Jean-Claude Trichet: The integration of European financial markets

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Deutsche Börse's New Year's Reception 2004, Frankfurt am Main, 26 January 2004.

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Introduction

Ladies and gentlemen,

Thanks very much for having invited me here today for the Deutsche Börse's New Year Reception.

I am probably at no better place and perhaps no better time to discuss with you our common objective of achieving financial market integration in the EU and the euro area in particular. I am at the right place because Deutsche Börse is undoubtedly a very important market player in the provision of European-wide financial services at the European and global level, as illustrated by the Chicago venture. Therefore, it should be well placed to exploit the opportunities flowing from the single financial market. And it is now an opportune time to reflect further on the overall process that will deliver integrated markets in Europe given that the Financial Services Action Plan is being finalised over the coming few months.

I believe that the key question for us - public authorities as well as market participants - is how we can contribute to the further integration of financial markets in Europe. In thinking about this question, I would like to focus my remarks on three particular aspects.

First, it is important to take stock of what the current situation is and how far we have come along the road towards fully integrated capital markets.

Second, in view of this audience, I would like to address the developments in securities markets, highlighting some of the most pressing challenges to further integration.

Finally, I would like to provide you with my thoughts about the possible elements of a forward-looking strategy for achieving financial market integration, involving both public authorities and market participants.

The integration of financial markets: state of play

The introduction of the euro now five years ago has undoubtedly led to larger, deeper and more integrated financial markets. This has been especially the case in wholesale markets, such as the unsecured money market, the government bond market and the related derivatives markets. These are of most direct interest to the ECB because of their close link with monetary policy.

Within the first weeks after the introduction of the euro, country differences in the overnight interbank rate fell to a level below the usual bid-ask spread, which is around 5 basis points, and there are good reasons to think that quickly thereafter it further declined to levels close to zero. Also the development in dispersions in the government bond yields reflect a growing integration of this market segment. As to the derivatives market, I do not have to recall here that Eurex has become the largest futures and options market for euro denominated derivatives, breaking new trading records last year by transacting over 1 billion contracts.

Progress also occurred, although at less impressive rates, in the corporate bond and equity markets. The elimination of the currency risk has diminished the importance of the local component in the securities business, with institutional investors increasingly taking a pan-European view in investment decisions. The corporate bond market has developed strongly and witnessed a large increase in issues since the introduction of the euro, although part of this increase was due to temporary factors, such as corporate restructuring and the liberalisation of the telecom industry. Over time, stock price variations in the euro area have become more sensitive to pan-European evolutions and new data and less to local informations and news.

However, not all wholesale markets are equally fully integrated, the repo market being a particularly special case. Participants in this market segment continue to trade preferentially with national counterparts and a significant share of the transactions are secured by national collateral. According to our data at the ECB, about 40% of all cash lending and borrowing against securities is conducted exclusively at the national level.

At this point, I would also highlight that the markets where integration has advanced the least are in the retail sector. In this area, there may well be structural explanations. For example, the proximity to the customer. I note that a great deal of market localisation is present in the U.S. in spite of the removal of barriers to intra-state and inter-state banking. According to a survey conducted by the Federal Reserve, more than 90% of banks' clientele is located within a distance of less than 20 miles of the banks' premises. I am convinced that the potential developments in new technologies and financial innovation will continue to exert their influence both in Europe and in the Unites States and may well make geographical proximity to customers less relevant. Public authorities also have a role to play in promoting the appropriate regulatory and supervisory environment that enhances investors' confidence in cross-border financial services.

The integration of securities markets

Given these general considerations I would like now to focus on the securities markets. I believe that perhaps more than in any other field, the trading and post-trading services in the securities industry are good examples to illustrate the scope for further integration and how we can contribute to it.

Let me start my discussion by stressing the importance of securities markets and the particular interest of the ECB. Securities trading, clearing and settlement are indeed at the core of our financial system and any inefficiencies in these processes are bound to have important negative implications. When trading, clearing and settlement are too costly or complex, financial transactions are discouraged. This in turn would have negative effects on the allocation of capital, risk sharing across agents, and economic growth. On its part, the ECB has a particular interest in integrated securities markets because all central bank credit operations need to be fully collateralised. The functioning of the payment system and the implementation of monetary policy therefore crucially depends on a smooth and efficient working of the securities clearing and settlement infrastructure.

Unfortunately, reality is quite different and substantial barriers continue to exist to efficient cross-border clearing and settlement, as identified by the Group headed by Alberto Giovannini. The European securities infrastructure today remains highly fragmented with over 30 national exchanges, about 20 national clearing and settlement institutions, and an additional 20 other systems in acceding countries. In this period of transition, we have to cope with a substantial degree of fragmentation of our securities infrastructure, which adversely affects market liquidity, leads to redundant investments in different systems, and requires additional layers of intermediation. Compared to, say the US, where the infrastructure has been over time highly consolidated, the costs of securities settlement are greater in Europe. Although it is very hard to calculate the benefit that we could gain from consolidation and therefore the opportunity cost of the remaining fragmentation, there can be no doubt that it is substantial.

I am of the opinion that there are good reasons to believe that integration in the European securities markets will accelerate in the future. The European trading and post-trading infrastructure is now in a period of consolidation, with technological and regulatory changes supporting the removal of barriers to the cross-border provision of services. The proposed new Investment Services Directive should simplify the regulatory framework and increase the uniformity of securities regulation. It will also lead to the effective adoption the single passport concept and contribute to safeguarding issuers and investors' interests. This would also be supported by the provisions of the Market Abuse and Prospectuses Directives. The adoption of an appropriate set of International Accounting Standards, as well as the proposed Transparency Directive, dealing with disclosure requirements of listed companies, should equally enhance investors' confidence and uphold the transparency of European equity markets. Overall, I also observe that there is an increasing sense of shared interests and aims among public authorities, market players and other stakeholders in securities markets. For example, market integrity issues are certainly seen more and more as a truly European concern.

In conclusion, I therefore foresee a great potential for further integration within securities markets, thereby fostering greater competition in this area.

Challenges for the further integration of securities markets

The optimism I express here should not make us forget that there are still considerable challenges ahead in the integration of securities markets. Let me outline those that I consider the most pressing.

First, the removal of remaining obstacles to competition. For example, the second Giovannini report identified three types of barriers to efficient and competitive markets: differences in technical requirements and market practice; differences in tax procedures; and issues relating to legal certainty. The ECB agrees with the general approach that promotes market-led solutions. But it also recognises that public authorities have a responsibility in this area and thus supports the work of the European Commission in seeking to remove some of these barriers. For its own part, the ECB contributes to removing obstacles to integration mainly by acting as a catalyst for improvement, encouraging discussions among the relevant players, and, last but not least, harmonising central bank procedures and operations. Ultimately, the final outcome will not only be the result of competition and market forces, but also of co-operation between market participants and public authorities.

The second challenge is developing a common market infrastructure. I use the term "infrastructure" here in its very broad meaning, covering areas such as trading platforms, clearing and settlement systems, standardised technical rules and market conventions. In effect, if we look closer at the reasons why some of the markets are more integrated than others, we are led to conclude that the presence of a common infrastructure is crucial.

Let me illustrate my argument with two examples. Integration in payment systems as well as in euro money markets was achieved very quickly after the introduction of the euro because of the existence of TARGET, the EU-wide large-value payment system operated by the Eurosystem. The Eurosystem has decided to introduce refinements to TARGET aimed at reinforcing the benefits that may be derived from a common infrastructure. In particular, the new system, TARGET 2, will aim at providing a harmonised level of services, with a single TARGET-wide price structure, while seeking cost effectiveness through a shared technical platform among the Eurosystem's central banks. TARGET is thus a clear illustration of how public authorities can contribute to financial integration by developing a common technical infrastructure. It is no coincidence that in the areas where such common infrastructure is missing, then integration is less well developed. The repo market, which is still hampered by a multitude of securities clearing and settlement systems, gives a still unfortunate example of that phenomenon.

Another example is the adoption of the EONIA rate, which underscores how market participants play an important role in fostering financial integration through the adoption of market conventions. The EONIA rate, which stands for Euro Over-Night Index Average, is the effective interest rate in the euro unsecured overnight interbank market. The technical definition and the procedures for calculation of the rate have been defined by market participants through a series of market conventions, which were key for the integration of this market segment. In this respect, I should also mention that ECB has a role in the process because it fixes the EONIA rate as a service to the banking sector. This illustrates that public bodies can indirectly foster financial integration by acting as a facilitator in private sector initiatives.

The third challenge is the design of public standards for risk management. Weaknesses in clearing and settlement arrangements can be a source of systemic risk. It is therefore paramount that effective risk management standards are applied by clearing and settlement systems. However, competition entails the risk that the service providers might try to improve competitiveness by applying more lenient risk management standards. Given the potential systemic effects of the failure of a major clearing and settlement system, the operators might assume that central banks will eventually bail it out and they might therefore not have sufficient incentives to address risks effectively. Against this background, the ECB takes the view that the establishment of public standards for risk management is essential. In fact, the Eurosystem has set such standards that securities settlement systems need to comply with in order to be eligible for the use in our credit operations.

All interested parties should be actively involved in the development and implementation of such standards. At the G10 level, standards for securities settlement systems have been developed by a Joint Task Force in which both the Committee on Payment and Settlement Systems (CPSS) and the International Organisation of Securities Commissions (IOSCO) are represented. The fruitful experience gained in this co-operation has encouraged similar work at the EU level. For this purpose, the ESCB has established a framework for co-operation with the Committee of European Securities Regulators (CESR), primarily aimed at assessing how the G10 recommendations should be implemented in Europe.

The post-FSAP period offers a unique window of opportunity

Finally, I will devote the last part of my remarks to some reflections on the strategy for financial integration going forward, now that the Financial Services Action Plan (FSAP) is approaching its completion. I believe that there is now an excellent opportunity to devise and engage in a strategy that delivers the full potential of financial integration. But in order to reap this potential, it is essential that a consistent post-FSAP strategy is adopted. I see several components in such strategy for public authorities and market participants. Let me begin with the role of public authorities.

First, it is crucial that authorities implement the FSAP measures, which provide the legal infrastructure for a single financial market, in a coherent manner. In this respect, I would highlight the provisions of the new Investment Services Directive, which will provide the single market for financial services with a core legislative framework. Furthermore, the Lamfalussy process of regulation and supervision, now being extended from the securities field to the banking and insurance sectors, will allow for more flexible and uniform technical regulations. This dynamic process should ultimately produce a genuine common financial legislation and regulation for market players, while respecting the principle of subsidiarity enshrined in the Treaty.

Second, there may be scope for simplifying the current regulatory framework, thereby reducing the corresponding regulatory burden on financial institutions. The implementation of FSAP measures and of the the so-called Lamfalussy approach should not, in any respect, lead to an additional layer of complex regulation - this would run counter to the spirit of the Single Market as it would not provide the right incentives for market participants to extend their activities throughout the EU. In this context, I want to recall that a main objective of the Lamfalussy process is to allow for more flexible and uniform technical regulations. If adopted ambitiously, such a process could lead to the development of a true EU rulebook to which institutions may refer directly for their cross-border business.

Third, promoting a robust supervisory and financial stability framework for integrated financial markets. As integration proceeds, financial institutions will increasingly engage in cross-border business. Furthermore, this is likely to bring a change in the transmission channels for systemic risk, notably as a result of a possible increase in the risks of cross-border contagion. Consequently, it is important that authorities - supervisors and central banks - seek to enhance co-operation and information exchange in order to monitor such developments and take co-ordinated action if required. Many steps have already been made in this direction. For instance, a Memorandum of Understanding between central banks and banking supervisory authorities on co-operation in crisis situations has been agreed upon in 2003.

Let me now turn to the role of market participants.

To complement the public sector initiatives I have just outlined, collective action by market participants at the European level is required. Let me provide two examples of where such collective action is needed.

First, it is crucial that market players participate and contribute actively to the European policy-making process. Let me recall that under the Lamfalussy process, market participants are being consulted extensively and called to contribute to the design of regulatory proposals and policy strategy. I note in this respect the European Commission's initiative of establishing expert groups to conduct a thorough assessment of the state of integration of European financial markets. As indicated by the Inter-Institutional Monitoring Group, there are considerable costs attached to consultation processes, for both authorities and market players. However, market participants could benefit from economies of scale in both costs and resources if collective action is co-ordinated more effectively at the European level.

Second, collective action of market players is also warranted in the area of market conventions. Markets do not function only on the basis of public regulation, but they also need rules devised by the market players themselves. Markets should not however remain segmented because of different national practices or the lack of product standardisation. The private sector should therefore establish such rules at the European level, possibly with the support of public authorities. The development of the EONIA overnight interest rate index I discussed earlier and the related role played by the ECB, is again a good illustration.

Concluding remarks

Ladies and gentlemen, let me conclude.

The potential gains from monetary union will only be fully realised if remaining barriers to integration of European financial markets are effectively removed. There is considerable evidence that wholesale markets are now much more integrated than before. But integration in securities markets needs to proceed further. Without an integrated European securities market the outcome of the entire process of financial market integration risks falling short of expectations.

The FSAP is now nearing completion. It is therefore important that we devise a coherent post-FSAP strategy. I have outlined my thoughts in this area, but I would invite you, as market participants, to also formulate your own ideas for furthering the process of financial integration. The final outcome of the will be the result not only of competitive pressure or policy decisions, but very much also of co-operation between market participants and public authorities.

I would however underline that given the speed of developments in financial markets, it is important that a post-FSAP strategy is implemented in a timely fashion, with clear milestones. Furthermore, such a post-FSAP strategy needs to be carefully and independently monitored and reviewed, in the same manner as the FSAP itself was. This would include regular reviews of the progress made on the various fronts, while ensuring the full accountability and transparency of the process. We have to make sure that the post-FSAP strategy proceeds in the right direction and at the right speed.

Ladies and gentlemen, with this challenging message for the future I want to conclude. I thank you for your attention and let me wish you all the best for 2004.