Lucas Papademos: Financial integration in Europe

Presentation by Mr Lucas Papademos, Vice President of the European Central Bank, at the press briefing on the occasion of the publication of the second edition of the ECB Report on financial integration in Europe, Frankfurt am Main, 29 April 2008.

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I. Introduction

Ladies and Gentlemen,

On behalf of the Executive Board of the European Central Bank, I would like to welcome you to this press briefing on the occasion of the publication of the second edition of the ECB's report on "Financial Integration in Europe".

The first report on "Financial integration in Europe" was published last year and we intend to release it annually. Its main purpose is to contribute towards the advancement of European financial integration and to raise public awareness of the Eurosystem's role in supporting the financial integration process.

Before I turn to the content of the report, let me briefly recall why we prepare and publish this report. The Eurosystem has a strong interest in the integration and the efficient functioning of the financial system in Europe, particularly in the euro area, because it facilitates the performance of our core tasks.

Starting with monetary policy, a well-integrated financial system facilitates the transmission of monetary policy throughout the euro area. Financial integration is also highly relevant to the Eurosystem's role in safeguarding the stability of the financial system. More integrated financial markets enhance the opportunities for sharing and diversifying risk and increase the market liquidity. At the same time, a more closely integrated financial system also raises the scope for spill-over effects and contagion across borders, as the recent financial market turmoil has manifested. Financial integration is also fundamental to our task of promoting the smooth operation of payment systems and of securities clearing and settlement systems. Finally, without prejudice to our primary objective of price stability, we support the general economic policies of the European Union. The completion of a single market for capital and financial services is an important policy priority which should foster the efficiency and development of the European financial system and help increase potential growth.

The ECB and the entire Eurosystem fully support the efforts of the private sector and the EU institutions to enhance the integration and development of the European financial system. In this respect, the ECB works very closely with the European Commission, which has a primary responsibility in this field. The ECB report complements the work of the Commission in this area. I now turn to the content of the report and will highlight some of the main findings.

The report consists of three chapters [see slide 2]. The first chapter sets out the ECB's assessment of the state of financial integration in the euro area. This assessment is based on a set of quantitative indicators we have developed. The second chapter contains in-depth analyses of selected issues relating to financial integration. The final chapter of the report gives an overview of the activities of the Eurosystem in 2007 aimed at advancing the integration and development of financial markets in Europe.

II. The state of financial integration in Europe

Let me start with the ECB's assessment of the state of financial integration in the euro area which covers the money, bond, equity and banking markets, as well as the underlying market infrastructures. The tables on this slide [see slide 3] and on the following one summarise our assessment of the degree of integration in the various market segments. Two key facts should be highlighted: first, financial integration is generally more advanced in those market segments that are closer to the single monetary policy; and, second, it depends on the degree of integration of the respective market infrastructures. These conclusions confirm the findings of last year's report.

In particular, the unsecured money market has been fully integrated since the introduction of the euro, and the repo market is also highly integrated. The full integration of the large-value payment systems has been instrumental in achieving this result. Government bond markets have also become considerably integrated. Similarly, the corporate bond market received a major boost with the introduction of the euro and has subsequently achieved a high degree of integration. Some progress has also been made in the integration of euro area equity markets, although the euro area securities infrastructure that underpins both bond and equity markets is not yet sufficiently integrated. However, efforts to reduce these barriers are currently under way.

Turning to the banking markets [see slide 4], integration has advanced well in the fields of wholesale banking and capital-market activities. The integration of the retail banking market has, however, been slow and hampered by the fragmentation of the European payment systems.

After this broad overview, allow me to illustrate some specific developments in particular market segments, also with reference to the recent episode of financial turbulence. In this context, a pertinent question is whether the financial market turmoil has had an impact on the degree of integration in various market segments. First, with regard to the nearly fully integrated money markets, the recent financial turmoil has undoubtedly left a mark on the cross-country standard deviation of the unsecured interbank lending rates, as you can see from this chart [see slide 5]. Looking at this graph, one may wonder whether the turmoil has in fact led to a higher segmentation, and therefore, less integration, in the market.

In response, let me now show you a related indicator for the secured money market which strongly suggests that this is not likely to be the case. As you see in the chart [see slide 6], the cross-country standard deviation of the interbank repo rates does not seem to have been similarly affected. As credit risk is an important element in the unsecured markets, but not so in the secured markets, this may lead us to conclude that the increase in differences in credit risk across institutions, rather than increased segmentation, is the likely explanation for the observed small but noticeable increase in the cross-country standard deviation in interbank lending rates. Of course, we continue to monitor the evolution of these and other indicators very closely in the coming months in order to obtain more information on the possible effects of the turmoil on the money markets as well as on other financial markets.

I already mentioned that retail banking markets continue to be less integrated than other banking market segments. The dispersion of total assets of euro area bank branches and subsidiaries across euro area countries illustrates the point [see slide 7]. The horizontal line within the pillars shows the median share of assets for both types of establishments. Whereas the median share of assets of foreign subsidiaries increased to 14.4% last year, the median share of assets of foreign branches slightly decreased, reaching 2.0%.

III. Special features

The second chapter of the report contains four "Special Features". These are in-depth assessments of policy issues relating to financial integration that are of particular relevance to the Eurosystem's tasks [see slide 8]. This year, we selected the following topics: (1) concepts and measures of financial development; (2) the STEP initiative; (3) the integration and development of mortgage markets; and (4) the integration of large-value payment and securities transactions. Out of these four, I should like to focus on two, namely on financial development and on the integration of mortgage markets.

III.1. Financial development

The special feature on financial development goes beyond financial integration and looks into other elements that affect the performance of the financial system [see slide 9]. The concept of financial development is introduced and is related to other concepts such as financial integration, efficiency and stability. More precisely, financial development refers to the process of financial innovation, institutional and organisational improvements that reduce asymmetric information, increase the completeness of markets and contracting possibilities, lower transaction costs, and enhance competition. In particular, financial development is complementary to financial integration in reducing market frictions and fostering financial market efficiency.

This chart [see slide 10] presents a simple framework to summarise the determinants of the performance of the financial system and its links to the performance of the broader economy. There are three levels of analysis. The first level concerns the fundamentals of the financial system that do not change very fast, such as legal and regulatory frameworks or features of the economy's financial structure. The second level relates to the performance of the financial system, that is, its efficiency and stability. The third level focuses on the performance of the economy as a whole, that is, economic growth and price stability. As you can see, financial integration and financial development are processes that influence the relationship between the fundamentals of the financial system and its performance.

A selection of indicators is provided in this Special Feature to monitor financial development and efficiency [see slide 11]. These indicators can be grouped into general and market-specific indicators. An example of general indicators is the size of capital markets, which aggregates the sizes of stock, bond and loan markets, as a percentage of GDP. On average, euro area capital markets tend to be smaller than those in the United Kingdom and the United States.

Let me continue with some examples of market-specific indicators. This chart [see slide 12] shows the notional amounts of nominal outstanding interest rate derivatives, that is, forward rate agreements, options, and swaps, by currency. By using derivatives, market participants can better manage risks, lock in the future price of the underlying assets and even alter the terms of the underlying financial contract. As a consequence, the allocation of capital and risk across time and space is improved. The chart clearly shows that the most active interest rate derivative markets are those denominated in euro and in the US dollar, with outstanding amounts in 2006 of 86 and 75 trillion euro, respectively.

Focusing on the evolution of the interest rate derivatives market over time, this chart [see slide 13] shows that the US-dollar denominated interest rate derivatives grew the fastest, with the amount outstanding increasing sixfold. The second fastest growing markets were the interest rate derivatives denominated in euro and in pound sterling, which both quadrupled from 1999 to 2006.

Securitisation of illiquid bank assets is a form of financial innovation that has expanded substantially in recent years. This chart [see slide 14] shows the extent of off-balance sheet securitisation via asset-backed and mortgage-backed securities relative to gross domestic product (GDP), using the location of the underlying collateral to link this financial innovation to countries. According to this indicator, the United States is by far the most active market for securitising mortgages and receivables such as car loans or credit card loans: the volume of issuance amounted to 25% of GDP. In the euro area, the average volume of issuance was only 2% of the GDP, with Spain, the Netherlands, Luxemburg, Ireland and Portugal having the highest levels. The lack of integration in European mortgage markets partly explains these facts. It also suggests that the ease with which issuers of asset-backed securities in one country can include illiquid assets from other European countries is an important factor that will influence the evolution of securitisation in Europe.

Another example of a market-specific indicator of financial development is the total amount of venture capital financing as a share of GDP [see slide 15]. Despite having grown substantially over the past ten years, venture capital financing remains only a fraction of the UK and US figures in most euro area countries, with the exception of Finland.

To sum up, on the basis of the indicators identified so far, it can be concluded that there still exists a fair degree of heterogeneity in financial development across markets and countries in the euro area. On average, the euro area financial system compares well to a group of benchmark countries, except perhaps relative to the United Kingdom and the United States, which perform better on the basis of most of the indicators presented in the report. There is certainly room for further analysis and assessment of financial development by enhancing the existing indicators and by identifying new ones. And there is room for structural reforms that can foster financial market efficiency.

III.2. The Short-Term European Paper (STEP) initiative

The second Special Feature, entitled "The STEP initiative", describes how the ECB and the Eurosystem can act as a catalyst for private sector activities and, in this way, promote financial integration in the euro area [see slide 17]. The Short-Term European Paper (STEP) initiative to develop a pan-European short-term paper market originated from the observation that the short-term securities market had been the least integrated money market segment since the introduction of the euro. The STEP label, given to issuance programmes that comply with a core set of commonly agreed market standards and practices, provides market participants across the euro area with a common framework. Since its launch in 2006, the STEP initiative has already yielded significant progress in market integration and transparency.

III.3. Mortgage markets in Europe

The third special feature of the Report on which I will elaborate, given its topicality, concerns the integration and development of mortgage markets in Europe. Mortgage markets are an important part of the euro area financial system: the provision of mortgage loans is a key financial service for households; mortgages accounted for almost 30% of total bank loans and about 60% of the household liabilities; and asset-backed securities – of which mortgage-backed securities represent a large share – have become an important source of collateral, accounting for approximately 16% of all collateral deposited with the Eurosystem, a slightly larger fraction than central government bonds.

Mortgage markets are very important, yet they remain one of the least integrated financial markets in Europe and progress towards further integration has been slow. This is partly due to natural barriers, such as language, affinity and consumer preferences. However, other factors such as domestic infrastructures and differing legal and consumer protection frameworks create barriers that can, and should, be addressed by policy-makers and market participants.

The chart on slide 19 on new housing loans in euro area countries, classified by the period of interest rate fixation, illustrates the diversity in the mortgage lending markets. In general, not only the use of fixed and variable rate mortgages, but also early repayment and prepayment options and loan maturities vary considerably across the euro area.

Similarly, diversity prevails on the funding side of mortgage markets. The chart on slide 20 illustrates the relative importance of residential mortgage-backed securities (RMBSs) and covered bonds in the national markets. The dominance of only one type of instrument in most countries is related to the presence of long-established legal frameworks, or the existence of certain legal or other obstacles. Consequently, there seems to be room to improve the availability of different mortgage funding instruments in euro area countries as well as in other EU countries.

This Special Feature examines in considerable detail the potential implications of further integration in European mortgage markets for the monetary policy transmission mechanism and for financial stability. Overall, the Eurosystem's assessment is that further integration of mortgage markets is desirable because it is likely to bring about a more uniform transmission of monetary impulses and a more stable financial system as a result of improved risk diversification [see slide 21]. At the same time, the process of financial integration may entail certain risks to monetary and financial stability, such as increased vulnerability of domestic financial systems to external shocks and intense competition that may lead to an erosion of credit standards. So while we strongly support further integration in mortgage markets, we are also of the view that this process should be carefully monitored.

That said, full integration of mortgage markets is a process that is likely to take many years and will largely be driven by market forces [see slide 22]. We believe that market participants' actions will help achieve significant further progress. For example, they can increase market transparency, improve statistics, promote standardised mortgage products and develop market benchmarks. Within the scope of its competencies, the ECB stands ready to support such market initiatives, as we have done in the area of short-term securities.

III.4. Integration of large-value payment and securities transactions: TARGET2, T2S, CCBM2

The final Special Feature, entitled "Integration of large-value payment and securities transactions: TARGET2, TARGET2-Securities and CCBM2", considers the advances towards an integrated and well-functioning European market infrastructure, focusing on the contribution of the Eurosystem [see slide 23]. During the run-up to the introduction of the euro, the Eurosystem established the TARGET system and the Correspondent Central Banking Model (CCBM) which enabled the area-wide settlement of large-value transactions in central bank money and the cross-border delivery of collateral to the Eurosystem. While these were undoubtedly already major steps towards the integration of crucial market infrastructures, TARGET and CCBM did not yet allow market participants to manage their cash, collateral and securities positions in an integrated way. The recent establishment of TARGET2 as a centralised technical service addresses this shortcoming for euro-denominated large-value and urgent payments. It also enables the move towards a fully integrated infrastructure in the fields of securities settlement, liquidity and collateral management. The envisaged TARGET2-Securities project and the Collateral Central Bank Management (CCBM2) facilities, together with TARGET 2, are "second generation" services, which represent a quantum leap forward in the integration and quality of the euro area core infrastructure, with substantial benefits for financial market integration.

IV. Eurosystem activities to promote financial integration

I now turn to the report's third chapter, titled "Eurosystem activities for financial integration". It provides an overview of the main Eurosystem activities in 2007. The ECB and the Eurosystem contributed to financial integration and development in a number of ways, building on their expertise and special nature as public institutions which are both active in the market and have close interaction with market participants. We distinguish between four types of activities [see slide 24].

First, we give advice on the legislative and regulatory framework for the financial system and make rules. A good example is the Eurosystem's contribution to the first full review of the Lamfalussy framework last year. The Eurosystem reiterated its support to the Lamfalussy framework subject to some necessary functional enhancements within the current institutional framework and in particular emphasised the need for intensification of cooperation and information-sharing between supervisors and central banks.

Second, we seek to act as catalysts for private sector activities. In this regard, we have been instrumental in the success of the short-term European paper, or STEP, initiative. This initiative aims to promote the integration of short-term paper market through the voluntary compliance of market players with a core set of standards. The outstanding amount of euro-denominated STEP-labelled securities already accounts for about 30% of all euro-denominated short-term paper placed by non-government issuers worldwide.

Third, we enhance knowledge, raise awareness and monitor the state of European financial integration. This Report, and the indicators of financial integration that are presented here, are an illustrative example of this type of activity.

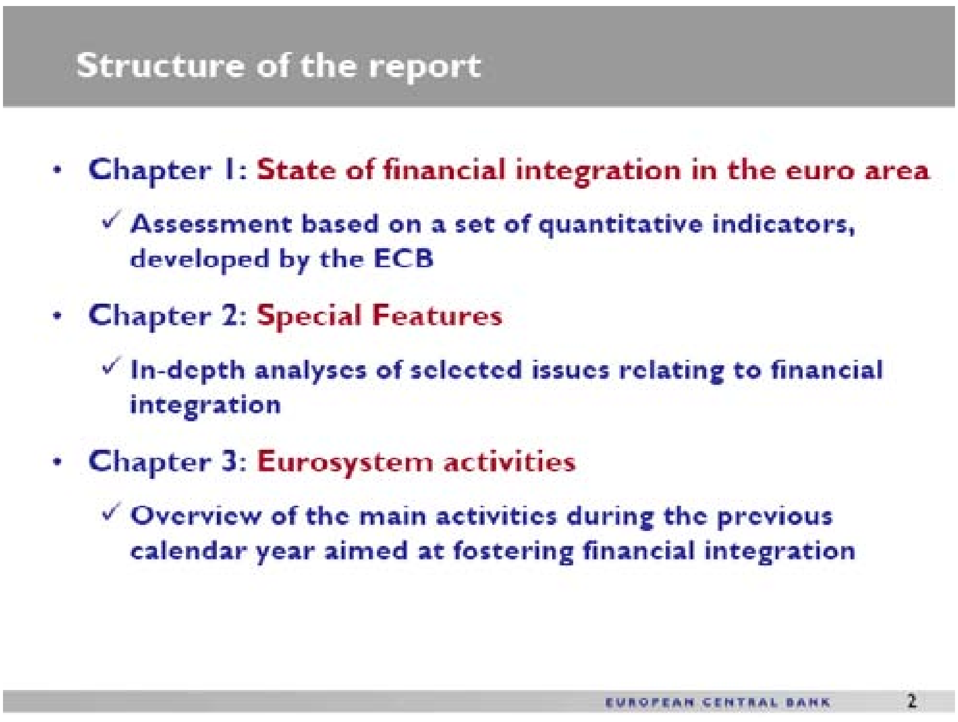
Fourth, we provide central bank services that also foster European financial integration. As an example, I choose our wholesale payment system, TARGET2. The successful launch of this single technical platform in November last year marks a significant milestone in financial integration. TARGET2, replacing TARGET, provides for a harmonised service level, a single price structure, and a harmonised set of cash settlement services in central bank money for all “ancillary” systems, such as retail payment systems, clearing houses and securities settlement systems. All central banks and TARGET users will have migrated to TARGET2 by 19 May this year.

V. Concluding remarks

This brings me to the end of my presentation. Central banks are at the core of financial systems and therefore closely follow developments which can foster integration [see slide 25]. The ECB and the entire Eurosystem devote a substantial amount of resources to this task, because we are convinced that progress in this area is important for the European economy, within the framework established by the Lisbon agenda.

Finally, I should also like to stress that, while financial integration is an important driver for increasing the efficiency of a financial system, financial efficiency also depends on financial development. Therefore, future reports are envisaged to encompass analysis and assessment of the various factors determining the efficient functioning of the financial system. The special feature on financial development that I presented is a first step in this direction.

Thank you very much for your attention. I am now at your disposal for questions.



Chapter I: The state of financial integration

Financial markets

Market	State of integration	Related infrastructures
Money markets		
a) Unsecured	Near perfect	Fully integrated
b) Secured	Advanced	Collateral leg fragmented
Bond markets		
a) Government bonds	Very advanced	Fragmented
b) Corporate bonds	Fair	Fragmented
Equity markets	Incipient	Highly fragmented

EUROPEAN CENTRAL BANK 3

Chapter I: The state of financial integration

Banking markets

Market	State of integration	Related infrastructures
Wholesale banking	Well advanced	Fully integrated
Capital-market activities	Advanced	Fragmented
Retail banking	Very low	Highly fragmented

EUROPEAN CENTRAL BANK 4

Chapter 1: Signs of turmoil in money market…

Cross-country standard deviation of average unsecured interbank lending rates across euro area countries

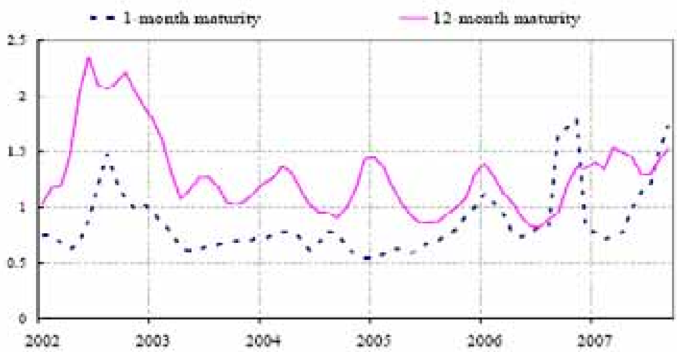
(61-day moving average, basis points)

Sources: : EBF, ECB calculations.

Chapter 1: …do not necessarily imply increased segmentation

Cross-country standard deviation of average interbank repo rates across euro area countries

(61-day moving average, basis points)

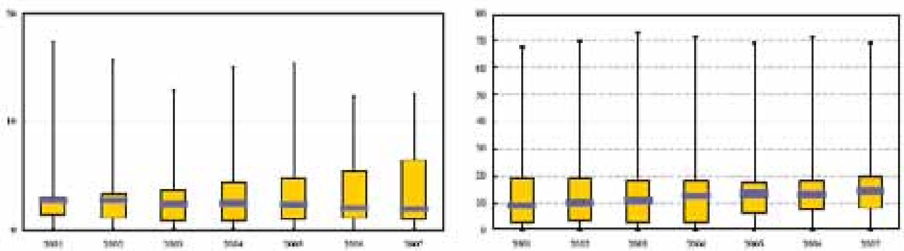


Sources: : EBF, ECB calculations.

Chapter I: Retail banking market still fragmented

Dispersion of the total assets of euro area bank branches and subsidiaries across euro area countries

(as a percentage of the total assets of the euro area banking sector)



Branches **Subsidiaries**

Source: ECB.

EUROPEAN CENTRAL BANK 7

Chapter II: Special Features

- In-depth assessments of major policy issues and/or analytical studies on financial integration
- Selected on the basis of their importance to the EU's financial integration agenda and relevance to the ECB's tasks
- Special Features of the April 2008 report:
  - ✓ Financial development: concepts and measures
  - ✓ The STEP initiative
  - ✓ Integration and development of mortgage markets in Europe
  - ✓ Integration of large-value payment and securities transactions: TARGET2, T2S and CCBM2

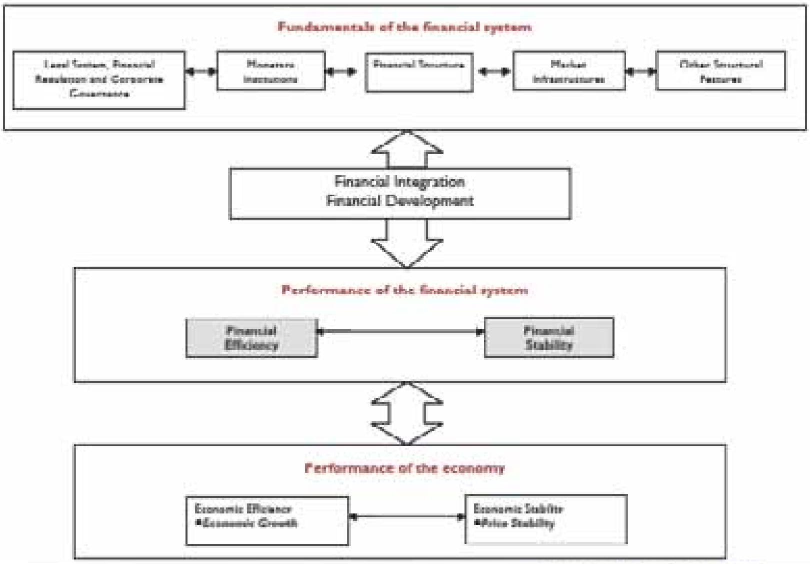
EUROPEAN CENTRAL BANK 8

Chapter II: 1. Financial development

- **Process of financial innovation, institutional and organisational improvements in the financial system that**
  - ✓ reduce asymmetric information
  - ✓ increase the completeness of markets and contracting possibilities
  - ✓ lower transaction costs and
  - ✓ enhance competition
- **Financial development is complementary to financial integration in reducing market frictions and fostering financial market efficiency**

EUROPEAN CENTRAL BANK 9

Chapter II: 1. Financial development



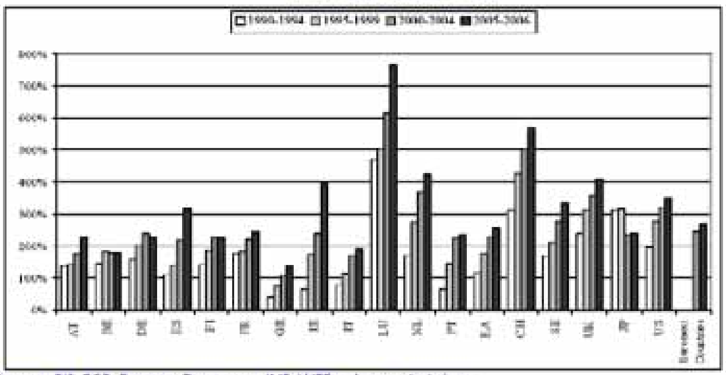
EUROPEAN CENTRAL BANK 10

Chapter II: 1. Financial development

- A selection of indicators to monitor and assess frictions in the financial system

Example 1: Capital Market Size

(as percentage of **GDP**)

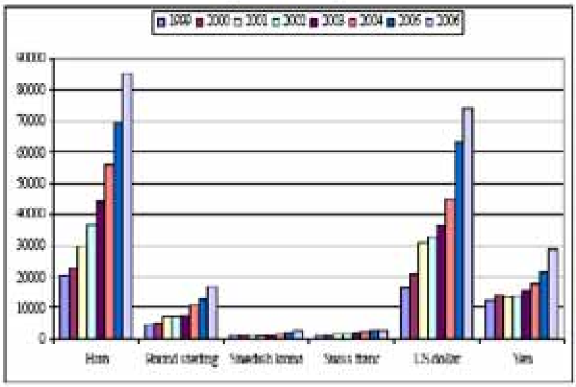


Sources: BIS, ECB, Eurostat, Datastream, IMF, WFE and own calculations.

Chapter II: 1. Financial development

Example 2: Notional amounts outstanding of OTC single currency interest rate derivatives

(EUR billions)

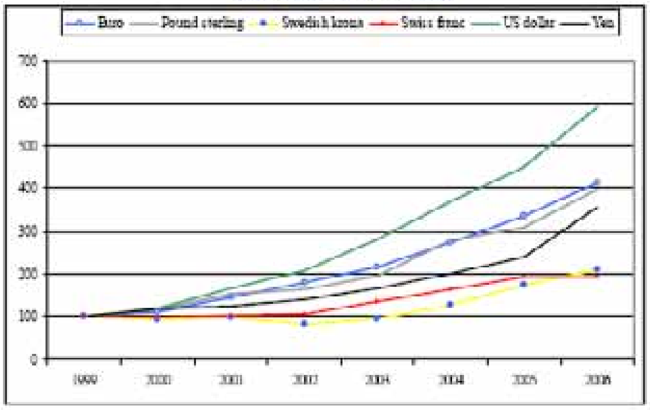


Sources: BIS and IMF.

Chapter II: 1. Financial development

Example 3: Notional amounts outstanding of OTC single currency interest rate derivatives

(EUR billions; 1999=100)

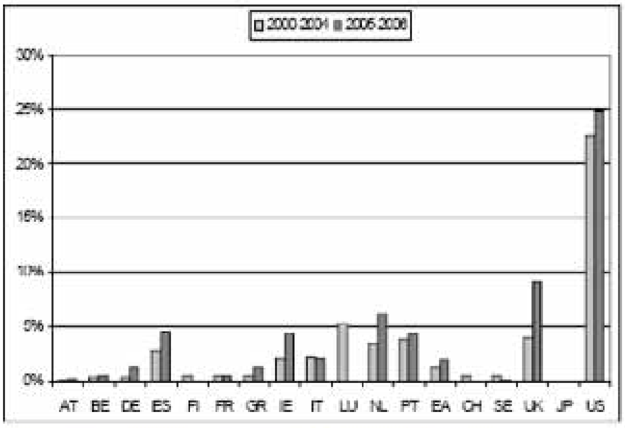


Sources: BIS, IMF and own calculations.

Chapter II: 1. Financial development

Example 4: Securitisation

(as percentage of GDP, by country of collateral)

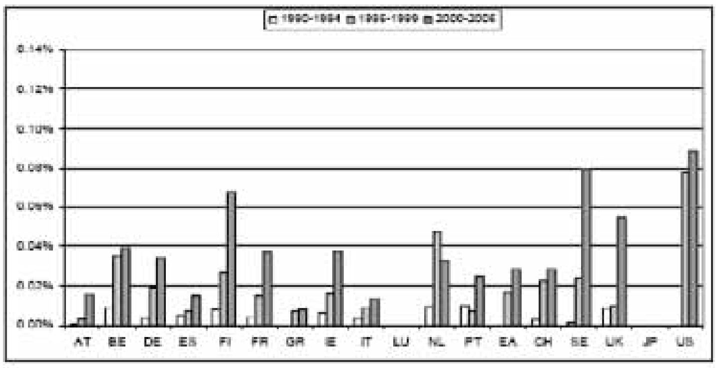


Sources: European Securitisation Forum, Bond Market Association and Eurostat.

Chapter II: 1. Financial development

Example 5: Venture capital financing

(early stage investments, as percentage of **GDP**)



Sources: World Bank, European Private Equity and Venture Capital Association, PricewaterhouseCoopers and Eurostat

EUROPEAN CENTRAL BANK 15

Chapter II: 1. Financial development

- **Two main conclusions:**
  - ✓ **A fair degree of heterogeneity in financial development exists across markets and countries in the euro area**
  - ✓ **Scope for further analysis of indicators of financial development and for the implementation of reforms to increase financial efficiency**

EUROPEAN CENTRAL BANK 16

Chapter II: 2. The STEP initiative

- Targeted to improve integration in the short-term securities market, the least integrated segment of the money market
- Improves integration via
  - ✓ Development of core market standards and practices
  - ✓ Voluntary compliance of market participants
- Significant progress in market integration and transparency
- There are still important challenges being faced in expanding the usage of the STEP label

EUROPEAN CENTRAL BANK 17

Chapter II: 3. Mortgage markets

- Mortgage markets are an important part of the euro area financial system
- State of European mortgage markets:
  - ✓ Low degree of integration; lending and funding markets continue to be fragmented and diverse across countries
  - ✓ Slow progress towards further integration
- Causes
  - ✓ Natural obstacles: language, culture, preferences
  - ✓ Other obstacles: domestic infrastructures, legal and consumer protection frameworks

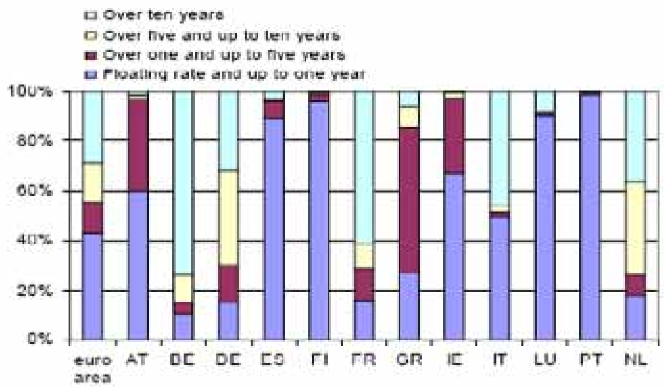
EUROPEAN CENTRAL BANK 18

Chapter II: 3. Mortgage markets

Diversity on the lending side

New business volume of loans to households for house purchase by period of initial rate fixation

(percentages of total; average between January and November 2007)



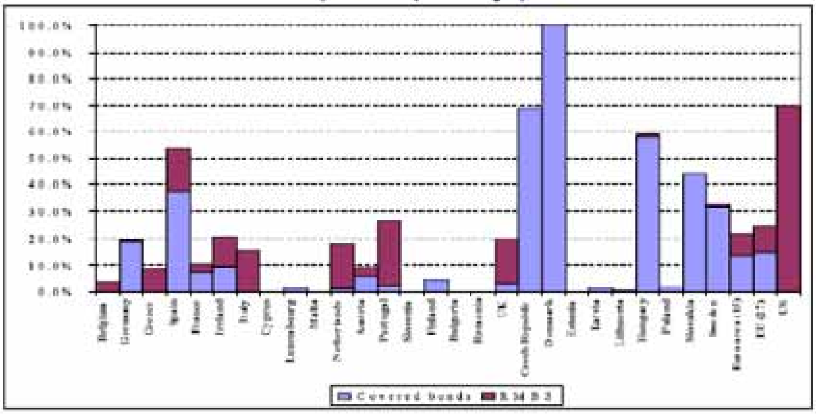
EUROPEAN CENTRAL BANK 19

Chapter II: 3. Mortgage markets

Diversity on the funding side

Share of covered bonds and Residential Mortgage-Backed Securities (RMBSs) as the source of residential mortgage funding

(end 2006; percentages)



EUROPEAN CENTRAL BANK 20

Chapter II: 3. Mortgage markets

- **Further integration desirable:**
  - ✓ More homogeneous transmission of monetary policy
  - ✓ More stable financial system
- **But:**
  - ✓ May also entail certain risks
  - ✓ Careful monitoring of process is therefore needed

EUROPEAN CENTRAL BANK 21

Chapter II: 3. Mortgage markets

- Significant progress can be achieved by the actions of market participants
- The Eurosystem stands ready to support and assist market initiatives in the areas of
  - ✓ Improved transparency and statistics
  - ✓ Promotion of standardised mortgage products
  - ✓ Development of market benchmarks

EUROPEAN CENTRAL BANK 22

Chapter II: 4. TARGET2, T2S and CCBM2

- **TARGET** and **CCBM**: first-generation systems providing euro area-wide payment services, but did not yet allow to manage cash, collateral and securities positions in an integrated way
- **TARGET2** has provided both the trigger and the enabler of new integration initiatives, **T2S** and **CCBM2**
- Significant combined benefits from the three systems, which include allowing market participants, issuers and investors to operate throughout the euro area on a single interface basis

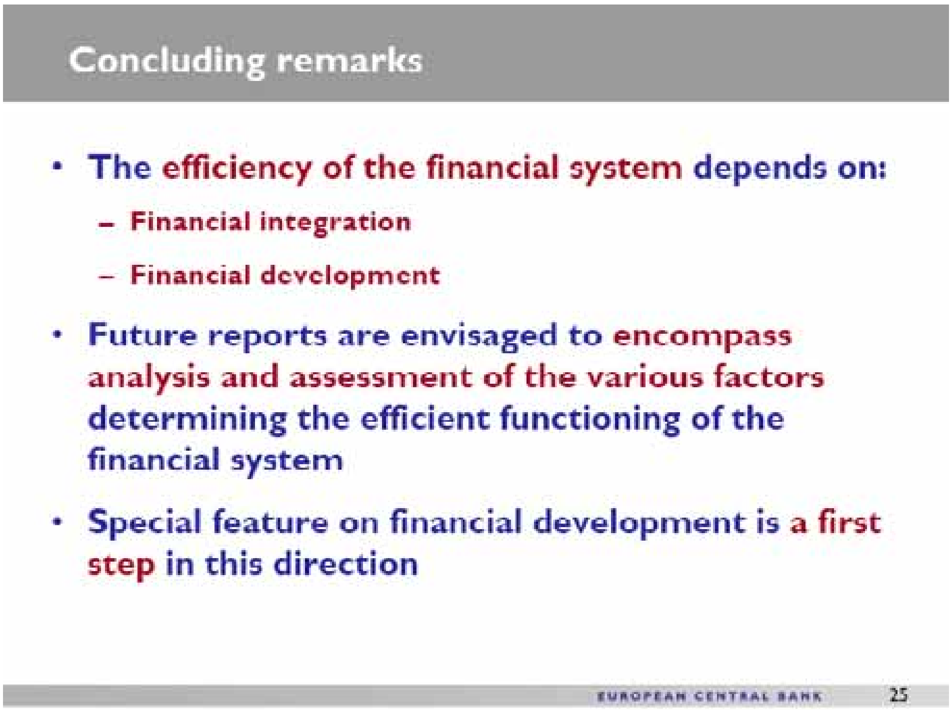
EUROPEAN CENTRAL BANK 23

Chapter III: Eurosystem activities

Four types of Eurosystem activities that foster European financial integration:

- Giving advice: e.g. review of the Lamfalussy framework
- Acting as a catalyst for private sector activities: e.g. **STEP** initiative
- Enhancing knowledge and monitoring: e.g. indicators of financial integration
- Providing central bank services: e.g. **TARGET2**

EUROPEAN CENTRAL BANK 24


Concluding remarks
• The efficiency of the financial system depends on:
– Financial integration
– Financial development
• Future reports are envisaged to encompass analysis and assessment of the various factors determining the efficient functioning of the financial system
• Special feature on financial development is a first step in this direction
EUROPEAN CENTRAL BANK
25