BANCO DE ESPAÑA

EUROPEAN INSTITUTIONS AND FRAMEWORKS FOR GREATER FINANCIAL INTEGRATION

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Benefits of financial integration

Efficiency

- **Improves the channelling of funds from surplus to deficit agents**

- **Better diversification and risk-sharing**

- **Deeper and more liquid markets**
  - increased availability of funds

- **Increase in competition and innovation**
  - lower intermediation costs
  - more efficient allocation of capital

Economic growth

Financial integration and financial stability

- **Pros and cons**
  - On the one hand, intensified cross-border financial links might increase potential contagion
  - On the other hand, more integrated financial markets increase risk diversification opportunities, thereby boosting the economy's shock-absorbing capacity

- **Overall, enhanced financial integration has a long term positive impact on the stability of financial systems and of the economy**
  - Increased resilience to shocks as a result of enhanced risk-diversification

Financial integration in Europe

- **The Euro has been a major catalyst for the integration of the euro area financial markets**

- **However, the speed and scope of market integration has not been the same across all market segments**

  1. The unsecured interbank deposit market has been almost completely integrated since the beginning of EMU in 1999, at all maturities

  2. Interest rate derivatives markets also display almost complete integration

Financial integration in Europe

3. Among money market segments, the least integrated is the short-term securities market

   - *the commercial paper market remains segmented*

4. Integration in the euro area government bond market is very high

   - *no exchange rate risk*
   - *remaining differences are result of different liquidity and credit risk*

5. The corporate bond market is relatively integrated and has increased its scope to riskier issuers

Financial integration in Europe

6. Equity markets remain fairly fragmented

   - *country effects are still very important in explaining stock price changes*

7. Banking markets

   - *interbank or wholesale activities are fairly integrated*
   - *retail markets show a slower process of integration*

Retail banking integration in Europe

- **The view of a slower path of integration in European retail banking markets, while correct, must be qualified**
  - Lower standard deviation of interest rates for mortgages and loans to firms across European countries
  - Local banks have certain advantages vis-à-vis national and multinational banks
    - *relationship banking, proximity to customer (convenience)*
  - Profitability is not positively related to size
    - *different banks might have different strategies*
  - Significant competition within national markets can discourage foreign entry
- **While retail banking markets remain fragmented, there are certain signs of increasing integration: some cross-border M&A and internet banks**

Institutional framework in Europe

- **In 1999 there was a single currency but not a single financial market in Europe**

- **The Financial Services Action Plan (FSAP, 1999-2004) contributed significantly to the construction of a single financial market in Europe**

- **Main objective: integration of financial markets in Europe**

- **Until FSAP: new regulations were needed but the changes in the European Union (EU) financial regulatory framework were not enough to complete the single financial market**

- **Directives were too complex and detailed**
  - rigid
  - difficult to change
  - long lags in their implementation in each EU country
  - differences in application in practice: single regulation, but 25 different interpretations

- **As a result, there was a need for an increase in efficiency of regulation**

Institutional framework in Europe

- **FSAP three main strategic objectives**
  1. To promote a single wholesale financial market
     - *e.g. investment services directive, accounting strategy, collateral, …*
  2. To make retail financial services markets more open and secure
     - *e.g. information and transparency (mortgages), consumer protection, …*
  3. To improve the prudential framework
     - *e.g. money laundering, capital requirements for banks and investment firms, solvency of insurance companies, conglomerates, …*
- **42 initiatives, 39 adopted by EU countries as of today**
- **23 new Directives in 5 years**

Institutional framework in Europe

- **The response is the Lamfalussy framework (3 levels):**
  - Level 1: Basic regulation
  - Level 2: Technical regulation (need to upgrade frequently)
  - Level 3: Application of the regulation

- **Level 1. Framework Directives**
  - Containing high level principles

- **Level 2: EU Commission and Regulators' (Treasuries) Committees**
  - In charge of technical regulation
  - Easier to change and/or update (Comitology procedures, EU jargon)

- **Level 3: Committees of Supervisors**
  - Ensure convergence of supervisory practices: common application of common regulation

- **Applied in 2000 for securities, extended to banks and insurance in 2003**

Institutional framework in Europe

- **In sum: FSAP + Lamfalussy framework are huge steps forward**
  - flexible model: it can respond to changes in needs of EU single financial market
    - *e.g. from supervisory cooperation to coordination / joint action if needed*
  - We have an EU system of regulation and supervision…
  - … though not yet a single EU regulator / supervisor

Some further important steps

- Integration of payments, clearing and settlements systems
- Implementation of Basel II and Solvency II
- Enhancement of cross-border competition in retail services
- Reduction of obstacles to cross-border retail banking integration
- Reduction of state involvement in several national financial systems
- Improved collaboration among European supervisors
- More intense dialogue between European financial authorities and those of other areas

Some lessons to be learned

- **Financial market integration requires both public and private initiatives**
- **Financial market integration is not an instant process, at least not in all dimensions**
  - Capital mobility, single currency and single monetary policy have been very important steps
  - Retail banking integration takes more time
- **Great benefits to be obtained from integration (significant increases in efficiency)**
  - particularly true for the banking system: liberalisation increases competition (lower intermediation costs and greater innovation)
- **As financial integration progresses, improved financial frameworks and cooperation among supervisors are fundamental**
  - crisis prevention and promotion of financial stability
  - the institutional framework is a key element to support coordination between supervisors

Some lessons to be learned

- **Relevance of the institutional setting**
  - Flexibility needed to respond to new challenges and requirements

- **A lot has been done in Europe but …**

- **…comparing the monetary policy framework with the financial stability framework…**

- **… many things can still be done in the financial area when and if needed**

THANK YOU