Klaus Liebscher: Financial deregulation in the EU – chances and challenges for financial stability

Speech by Dr Klaus Liebscher, Governor of the Austrian National Bank, to the 5th Annual CSI Conference - "New Agenda of the WTO: Challenge and Contribution of the European Union", Innsbruck, 18 November 2005.

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Ladies and gentlemen!

It was with great pleasure that I accepted your invitation to again take part in the annual conference of the Centre for the Study of International Institutions (CSI). I feel honoured that the speech by the Governor of the Oesterreichische Nationalbank has obviously become a traditional part of this conference.

The liberalisation of trade in goods and services was at the centre of your discussions in the previous days. World trade is, after all, the most visible example of global economic integration. As a result of numerous trade agreements and tariff reductions, global exports have increased from one-tenth of world GDP in the early 1970s to one-quarter of world GDP today.

A less visible, but even more dynamic recent phenomenon is global <u>financial integration</u>. Some decades ago, the realisation of investment projects depended largely on the availability of capital in the local economy. Meanwhile, both fund raising and investment occurs at an international level, which can be attributed mainly to the deregulation of capital movements. In the 1970s, worldwide cross-border holdings of assets amounted to only <u>one-tenth</u> of world GDP. Now, countries have accumulated foreign assets <u>equivalent</u> to the annual GDP of the entire world.

Over the past 30 years, annual foreign direct investment (FDI) worldwide grew from around EUR 8.5 billion to almost EUR 1 thousand billion – half of which is provided by the European corporate sector. At the same time, half of world FDI is invested in Europe. For Europe, these international linkages are of particular importance, and they illustrate that regional economic integration does not hinder global integration, but foster it.

Before taking a closer look at the European process of deregulation and integration, let me reflect a little on the <u>objectives</u> of financial integration: The integration of national financial markets, which used to be subject to entry barriers as well as different national regulations, practices and currencies, aims at fueling competition, reducing transaction costs and creating markets which are deeper, more liquid and more efficient. Cross-border integration requires the removal of entry barriers, the convergence of legal, supervisory and fiscal conditions underlying financial markets, the harmonisation of financial standards and the creation of common payment, clearing and settlement systems. To a certain extent, the geographical dimension of financial market integration is brought about by institutional integration. This comprises the cross-border consolidation and expansion of financial institutions, the main purposes of which are to make use of economies of scale and scope, and to improve risk diversification.

Let me start with a rundown of the milestones of <u>European financial integration</u>, which began several decades ago and is still an ongoing process.

- The Treaty of Rome, signed in 1957, contained the basic principles for the creation of a single European market for financial services.
- In 1985, the Single Market Programme provided a general strategy based on minimum harmonisation of standards, a "single passport" and the mutual recognition of a financial firm's licence obtained in one EU member state.
- In 1987, the Single European Act entered into force with the aim of establishing a single European market including free movement of capital.
- From 1999 onwards, European financial integration gathered additional momentum with the introduction of the euro and the Financial Services Action Plan (FSAP). The adoption of the single currency eliminated currency risk for the Member States of the euro area and at the same time made it easier for borrowers and investors to take advantage of borrowing and investment opportunities within the euro area. The purpose of the FSAP was to complete by

2005 the legal framework enabling the effective exercise of market freedoms in financial services throughout the European Union.

- The Lisbon Agenda, launched in 2000, gave further stimulus to the integration process by enhancing structural reforms in order to increase competitiveness.

What has been achieved so far with respect to European financial integration? To answer this question, I am referring to a new report published by the ECB with the aim of monitoring the progress of financial integration in the euro area. Both this report and the European Commission's Financial Integration Monitor for 2004 point out that the integration of financial markets has deepened considerably in the recent past, but its degree varies widely among markets. Generally, it can be said that the integration of a market segment is the more advanced the closer it is to the single monetary policy.

The introduction of the euro has entailed the quasi-perfect integration of the unsecured euro money market, which has been reflected in the disappearance of differences in short-term interest rates. The secured money market has not yet been fully integrated due to national differences in securities and fragmented securities settlement systems.

A high degree of integration has been achieved in euro-denominated government bond markets as well. It is true that the integration of these markets had already been progressing in the run-up to monetary union, in particular from the mid-1990s. For ten-year government bonds, the maximum yield spread between euro area countries (except for Greece) has decreased from more than 250 basis points in 1995 to between 20 and 30 basis points after 1999. The remaining differences in long-term bond yields within the euro area can be mainly attributed to varying levels of market liquidity, to the availability of derivatives markets and to the credit risk of the respective issuer.

In the corporate bond market, integration has accelerated as well, which has been reflected in reduced interest rate differentials within Europe and in the growing percentage of foreign market participants.

The indicators for the euro area equity market suggest that the degree of integration is rising, although room for further integration remains. As in the case of the secured money market, national legal provisions and fragmented securities settlement systems prevent the integration process in the stock and bond markets from deepening more fully.

As regards banking markets in the euro area, the ECB integration indicators show that retail banking is generally far less integrated than wholesale banking and banks' capital market-related activities. Cross-border inter-bank loans and cross-border holdings of securities have, in relative terms, experienced substantial growth.

Cross-border loans of euro area monetary financial institutions (MFI) to other euro area countries have increased from 15% at the end of 1997 to 23% in the middle of 2005. At the end of 1997, 15% of securities held by euro area MFIs were issued by non-MFIs of another euro area country. This share has now reached almost 40%.

In contrast, the level of banks' cross-border retail lending activity within the euro area increased only slightly from a mere 2% at the end of 1997 to around 3.5% today. The main reasons for the lesser integration in retail banking are the local marketing and distribution channels used in retail banking, customer relations that are still excellent in these markets and the better reputation of long-established institutions.

Another indicator for the level of integration of financial markets is the share of cross-border mergers and acquisitions (M&A) in total M&A transactions. This share is still comparatively modest and increasing only slightly. Of the almost EUR 500 billion worth of intra-EU mergers and acquisitions in the financial sector between 1999 and 2004 only about 20% were cross-border deals. The reasons for the low level of cross-border M&A activities are legal and tax barriers, differing supervisory rules and requirements as well as economic hurdles, like non-overlapping fixed costs, which cannot be spread over several countries. Although cross-border M&A activity has been relatively limited in the EU, recent high profile acquisitions of Bayerische Hypo- und Vereinsbank and BA-CA by Unicredit or Abbey National's acquisition of Banco Santander Central Hispano may mark a turning point.

As regards cross-border mergers and acquisitions, the Austrian financial sector could be considered as an exemption. In particular Austrian banks' activities in Central and Eastern Europe are outstanding. Austrian banks, for example, were among the first to invest in this region and are now the biggest investors with a market share of about 22% on an average basis over the region. Relatively low domestic profitability, geographical proximity and historical ties as well as above-average growth and profit potential were key reasons for banks' pioneering role in investing there.

To sum up, it can be argued that financial integration in the euro area

- is nearly perfect in the money market,
- has advanced considerably in the government bond market,
- has increased in the corporate bond and equity markets,
- differs widely among various banking market segments, and
- has just begun in terms of cross-border consolidation of financial institutions.

In other words, financial integration – though having progressed significantly in a number of markets – is still an ongoing process in the euro area and in the EU. As the FSAP has nearly been completed and the priorities for the next five years are being reflected on, we are now at a decisive moment as regards financial integration in the years to come.

This spring, the European Commission released the Green Paper on Financial Services Policy, which looks ahead to the period up to 2010. It aims primarily at consolidating and simplifying the existing Community legislation, while ensuring that the measures adopted thus far under the FSAP are effectively and consistently implemented and enforced at the national level. In this paper, the Commission also argues for a better regulation approach in order to ensure that any new European proposal for financial services legislation and implementing rules will yield significant economic benefits in terms of efficiency and stability. In order to meet this objective, the Commission inter alia intends to conduct open and transparent consultation at all levels, to establish thorough economic impact assessments before launching a new proposal and to carry out ex-post evaluation. The Commission's final policy programme for the next five years is expected to be published in the form of a White paper before the end of this month.

Also the European System of Central Banks (ESCB) contributes to improving financial integration by replacing the euro area's current decentralized payment system with a single technical platform, called TARGET2. It will increase cost-effectiveness and allow for the provision of a harmonised level of services across Europe, supported by the implementation of a single price structure for domestic and cross-border payments.

In addition to the wholesale financial infrastructure, I would like to mention the field of retail payments, namely the Single Euro Payments Area (SEPA) project, an initiative of the European banking industry, which will go live in 2008. The SEPA will enable European citizens and enterprises to make payments throughout the euro area from a single bank account using a single set of payment instruments, as easily and safely as they do today in the national systems. In addition, national infrastructures should migrate to a pan-European payments infrastructure by the end of 2010, which means that investments in the next generation of national systems should be made from a pan-European perspective in order to ensure compliance with the SEPA.

I have so far spent a fair amount of time taking stock of the development and present state of financial integration in Europe. After all this, it is time to ask: What are the chances and challenges of financial deregulation and integration for financial stability? And what, in fact, is meant by financial stability?

In brief, financial stability is a condition where the financial system, comprising financial institutions, financial markets and financial infrastructures, is capable of directing capital to its most profitable risk-adjusted use without major disturbances.

How can financial integration in the EU contribute to financial stability? According to the definition given above, the stability of a liberalised financial system ties in with efficiency, namely the capability of allocating capital in the most efficient manner. Thus, increased efficiency brought about by the integration process produces a higher degree of stability, at least in the long run.

In the EU, the elimination of entry barriers and the harmonisation of regulations intensified competition in financial markets. Moreover, the introduction of the euro made capital allocation more efficient, since it eliminated the costs for foreign exchange transaction and hedging, and made prices easier to compare.

Increased integration is undoubtedly beneficial for structural progress and efficiency. Greater competitive pressure compelled financial intermediaries to offer price concessions to their customers, which reduced transaction costs and consequently facilitated a more efficient allocation of financial resources. By contrast, higher competition may lead to a reduction in interest rate margins and without a compensating rise in cost efficiency might adversely influence banks' profitability. As a result, banks may be tempted to loosen their credit policies and take on more risk in search for maintaining profitability. Ensuring that banks' risk monitoring capacities keep up with this process and additional risk is properly priced is a major challenge.

Free access to the financial markets of the other EU member states, roughly equal competitive conditions and the introduction of the euro have enabled European financial institutions and investors to diversify regional risk more broadly. In other words, they have been able to reduce the "home bias" of their investments.

Let me give you one example: Austrian mutual funds saw the percentage of their capital invested abroad increase from about 30% in 1995 to almost 75% in 2004. The broader regional basis for financial investment has made financial stability of individual member countries less vulnerable to asymmetric (country-specific) shocks than it would have been if financial investment had been concentrated regionally.

Not only has the participation in the economic and monetary integration process offered domestic financial intermediaries more possibilities of protecting themselves against country-specific shocks, but it has also reduced the probability of large shocks which could endanger financial stability.

The degree of asymmetry of country-specific shocks, for instance, has decreased simply due to the ever-closer economic relations between EU member states. Economic disturbances brought about by exchange rate shocks are no longer possible in the euro area. The same holds true for interest rate fluctuations caused by speculative attacks against single national currencies, such as those that occurred frequently within the exchange rate mechanism of the European Monetary System.

Finally, financial integration is an important factor in improving market discipline and in adopting internationally recognised best practices with respect to corporate governance, transparency, risk management techniques etc. The implementation of such practices clearly supports financial stability.

However, the rapid integration of financial markets across borders is not without risks. There are initial adjustment costs, which are sometimes concentrated on specific regions and sectors. In order to maximise long-term benefits of financial integration, countries aspiring closer integration with other economic areas have to modify at least part of their institutional and structural environment, which results in costs that are often front-loaded.

For example, the introduction of the euro caused significant setbacks in certain types of banks' earnings, especially in the fields of international payments, money exchange, interest arbitrage and hedging against exchange rate risks. In addition, the increase in competition brought about by the common currency also had some adverse effects on commission and interest income of financial institutions. Financial intermediaries that were not able to offset the decline in earnings by cutting costs saw profits decrease and hence their risk-bearing capacity weaken. When the institutions affected, however, responded to the setbacks in earnings by increasing their cost efficiency, financial stability was not compromised. A typical strategy of cutting costs in the process of integration consists in taking advantage of economies of scale and scope produced by vertical and horizontal integration of financial institutions on a domestic or cross-border basis. Merging two or more institutions into one with a single management structure is an obvious strategy for companies which want to gain influence in the single financial market beyond their home region and to reduce costs.

However, mergers and acquisitions in the financial sector – no matter whether they are national or cross-border events – increase both the market power and the systemic relevance of individual institutions. The influence of these institutions may be so great that the whole financial system of certain countries is "at their mercy". Aside from the problematic concentration of stability risks, in dominant financial institutions there is also a greater danger that their management is tempted to succumb to moral hasard by assuming that their businesses were too big to fail.

On the other hand, large financial institutions usually have a more advanced risk management system, which promotes financial stability. When consolidating financial institutions of different sectors into financial conglomerates additional stability risks arise, such as regulatory arbitrage, complexity and contagion. An increased risk of contagion exists not only for cross-sectoral integration, but also for cross-border integration. This can be the result of the expansion of financial institutions into other EU member states. As a case in point, the banking sectors of the new member states (NMS) are particularly characterised by high levels of foreign ownership. In 2004, on aggregate, 71% of total assets of the NMS banking sector were foreign-controlled compared to only 15.5% in the euro area.

Other factors promoting cross-border integration of financial institutions are the common money market, common payment systems and the increasing importance of inter-bank business. From the perspective of financial stability, the increased potential risk of a spill-over of foreign financial crises into the domestic market in the wake of integration mirrors the decreased susceptibility to asymmetric financial crises at home.

What can be done to intensify the effects promoting financial stability and to weaken those reducing it? To be brief, EU member states have to co-operate closely in financial market regulation, financial market integration and crisis management. Only this can ensure that financial institutions, whose organisation and activities are more and more of a cross-border type, can be regulated and supervised in an appropriate manner. And this co-operation is indispensable for preventing regulatory and supervisory arbitrage.

The EU's approach in this context consists in bilateral and multilateral co-operation between national regulators and supervisors, which has been reinforced by the Lamfalussy process, which represents a move from minimum harmonisation to the adoption of a level playing field.

In the banking system, for example, the supervisory regime within the EU is based on three pillars. The first pillar can be described as harmonisation of minimum supervisory requirements and mutual recognition. The second pillar is based on the principle of national responsibility for the (operational) supervision of the financial institutions in question. The third pillar focuses on the co-operation between national regulators and supervisors. Within the ESCB, central banks and banking supervisors work together in the Banking Supervision Committee (BSC), which addresses mainly macro-prudential issues. At the EU level, co-operation has been intensified in the European Banking Committee (EBC), which is composed of finance ministry representatives, and in the Committee of European Banking Supervisors (CEBS), comprising banking supervisory authorities and central banks from the European Economic Area (EEA), including the OeNB.

CEBS is a so-called level-3 Lamfalussy-committee and particularly aims at achieving supervisory convergence and establishing supervisory networks in order to ensure efficient and effective supervision of cross-border banking groups. These efforts cover both day-to-day supervision as well as crisis situations, and for the latter purpose a joint Task Force has been established together with the BSC.

Co-operation in crisis management, for example efforts to minimize negative effects of financial crises, can surely be intensified. The second Brouwer report, which had been commissioned by the Council of Economics and Finance Ministers, stated and confirmed that, above all, further improvements in information sharing were necessary.

This proposal was taken up, for instance, in a multilateral Memorandum of Understanding on co-operation between the banking supervisors, central banks and finance ministries of the EU in financial crises situations.

In concluding, I am convinced that the process of European financial integration is on track. However, to deepen integration, a lot of efforts are still necessary. Nevertheless, I sincerely do believe that we will be able to handle these issues in good time and shall then be able to appreciate the benefits of integrated financial markets in Europe.