

II - Perspectives and challenges on financial integration in the European Union

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– Lessons for Mercosur”

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Outline

1. State of integration
2. The post-FSAP
3. The new Member States
4. Lessons

1. State of EU financial integration

Uneven progress

MORE PROGRESS

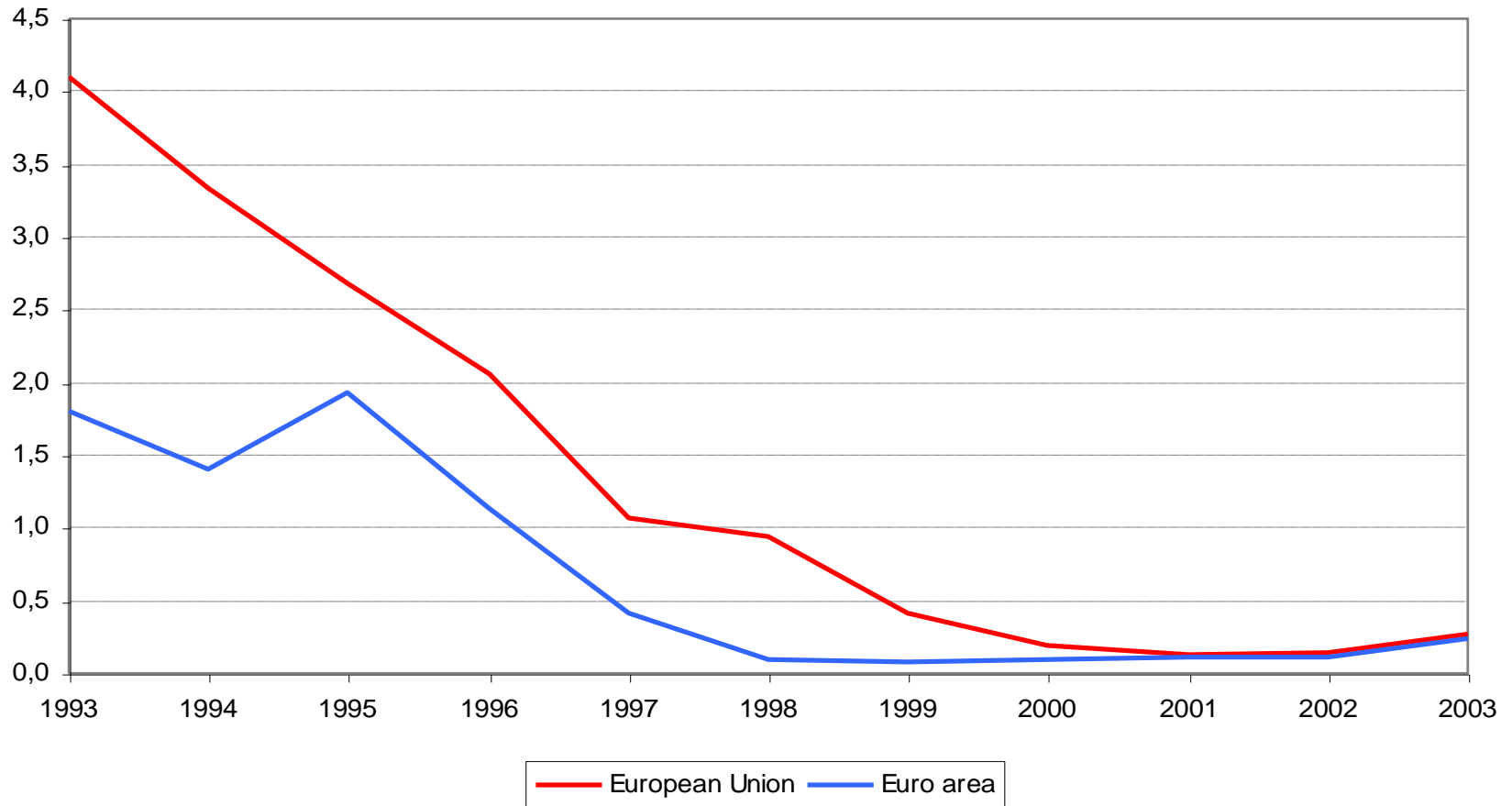
- Unsecured money market fully integrated
- Government bond yields and retail loan rates have converged
- Corporate bond market
- Investment strategies have moved from country to European strategies (e.g. based on sectors)
- X-border inter-bank activity has increased
- Large institutions reorganise value chain at EU level
- Trading infrastructure is consolidating

Uneven progress

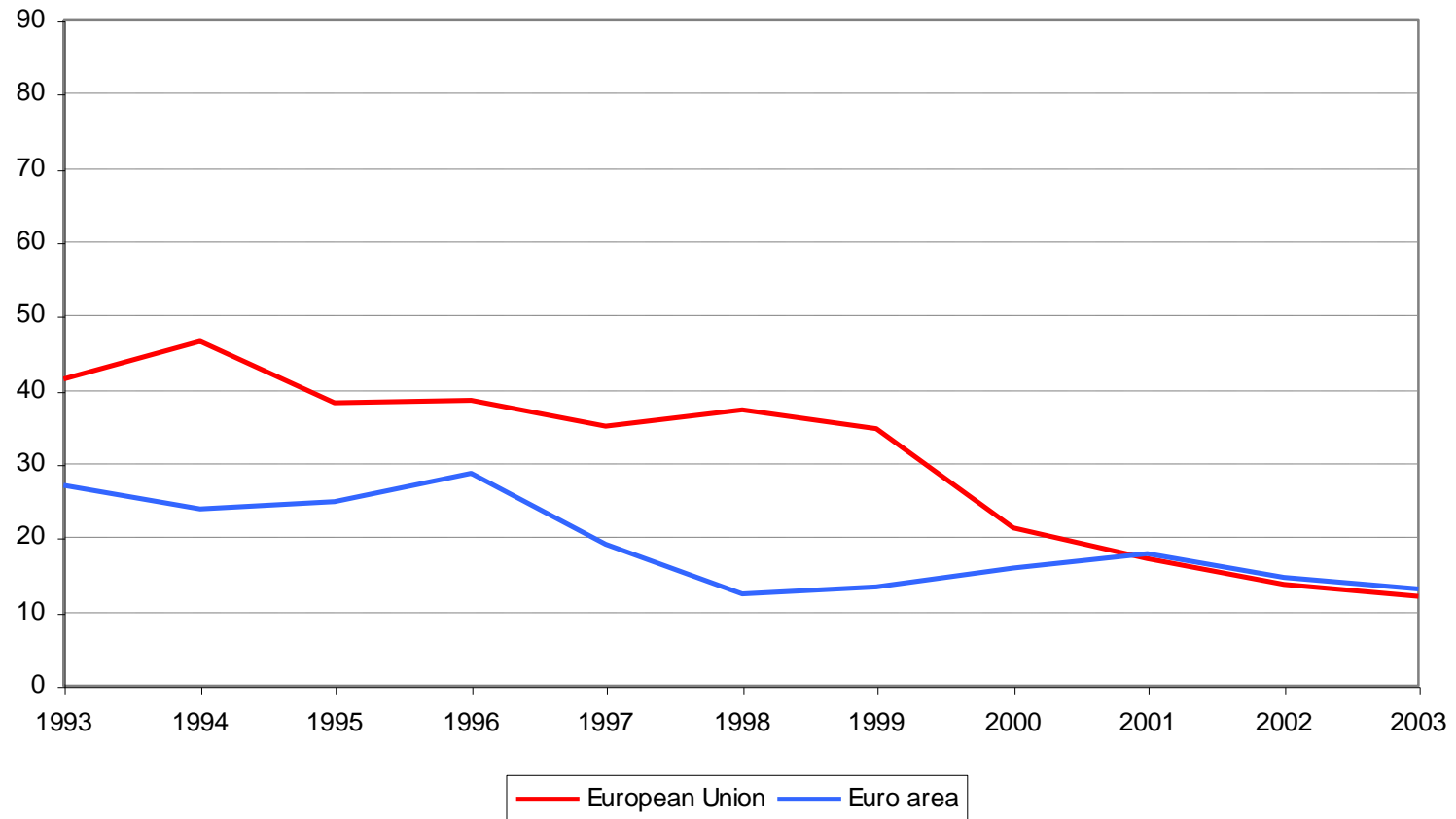
LESS PROGRESS

- Secured (repo) money market
- X-border securities transactions much more expensive than domestic ones
- Consolidation in the banking sector mainly domestic
- Practically no European-wide retail products
- Direct X-border provision of financial services to firms and individuals still small

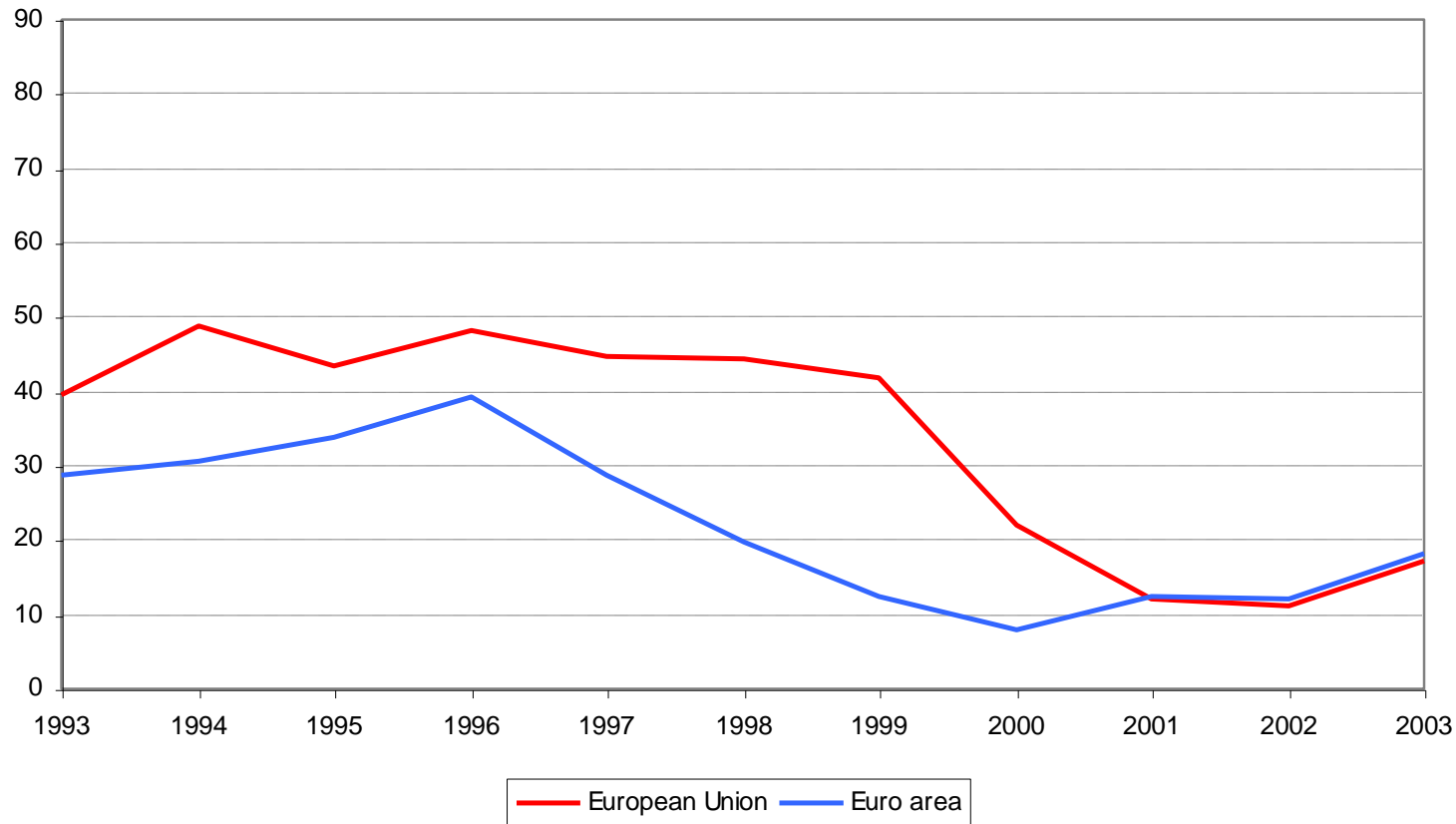
Convergence in government bond yields (coefficient of variation)



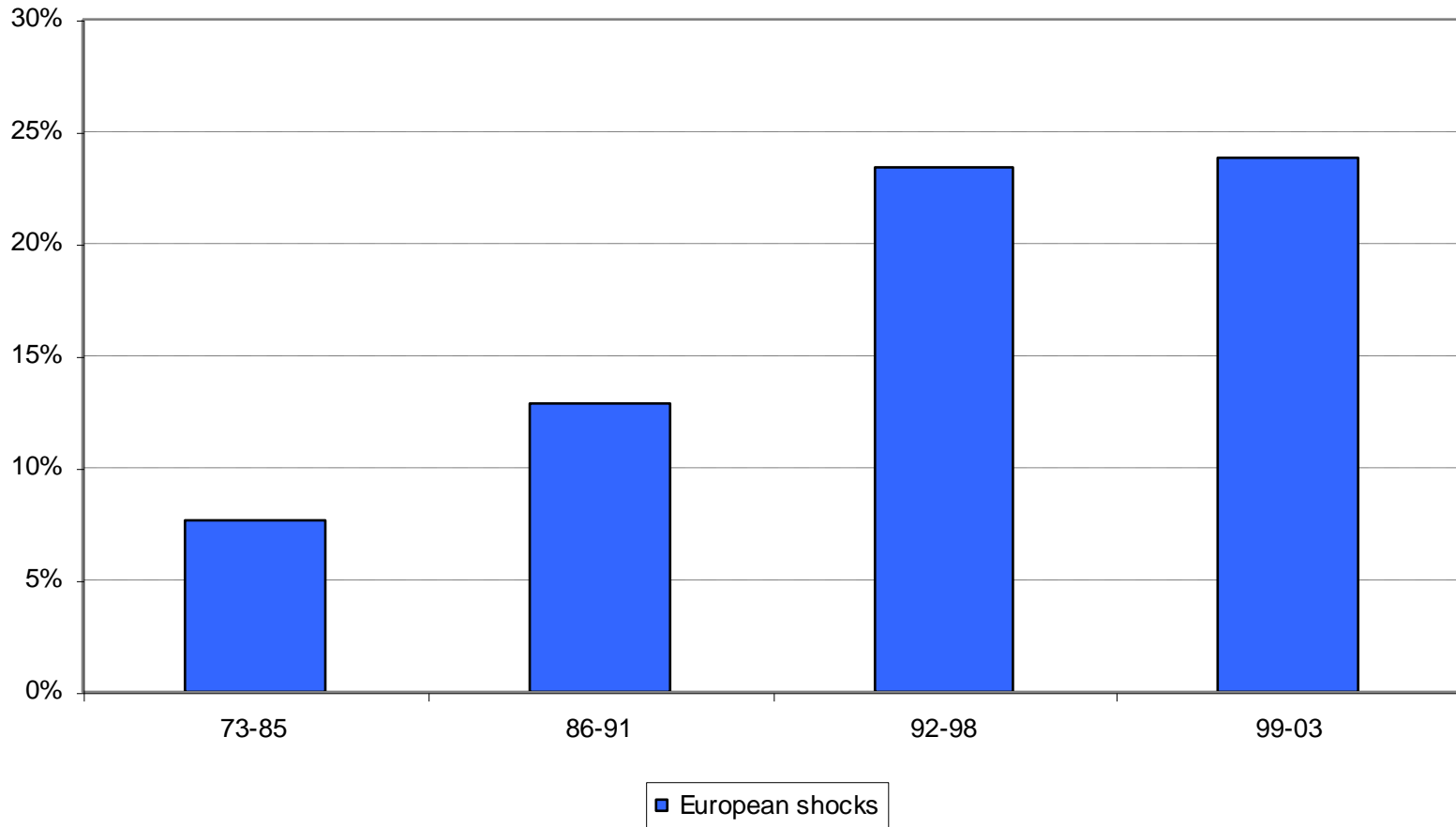
Convergence in medium and long term loans to enterprises (coefficient of variation)



Convergence in short-term loans to enterprises (coefficient of variation)



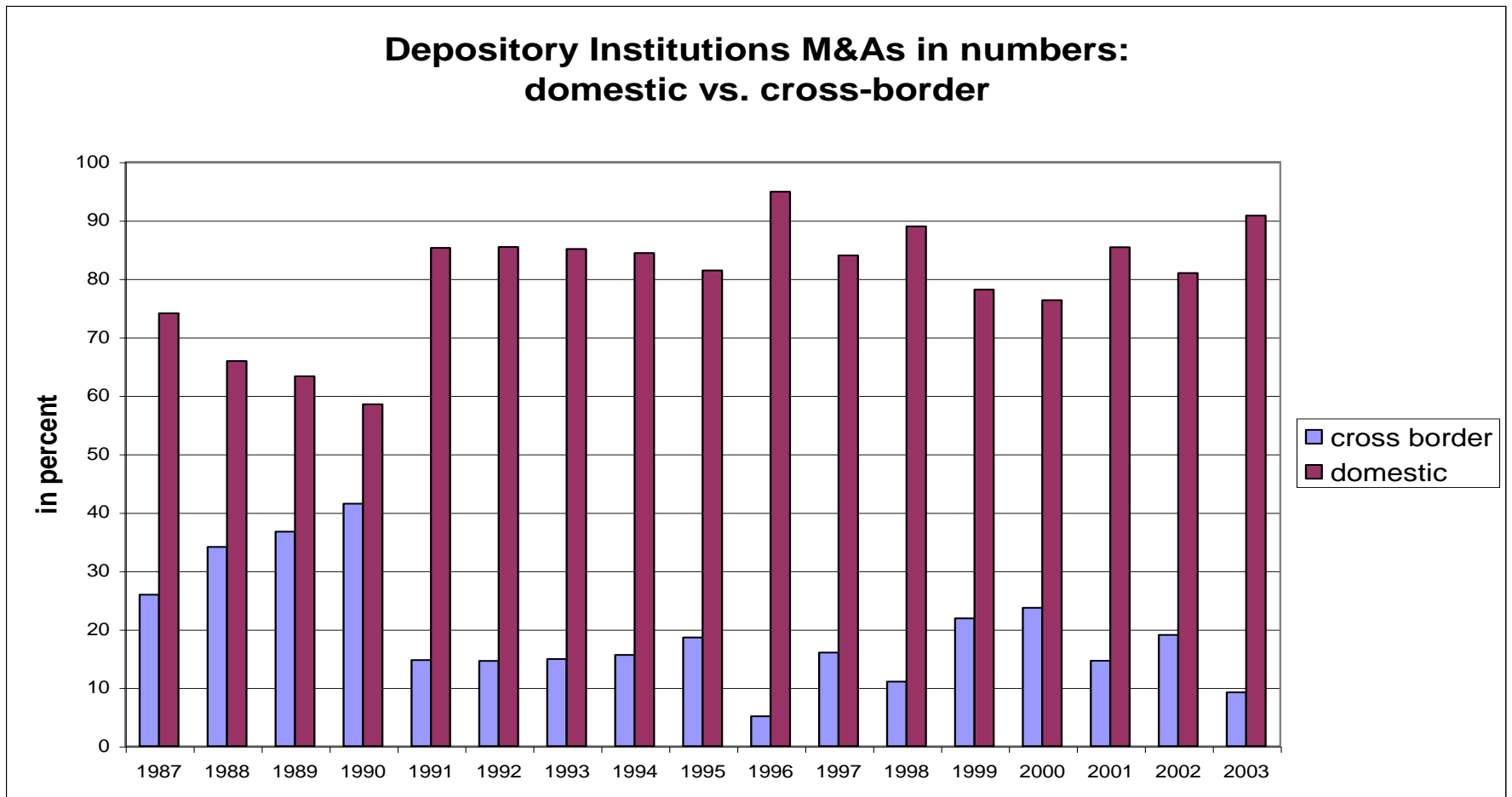
Average proportion of stock price variations explained by pure euro area shocks



Trends in banking sector consolidation

- Steady number of mergers
- Cross-border mainly in investment banking
- Retail : mainly domestic and often involving small credit institutions
- Looser alliances (not M&A) common
- Trends towards conglomeration
- Emerging top-tier of large pan-European institutions

Banking M&As



Reorganisation of the value chain on a European level

Large pan-European financial institutions can concentrate some back office and strategic activities , e.g. :

- balance sheet management for insurances
- liquidity management for banks
- trading rooms
- planning
- product development
- risk control

Consolidation of exchanges

- Euronext (Amsterdam, Brussels, Paris, Lisbon) plus LIFFE (London)
- Deutsche Bourse (Clearstream)
- London Stock Exchange
- NOREX (Stockholm, Helsinki, Copenhagen, Oslo, Iceland)

2. The post-FSAP

2004: reflection phase on post-FSAP

- 4 forum groups of experts (banking, insurance, asset management, securities) + one on mortgage credit
 - Mandate : to assess FSAP + remaining barriers
- Wider consultation
- Financial Services Committee report
- European Parliament draft report

Much consensus

- Regulatory fatigue : no appetite for a FSAP II

Priorities :

- Complete FSAP
- Implementation and enforcement
- Supervisory convergence and cooperation
- New intervention only in areas with clear benefits

A regulatory pause?

End-2004, new Commission - Mc Creevy announced a regulatory pause. “The watchword is consolidation”

However, there is a number of ongoing initiatives ...

- CAD , Reinsurance, Insurance Solvency II
- C& S
- Level-2 legislation (eg MiFID)
- IAS, Corporate governance and Company law, Auditing

...and selected new areas have been identified

- retail financial services
- asset management

→ COM Green Paper in June 2005

Implementation and enforcement

- Key role for the level-3 committees of supervisors
- Possible concrete measures
 - Transposition workshops (COM + MS + regulators)
 - Monitoring and transparency: transposition overviews
 - Easier confidential complaints procedures
 - More infringement procedures
- Consolidation of EU rule books
- Pro-active competition policy
- Monitoring and ex-post evaluation

Retail financial services

- Still difficult to sell the same product/service in different markets :
 - Consumer protection rules ; legal frameworks ; language and culture ; impediments to X-border establishment
- Politically important
- Criticism of FSAP: it has focused on wholesale banking and not done much for consumers
- COM is considering targeted initiatives:
 - Retail payment systems
 - Mortgage credit

Retail payment systems

Large value systems → integrated and efficient;
Retail → still fragmented and costly to operate

- Objective: cross-border payments by credit card, debit card and credit transfer should become easier
- 2001 EU Regulation: same price for domestic and international payments → higher p of domestic transactions to subsidise cross-border (1% of total)
- Banking sector initiative for a single European payment area by 2010 not fulfilled → COM now threatening to propose legislation (e.g. on technical standards)

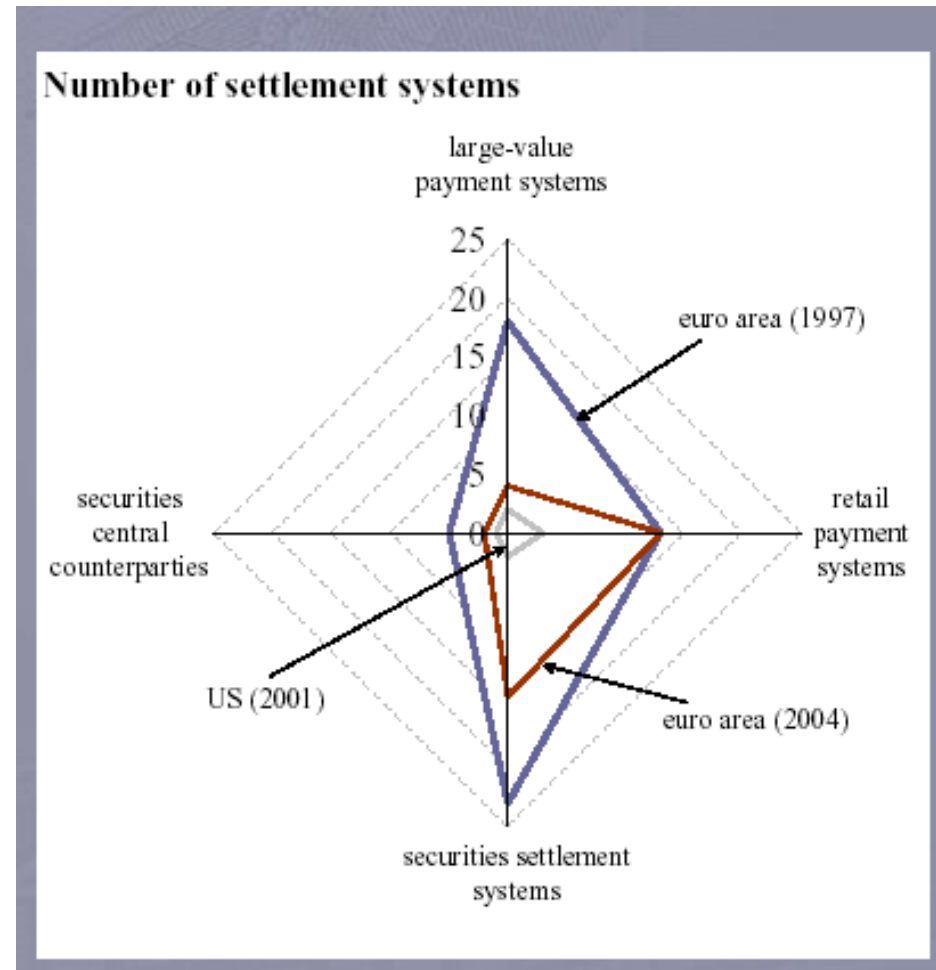
Market infrastructure

Pre –EMU

18 large value payment systems, 13 retail systems, 23 securities settlement systems (US: 2, 3 and 3)

Today

- EU-wide systems for large-value payment (TARGET + Euro 1)
- retail payment systems still fragmented



Clearing and Settlement

- Initially overlooked in the FSAP, now recognised as a key issue
- Very technical area
- Innovative approach: extensive analysis by a group of private sector experts (Giovannini group)
- COM preparing action plan with the support of market participants
- A Directive?

Asset management

- Investment funds growing in size
 - Important in relation to pension system reforms
 - Efficient AM industry implies higher returns for investors
 - 1985 UCITS Directive → facilitate X-border offer of investment funds to retail investors... but, X-border sales remained limited
 - Need to respond to financial innovation (hedge funds etc)
- **COM to review UCITS : Green Paper in June 2005**

Mortgage credit

- No EU law, only Code of Conduct on pre-contractual information
- Fragmented markets: interest rates have converged, but product availability, funding methods, government schemes, etc. vary enormously across MS
- Macroeconomic significance: wealth and income effects; saving behaviour; labour mobility
- Need to tackle consumer protection rules, legal frameworks, collateral, distribution, funding.
- A 26th regime for mortgages ?

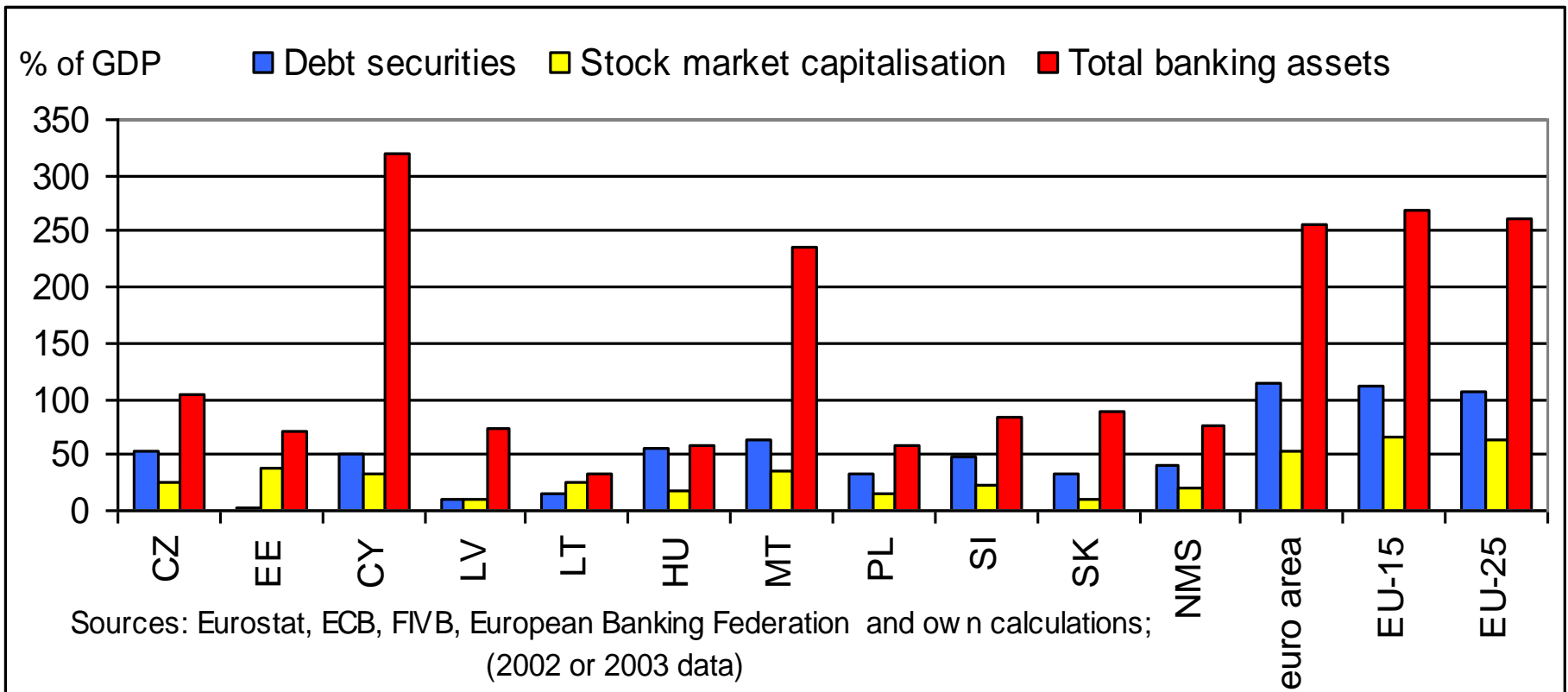
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The Recently Acceded Member States (RAMS)

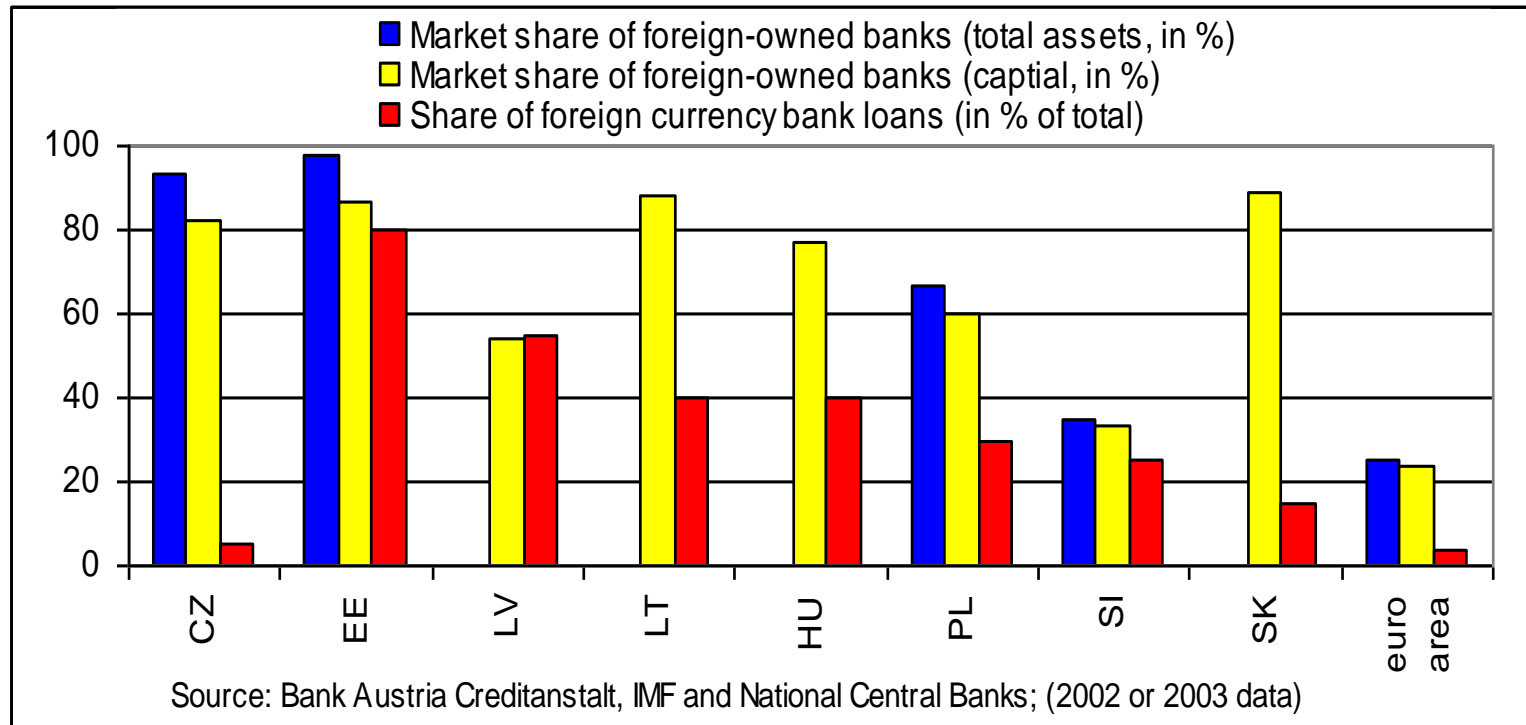
RAMS

- Adoption of the “acquis” prior to accession
- Underdeveloped and bank-dominated financial systems
- Liberalisation and privatisation during the 1990s
- Large foreign presence

Underdeveloped financial systems



Large foreign ownership



Issues specific to RAMS

- Key issue: Financial stability during convergence
- Supervision: progress made in upgrading the quality of local supervision, but...home country control may imply that most of the national banking system is supervised by fx authorities
- For a large fx bank activity in the RAMS may be only a small part of total exposure → less incentive to monitor risk
- Convergence dynamics → risk of boom-bust cycles (fast credit growth, large K inflows, appreciating REER, rising asset prices, followed by a sharp reversal)
- Changes in monetary policy regime complicate matters
- Strategic choices on infrastructures

4. What lessons ?

Lessons

- o Integration as an economic reform process

- o Success depends on
 - Prevailing economic policy philosophy
 - A convincing economic case
 - Width and voice of pro-integration constituency (efficient intermediaries; users and borrowers). Different by country

- o Transparency and consultation
 - Support gathering
 - Vital technical advice
 - How to give voice to users/consumers?

Lessons

- o Institutions
 - The EU has adapted over time
 - Integration brings new institutional needs (eg supervisory cooperation)

- o Method
 - EU success largely due to commitment to a list of measures within given timetable

- o A variety of policy approaches
 - Minimal harmonisation + mutual recognition
 - Minimal vs maximum (complete) harmonisation
 - '26th regime': introduce a new, optional EU regime (precedent : European Company Statute)

Lessons

- o Instruments - not only regulation
 - Competition policy. Now more pre-emptive (e.g sector studies)
 - Infringements – leverage EU legal system
 - Soft measures (codes of conduct)
 - Coordination of private sector initiatives

- o Rule book not enough
 - Implementation and enforcement are key

- o A dynamic disequilibrium leading to more economic integration ?
 - A European regulator not needed now

Questions ?