more necessary between the US and European authorities, as they represent the main financial centres. In that regard, the recent initiatives undertaken by the EU authorities are welcome. This dialogue should be the beginning of a sustained and deepening process of mutual understanding, co operation and, above all, commitment on transatlantic regulatory equivalence.

- Second, let me say a word concerning the current move towards a uniform body of accounting standards and the implementation of International Accounting Standards (IAS) for listed companies. Such a move is expected to bring about greater transparency and comparability in financial reporting. However, it is crucial that all the impact of such a major reform be carefully identified and analysed. In fact, as a Central Banker and a banking supervisor I have already expressed concerns on the potential impact of some of the proposed standards (namely IAS 32 and 39) on the balance sheets of credit institutions: the rationale for an extensive fair value approach needs to be pondered against the principle of prudence and the risk of introducing artificial volatility in banks' earnings and equity. These risks clearly show that the debate here is not only a technical one, and that standard setting bodies need to engage in a continuous dialogue with all interested parties, among them Central Banks and banking regulators. In this context, the recent decisions by the European Commission to re-examine this question is welcomed. More generally, any project of reform has to be precisely studied in order to take duly into account financial stability concerns and to prevent risks of hidden and counterproductive effects.

*

* *

Ladies and Gentlemen, I will have only one concluding remark. Financial Stability should not only be an expression for appropriate use in speeches to enrich our rhetoric. It must be a permanent goal of the entire International Community - as the setting up of the Financial Stabilty Forum has illustrated - and each and every piece of the global economic and financial system should be examined carefully and permanently through that grid.

Thank you for your attention.