Financial Integration and the Market

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ABSTRACT

While increased financial market integration has taken place in many market segments in the euro area since the introduction of the single currency, the market for short-term paper continues to be somewhat fragmented and domestic in nature, owing primarily to different legal systems combined with a lack of homogeneity of the terms and features of the differing commercial paper (CP) markets. The French, Spanish and German markets for short-term paper have long dominated issuance in the euro area, with the increased emergence of Euro Commercial Paper (ECP) helping to create a more integrated market. Acknowledging the need for further integration in the euro area market for short-term paper, ACI — The Financial Markets Association and the European Banking Federation, with support from the Eurosystem, are aiming to launch an initiative entitled the 'Short-Term European Paper (STEP) Label'. The STEP Label will be awarded to short-term paper programmes that voluntarily comply with a set of common standards set out in the STEP Market Convention, with the aim to promote the development of a euro area-wide short-term paper market through convergence in standards and practices. Further integration in this market segment will benefit issuers and investors as well as having important implications for risk management and monetary transmission in the euro area.

1. Introduction

Financial integration in the euro area has been a topic of considerable analysis and review in the years following the adoption of the single currency. Increased financial integration across all the market segments is seen as an important end-goal for the euro area in order for issuers and investors, as well as the financial system as a whole, to maximise the benefits and economies of scale and scope arising from a fully integrated single currency region. Furthermore, financial integration across market segments has implications for monetary transmission in the region; the pillar on which a single currency area is based. Differing analysis produces differing evidence as to the degree of financial integration across the many financial markets in the euro area, with evidence showing that integration is more advanced in those market segments that are closer to the single monetary policy, i.e., the money market, and in particular, the interbank segment of the money market (Trichet, 2005b). While different segments of the money market show different degrees of integration, it is evident that the market for short-term securities is the least integrated segment.

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Looking abstractly at the euro area commercial paper market as a whole, it lags considerably behind that of the more integrated US commercial paper market in terms of depth and liquidity. The market for CP in the euro area is far more segmented in reality with independent national markets dominating the spectrum, reflecting, *inter alia*, differing legal systems and issuance criteria. The main domestic markets for CP continue to be the French and German markets. Endogenous national characteristics continue to create a hindrance to financial integration in the market. The increased emergence of ECP, which is the only short-term paper traded on a cross-border basis to any significant degree, has provided some relief to a stifled euro area-wide market, although an insufficient degree of homogeneity across the euro area issuances of CP still leaves a barrier to continued integration of the market.

In recognition of the need to promote and further the degree of financial integration in the market for short-term paper, ACI – The Financial Markets Association[1] proposed the STEP Label, which will be awarded to programmes which voluntarily comply with a common set of standards as set out in the STEP Market Convention. The awarding of the STEP Label will attempt to indicate a degree of homogeneity among CP programmes across the EU, thereby helping to create a framework for common structures across programmes and a pseudo-single commercial paper market. The Eurosystem, also recognising the benefits to be obtained from further integration in this segment and its role in promoting financial services in the euro area, intends to play a supporting role in the initiation period of the STEP Label.

The joint participation of private-sector entities and the Eurosystem to help foster further financial integration illustrates the importance placed on realising the benefits of an integrated market. These benefits will be realised by issuers and investors on the private-sector side through a wider, more transparent marketplace and, from a Eurosystem aspect, by providing additional risk-management opportunities and clearer monetary transmission. The remainder of this paper is structured as follows: the second section looks at the existing commercial paper market structures in Europe and that of the US. The third section discusses the benefits of financial integration in the short-term

1 ACI was founded in 1955 as Association Cambiste Internationale. It was originally established as the umbrella body for the growing number of national Forex Clubs but has since broadened its membership base. To reflect this widened base of membership the association changed its name, in 1995, to ACI – The Financial Markets Association. The Association has a clear mission statement to be a leading global association of wholesale financial market professionals contributing to the market development through education, market practices, technical advice and networking events. Euribor ACI is an international association created in 1999, whose executive members are the ACI national associations of the countries that have adopted the euro.

paper market, while the fourth section gives an overview of the rationale and function of the STEP Label. The final section concludes.

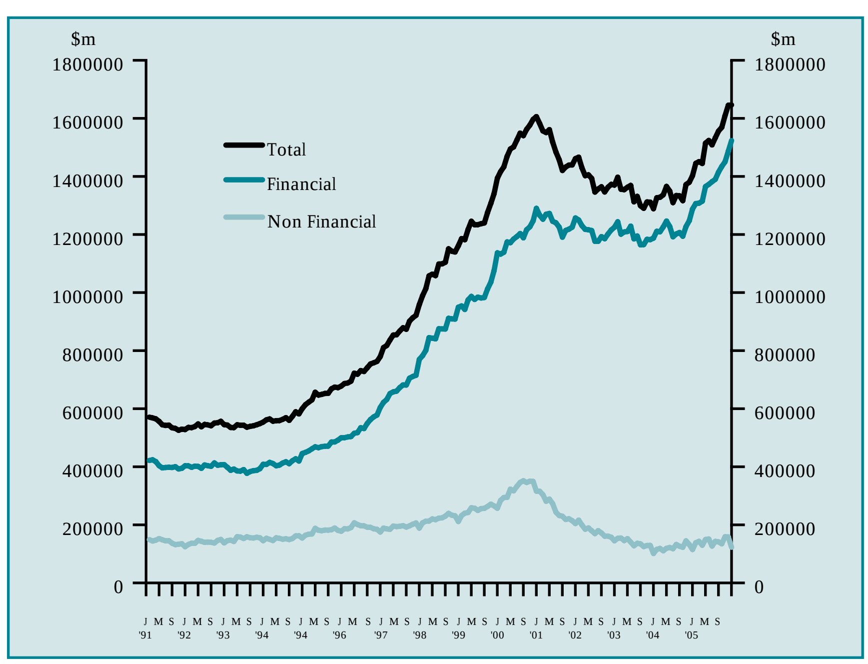
2. Existing Commercial Paper Market Structures

The common definition of CP refers to a short-term security in the form of an unsecured promissory note issued for a specific amount and maturing on a specific day. The variables in the structure and conditions of CP contracts vary from market to market according to legal systems and regulatory requirements. The following provides a brief overview of some of the relevant CP markets from a euro area perspective.

2.1 The US Market for Commercial Paper

The benchmark for financial integration in the CP market segment is set by the market for US commercial paper (USCP). Commercial paper, as defined by the US Federal Reserve, consists of short-term, unsecured promissory notes issued primarily by corporations. Maturities range up to 270 days but average about 30 days. Many companies use commercial paper to raise cash needed for current transactions, and many find it to be a lower-cost alternative to bank loans. The world's largest market for CP, US issuance began in the 1960s and has risen steadily since then to an amount outstanding of approximately €1·65 trillion at 2005 Q4 in what is a fully integrated and single market place.

Chart 1: US Commercial Paper Outstanding



As illustrated in Chart 1, the amounts outstanding in USCP increased rapidly during the latter half of the 1990s but declined rapidly in 2001. This decline was largely attributable to a reduction of issue by non-financial issuers and partly attributable to credit deterioration and to economic downturn coinciding with a reduced demand for working capital financing. The market has since recovered most of this reduction in issuance, largely through strong issuance by financial institutions.

Much of the increased issuance in CP in the US over the past decade has been attributable to growth in the asset-backed commercial paper (ABCP) segment. ABCP issues are senior secured short-term debt instruments backed by receivables and generally issued by a special purpose vehicle or conduit sponsored by a bank. Their popularity has grown due to their cheap source of short-term funding, the off-balance sheet treatment of underlying assets and the preference for secured asset-backed CP (Doran and Murphy, 2005).

2.2 The European Market for Commercial Paper

2.2.1 Domestic Commercial Paper Markets

The market for CP in the euro area is dominated by individual domestic markets as opposed to an integrated single market as is the case in the US. This fragmented structure largely prevails due to differing legal and regulatory systems across the euro area. Some countries have enacted a specific legal basis for CP in the national legal system (e.g., Belgium, France and Ireland), while others take as their legal basis general securities and safe custody regulations and general rules of civil law (e.g., Germany, Spain, Italy, the Netherlands, Finland) (EFMLG[2] Report, 2002). Conversely, other countries have no specific legal basis for CP whatsoever (e.g., Greece). While, cumulatively, the euro area market for CP has grown substantially, the fragmented composition of the individual markets indicates a lack of integration within the segment for the euro area as a whole. Integration is further hampered by differing requirements across the markets as to maturity, minimum issuance amount and type of issuer.

A small number of domestic CP markets tend to account for a significant proportion of the growth in CP issuance in the euro area, with the French market being the most notable. The French market for CP, *Bilets de Tresorerie*, is part of the wider French market for negotiable debt instruments, *Titres de Creances Negociable* (TCN), and began in 1985. TCN are defined under French law as "negotiable debt securities issued at the initiative of the issuer and traded on a regulated market or over the counter

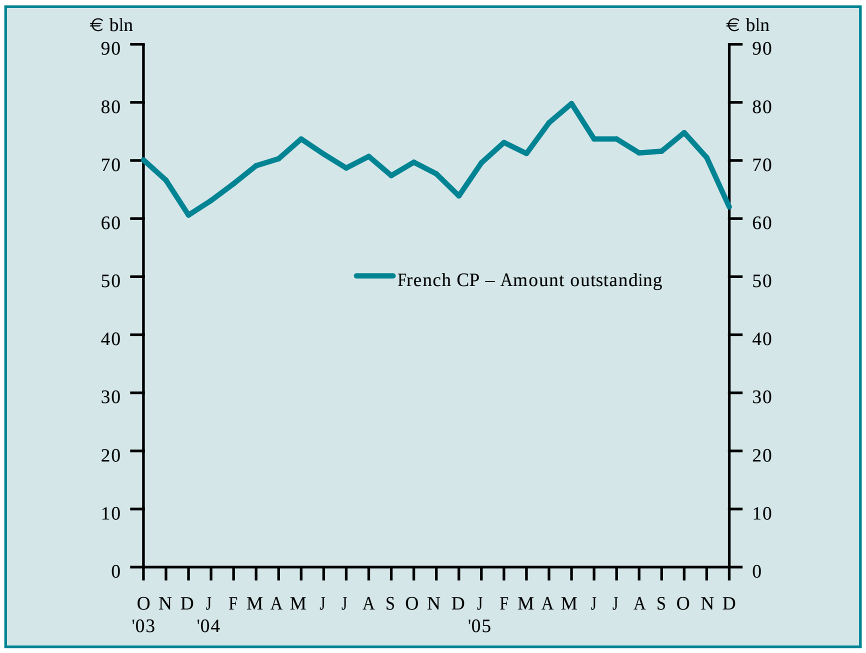
2 The European Financial Market Lawyers Group (EFMLG) is a group of legal experts from the EU banking sector dedicated to analysing and undertaking initiatives intended to foster the harmonisation of laws and market practices and facilitate the integration of financial markets in Europe following the introduction of the euro.

which each represent a fixed term debt''. This definition of TCN includes certificates of deposit (CDs), CP and medium-term notes (MTNs). Regarding issuance specifics, CP must have a fixed maturity date, a maturity of between one day and one year and a unit value equivalent to at least €150,000.[3]

The depth and liquidity of the French market are largely a result of its openness to non-resident issuers and investors, its flexible regulations, its high levels of security and transparency and the efficient delivery-versus-payment systems that process CP (Sahatdjian, 2001). In addition, the Banque de France plays an important role in the market structure through acting as supervisor and also in providing statistics on CP, while same day settlement is facilitated by the clearing and settlement system provided by Euroclear France.

Chart 2 shows amounts outstanding of French CP, which reached almost €80 billion by end-May 2005 but this fell to €62 billion by end-December 2005. This amount outstanding was issued by a total of approximately 90 issuers who were active in the market at the time. While issuance contracted somewhat at beginning of the century, owing to shorter initial maturities and downgrading of large issuers, issuance and amounts outstanding have increased since then. Much of the success of the French CP market is brought about by the role of the Banque de France in facilitating a secure and transparent market.

Chart 2: French Commercial Paper – Amounts Outstanding



3 See EFMLG Report 2002 for a detailed review of the legal aspects of the French, and other, commercial paper markets.

The other notable domestic CP markets in the euro area are those in Spain and Germany. The Spanish market for *pagares de empresa* (commercial paper) has an outstanding amount of approximately €57 billion at end-Q4, 2005, having grown from an outstanding amount of just €15 billion at end-2000[4]. Similar to France, albeit to a lesser extent than the US, the German market for CP contracted somewhat in the early years of the 21st century, though amounts outstanding have recovered to reach approximately €30 billion by 2005 Q3. Among the particulars of the German CP market, an exchange admission is seldom sought by issuers while secondary market trading activities have been relatively small and although the market is not regulated as far as issuance is concerned, it follows a standard of good market practice (Euribor-ACI, 2002). Furthermore, German law makes no direction as to minimum tradable amounts for CP issuance, whilst CP maturity can range from between seven days to two years less one day.

Issuance of CP in Ireland is quite low and for the most part CP is issued privately with the result that there is no secondary market for Irish CP (ACI-STEP Task Force, 2002). The legal basis for commercial paper in Ireland defines CP as short-term unsecured, unsubordinated promissory notes issued by both Government and private issuers, with a maturity range of between seven days and one year.

2.2.2 The Euro Commercial Paper Market

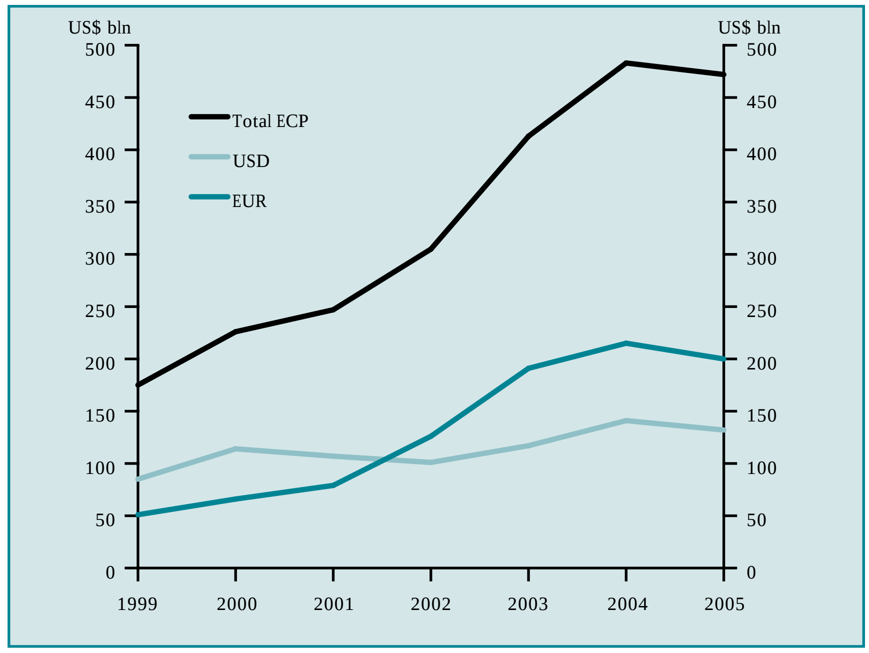
These and other CP markets in the euro area are governed by the respective legal systems of their home countries, which create the difficulty in issuing instruments with enough euro area-wide conformity to provide liquidity and create demand. Euro Commercial Paper provides the only resemblance of a cross-border market for CP in the euro area and is traded on secondary markets across the euro area. The ECP market began to develop in the 1980s and has since developed into a multi-currency short-term market. The ECP market attracts a wider issuer base than the other European domestic CP markets, in that a wide range of banks and non-financial corporations access it. Despite the ECP market being non-regulated, it has grown significantly in issuance and importance. English law governs most ECP programmes, while the law of the location on the securities depository holding the immobilised global certificate governs the nature of the investor’s rights (EFMLG Report, 2002).

As can be seen from Chart 3, amounts outstanding in the ECP market have risen from approximately US$175 billion equivalent at the end of 1999 to US$472 billion equivalent at end-December 2005. It is also evident that over this period, the amount outstanding of euro-denominated issuance has surpassed that of US$-denominated issuance, having grown from US$51 billion equivalent at end-1999 to US$200 billion equivalent at end-2005.

4 Source: Banco de España.

Furthermore, a large portion of the development in the ECP market is attributable to significant growth in the ABCP sector.

Chart 3: ECP Amounts Outstanding (US$ Equivalent, at year-end)



Of the recent outstanding amounts, as illustrated in Table 1, approximately US$200 billion equivalent of the total ECP amount outstanding (or 42 per cent) was issued in euro denomination, substantially higher than the amount of US$ ECP issuance (roughly 28 per cent) and approximately double the amount of GBP£ ECP issuance amount outstanding (roughly 22 per cent). A range of other denomination issuances account for the balance of amounts outstanding, including Swiss franc (approximately 3 per cent) and Japanese yen (approximately 1 per cent).

Table 1: Euro Commercial Paper — December 2005

Currency	Outstanding amount	USD equivalent	%	Number of issues	%
AUD	11,339,584,809	8,296,041,099	1·76	338	3·21
CAD	1,607,583,000	1,380,255,001	0·29	139	1·32
CHF	18,704,144,000	14,189,154,908	3·01	445	4·23
CZK	2,555,000,000	103,920,931	0·02	4	0·04
EUR	169,832,426,740	200,334,566,497	42·45	4,103	38·98
GBP	59,854,410,256	102,967,712,076	21·82	1,883	17·89
HKD	38,885,500,000	5,014,572,184	1·06	149	1·42
JPY	477,877,200,000	4,058,749,788	0·86	96	0·91
NOK	2,890,000,000	426,883,309	0·09	6	0·06
NZD	1,480,718,000	1,010,294,549	0·21	63	0·60
PLN	1,880,000,000	574,519,451	0·12	8	0·08
SEK	13,556,142,000	1,702,220,297	0·36	57	0·54
SGD	30,000,000	18,032,097	0·00	1	0·01
USD	131,909,274,607	131,909,274,607	27·95	3,235	30·73
Total		**471,986,196,794**		**10,527**	

Source: Euroclear.

The relative success of the ECP market acknowledges its contribution to addressing some of the deficiencies in the alternative more domestic natured CP markets through its ability to facilitate a higher degree of cross-border trading. A significant feature of this is attributable to ECP issues taking the form of a Global Certificate, which is deposited and cleared through a central securities depository such as Euroclear or Clearstream.[5] In addition, a distinct advantage of the ECP market is that it provides a cheap source of funding to credit institutions, particularly those which need short-term funding to finance business growth, working capital and to bridge between lending and longer-term debt. In an Irish context, few ECP issuances are listed on the Irish Stock Exchange's debt securities listing facility, which currently includes the ECP programme of a single non-resident financial institution.

On the basis of amounts outstanding, the euro area market for CP is slightly above half the size of the USCP market. Yet this still masks the fact that while the US market is integrated, the short-term securities markets in the euro area remain highly segmented. Many of these differences between Member States' legal and regulatory regimes on short-term securities appear to have developed for historical reasons related to local market conditions (EFMLG Report, 2002). Despite the increase in cross-border activity through the ECP market, issuance is fragmented across different euro area CP markets for different reasons and issuers and investors in the European short-term paper markets are therefore confronted with reduced depth and liquidity and they have less diversification opportunities than in the US (Trichet, 2005b).

In this regard, the US CP market remains the benchmark for the successful development of an integrated market. In taking the US market as the benchmark, the following features are identified by the ACI-STEP Task Force Report (2002) as necessary to ensure the development of an integrated ''domestic'' market at euro area level:

i) Pan-European placement/distribution: Intermediaries have a key role in introducing issuers to a wide range of investors across the entire market and introducing investors to a larger range of issuers. This is important in terms of the ability of CP to effectively fulfil the needs of investors in terms of credit diversification;

ii) same-day settlement: Same-day settlement and an efficient infrastructure, as well as the ability to issue

5 Debt instruments that are traded internationally are usually issued in registered form and represented by beneficial interest in a Global Certificate, which is registered in the name of a subscriber or nominee. This is deposited on behalf of subscribers with a common depository such as Euroclear or Clearstream. Subscribers' interests are usually represented initially by a Temporary Global Note which is exchangeable after a specified period after the closing date for offers for a Permanent Global Note.

overnight CP have the advantage of attracting to the market users concerned with cash management;

iii) central location for custody/settlement: A sole custodian exists for the entire US market and a single location for settlement of all domestic CP in Europe would likely facilitate access to the market for a wider range of users; and

iv) regulation: Although the ECP market is not regulated itself, there exists a compelling argument that regulation facilitates investment as it provides investors with a ‘‘guarantee’’ as to the quality of the product.

Demand does exist for a more integrated cross-border European CP market, evidenced by the high take up of issuance on the ECP market by issuers from a range of European countries as well as the US. Nevertheless, given the naturally segmented nature of European domestic legal systems as well as regulatory requirements and standards, there would appear to be a limitation as to the extent to which a fully integrated European CP market can be achieved.

3. The Benefits of Financial Integration in the Short-Term Paper Market

At first glance, the need to foster further integration in the short-term paper market across Europe may appear tenuous given the apparently healthy stylised facts of amounts outstanding and market exposure presented above. However, viewed in isolation in terms of the structure of the domestic CP markets, these statistics mask the economic and financial deficiencies generated by the fragmented nature of the CP markets in Europe. In reality, the increased integration of the short-term paper market is seen as a further essential step in completing the optimal integration and efficacy of the single currency market. This optimal position is represented by benefits arising from the inter-linkages between financial integration and monetary policy, financial stability and the real economy.

3.1 Financial Integration and Monetary Policy

Financial integration has important implications for the implementation and efficacy of monetary policy in the euro area. The implementation of monetary policy is channelled through the financial system and the smooth and efficient transmission of monetary policy through these channels requires efficient integrated financial markets which are accessible to all market participants on an equal basis. This is to ensure that monetary policy is transmitted equally to all segments of the market and to all market participants in a smooth and timely manner, in order to meet the policy requirement. The degree of financial integration is therefore important in determining how effectively this transmission will work in practice: with due regard also being paid to the role of the payment and settlement systems (Trichet, 2005a). A lack of integration in financial markets will result in the transmission of monetary policy in an uneven fashion across member countries and, in more extreme cases, market segments operating on a fragmented basis in a single currency area may be immune to policy changes entirely.

There are a number of ways in which the transmission of monetary policy and the expectations of policy changes are reflected in efficient CP markets. First, owing to arbitrage amongst credit options, CP yields will rise or fall in line with an increase or decrease in the policy interest rate. The result is that the transmission mechanism of monetary policy will extend through this credit channel and into the short-term paper market and thereby adjust the cost of capital in accordance with the intention of the policy measure. Furthermore, in an integrated and efficient CP market whereby market participants are equally well informed, the expectations of policy rate changes will be incorporated into the risk and term premia of CP yields in advance of the actual rate change. These elements of arbitrage and market efficiency facilitate the smooth transmission of monetary policy through the CP market. The absence of a sufficiently integrated CP market, where there is insufficient liquidity, harmonisation and information across market regions and participants, will result in the fragmented transmission of monetary policy and result in differing costs of capital amongst different market participants.

The timely transmission of monetary policy through the CP market causes the policy action to take effect in what is a significant credit channel for both financial institutions and corporate sector entities alike. This, therefore, allows the policy action to have the desired affect on firms' activities and cash flow positions and requirements through its ability to adjust the cost of servicing CP. As a result, this has implications for the maturity structure of CP being issued and being held. Given that the maturity structure of CP reflects expectations, it is likely that issuers would modify the maturities of CP that they sell as a hedge against the possibility of errors in their policy forecast.

In addition, knowing the maturity structure of outstanding CP helps to predict yields over a short horizon and market participants often point to heavy expected maturities as a factor that helps to determine day-to-day prices (Downing, 2001). The relationship between monetary policy and financial asset prices is also of crucial importance and the degree of financial integration can act as a link between the two. Integrated and efficient markets allow for arbitrage to take place, both between asset price misalignments within an asset class and also across substitute asset classes. Fragmented markets can result in asset price misalignments in some market segments, however, where high demand coupled with a lack of options and substitutability leads to overly inflated asset prices in one region; and, in contrast, a lack of homogeneity and credibility in another region can result in inadequate demand for a liquid market and comparatively lower asset prices. The information content of financial asset prices can be an important tool in monetary analysis, as asset yields incorporate expectations for future interest-rate movements. In the absence of liquidity and risk premia, it would be expected that, due to arbitrage, the yield on short-term paper would converge to that of the policy interest rate. If in addition, agents were rational and term premia were zero, then forward overnight rates would provide unbiased forecasts of future spot overnight rates. Thus we could use the forward overnight CP rates to forecast the future path of the policy interest rate (Downing, 2001). However, term, credit and liquidity premia are not zero and are the difference between the forward CP yield and the future spot policy rate. For the purposes of monetary analysis, where these premia are well behaved they can be proxied or extrapolated allowing analysts to read what the market expects interest-rate policy to be over a future time horizon and to measure the perceived riskiness of adopting that position. This holds where markets are integrated and well informed.

In the absence of financial integration in the relevant market, the information that analysts try to extract in order to ascertain expectations is polluted by a noise problem arising from the inefficient pricing of the asset owing to the fragmented nature of the market. In such circumstances, the noise problem can make it indistinguishable whether certain regions or participants of a market are demanding higher premia or whether they simply have alternative interest-rate expectations to other market participants or those in another region. A fragmented market place in a single currency area can particularly suffer from this problem. The optimal information allocation and arbitrage opportunities afforded by a fully integrated market would eliminate such misalignment of prices within an asset class across markets within a region, thereby allowing both analysts and other market participants to better judge the market expectations.

A more integrated and liquid CP market across the euro area is of further interest from a monetary policy operations perspective as CP is accepted as collateral by the Eurosystem from credit institutions who engage in open market operations and intra-day credit operations. Further integration in the CP market will facilitate increased liquidity and demand, resulting in additional issuance of CP being available for use as collateral. An integrated euro area CP market, with increased liquidity and homogeneity, would facilitate a more active cross-border market, enabling investors (and credit institutions) to more easily purchase CP issued in other Member States. In fragmented domestic CP markets, domestic credit institutions will purchase CP according to their portfolio needs and this can be used as collateral, whereas credit institutions and investors in other countries are less likely to buy into the market. A more integrated CP market, however, can be easier accessed by credit institutions in the country of CP issuance but also by credit institutions in other Member States, resulting in a wider range of CP being considered for purchase by credit institutions across the euro area and in the use of this CP as collateral on a cross-border basis. Thus, increased integration and cross-border participation in CP markets would maximise the volume of CP eligible for use by credit institutions as collateral in Eurosystem market operations and accentuate the 'level playing field' in the availability and use of collateral across the Eurosystem.

3.2 Financial Integration and Financial Stability

The link between financial integration and financial stability, while entailing synergies with the link between financial integration and monetary policy as discussed above, is also of importance in its own right. The pillar on which financial stability is based requires that financial markets, participants, institutions and the financial system as a whole are able to withstand an adverse shock. The ability (inability) of each of these facets to withstand such a shock and to maintain financial stability is related to the degree (lack) of financial market integration and its associated efficiencies (inefficiencies).

The contribution of financial integration to financial stability takes effect on a number of levels. Financial integration is conducive to increased market participation, thereby bringing a wider number of market participants together from a number of regions and/or on a cross-border basis. This offers additional opportunities for financing and risk diversification through the ability of market participants to access a wider range of financial products and transaction counterparties in a more liquid market. This additional range of financial products and counterparties allows market participants to diversify their portfolios to a greater extent, to take positions in the market that they would perhaps otherwise not be able to adopt and to share idiosyncratic risk across regions with a wider range of counterparties. These options allow market participants to adopt an improved diversified portfolio position and, at the same time, idiosyncratic risk is shared over a wider financial system thus strengthening the ability of the system as a whole to withstand any shock and maintain financial stability. This will further improve the soundness and robustness of an integrated financial system (Trichet, 2005d).

Financial integration contributes to financial stability through the creation of deeper financial market participation by facilitating a smooth and efficient reallocation of financial resources between savers and investors, allows increased and better risk management to take place across regions and facilitates the more accurate assessment and pricing of financial risks (Trichet, 2005d)[6]. In contrast, the sub-optimal allocation and pricing of financial risks that are inherent in fragmented and poorly integrated markets presents a more condensed level of risk to a market and can lead to/or accentuate risks to financial stability and the inability of the wider financial system to cope with such risks. Such events can have knock-on effects on the confidence in financial markets and on real economic activity and price stability.

As financial markets integrate to a higher degree, participants can benefit from the deeper markets as outlined above. Once the integration process has finished, however, the financial risks and portfolios held by the wider financial system itself can no longer be diversified any further and careful analysis of the cross-border inter-linkages and possible contagion that may arise from the increased sharing of risk exposures and their implications for financial stability is warranted. Therefore, the end-point in financial integration brings with it its own inherent risk, that optimal diversification on a micro level causes the wider system, on a macro level, to be more susceptible to failure due to increased co-exposure to certain risks. Financial integration nevertheless strengthens the resistance of the financial system to shocks that threaten financial stability through the increased risk diversification and the creation of a more robust financial system in the face of cross-border financial shocks. This is not withstanding that the integration process necessitates caution and analysis as to the transmission path and response functions of increased cross-border and common risks, insofar as is possible to ensure that financial instability in one country does not threaten to cause equal damage in another.

3.3 Financial Integration and Real Activity

Financial integration can also influence real activity in the economy, both in its own right and through the channels highlighted above. As indicated, increased financial integration can lead to deeper and more accessible markets allowing greater opportunities for diversification and risk sharing and thereby facilitating financial stability. The presence of confidence in the financial system and sustained periods of financial stability

6 This is of commensurate importance in terms of financial asset prices as in a poorly integrated and fragmented market with a lack of substitutability, strong internal demand within the small market for a financial asset of inadequate supply may result in the asset becoming over-priced and an asset price-bubble ensuing. This itself carries significant risks to financial stability. In addition, if certain assets are mis-priced they can prevent participants and analysts from gauging market expectations which can in turn cause poor risk diversification through price constraints and bad judgement.

throughout each facet of the financial system is, in itself, conducive to higher levels of real activity. Such confidence in the financial system encourages financial transactions and thereby encourages investment and expenditure, generating increased productivity and output.

Also, an equal transmission of monetary policy throughout the euro area, arising from financial integration, facilitates a ‘level playing field’ in the cost of funding for market participants across the region. This eliminates any advantages (disadvantages) some countries/regions may have experienced in cost of funding and is therefore conducive to equal market conditions across the euro area and thereby helps to eliminate regional distortions in demand and real activity.

Financial integration, in its own right, leads to deeper and more liquid markets, which encourages the expansion of financial intermediaries within and across borders. This in itself is a boost to real activity through increased flows of money and employment in the sector. This encourages deeper markets and further economies of scale and scope within the sector, and facilitates further financial innovation and services across borders. Such second round effects also encourage real activity through the increased investment and risk diversification options and sources of funding on offer. This will, as a result, lead to greater efficiency in the euro area financial sector and put downward pressure on the cost of financial services (Trichet, 2005a). By increasing the supply of funds available, particularly in regions that may previously have been less financially developed, additional investment opportunities will arise and increased real activity and output will ensue, with a rise in GDP being the ultimate recognisable real benefit.

The effect of financial integration will be to create more efficient and liquid financial markets which provide additional investment and risk diversification opportunities, leading to increased real activity and economic growth. In generating economic growth through financial innovation, cross-border expansion and financial flows between market participants and intermediaries, financial integration is viewed as creating a more sustained non-inflationary economic growth through a build up of first and second round levels of real activity as opposed to arising from second round or wealth effects from asset price bubbles. In this regard, the real activity and output generated from increased financial integration are of significant importance to the future prosperity and long-run success of the euro area.

4. The Role and Functioning of the STEP Label

In an attempt to overcome the fragmentation described in the market for short-term paper and to foster development and integration in the market, ACI — The Financial Markets Association and The European Banking Federation, Euribor-FBE[7], will act as joint promoters of The Short-Term European Paper initiative. The STEP Label will be awarded to programmes which voluntarily comply with the standards set down in the STEP Market Convention in order to encourage the convergence of standards and practices which currently prevail in the European domestic markets and the international ECP market. This convergence and voluntary compliance with standards will take place within the existing national and European legislative, regulatory and supervisory frameworks. Commercial paper and certificates of deposit programmes governed by the laws of EU Member States are eligible to apply for assessment to qualify for the STEP Label.

The STEP Market Convention (the Convention) contains the standards and eligibility criteria which short-term paper programmes must meet in order to be awarded the STEP Label. The criteria relate to information disclosure, extent of documentation, settlement, issuance amount and duration, although the STEP Label will stop short of implying the creditworthiness of the issue or the issuer(s). These voluntarily achieved criteria will encourage an increased degree of harmonisation of short-term paper programmes across Europe and indicate a commonly achieved set of standards and uniformity across the different short-term paper markets, irrespective of country of issuance or listing, thereby bringing the domestic CP markets, such as the French, closer to the ECP market. This indication of uniformity and tradability will foster a deeper and more liquid short-term paper market and encourage increased investor demand.

The STEP Market Committee will be the joint steering committee of the European Banking Federation and Euribor-ACI in their STEP Labelling work and is responsible for the STEP Market Convention. The STEP Secretariat, which will perform the STEP Labelling and act as secretariat to the STEP Market Committee, will be created under the joint responsibility of Euribor ACI and Euribor FBE, but will be part of the structure of Euribor FBE. All applications for the assessment as to the eligibility of a short-term paper programme will be handled by the STEP Secretariat who, following a review of the information memorandum and the available information, will decide on whether to award the STEP Label on the basis of the programme’s ability to meet the criteria.

In order to obtain and maintain the STEP Label for a short-term paper programme, the issuer, the features of the programme and the notes issued under the programme must comply with the requirements of the STEP Market Convention, including its

7 Euribor FBE — Euribor Federation bancaire europeene.

annexes. The criteria and requirements for the STEP Label include the following:

i) types of issuers: The issuer shall be in one of the following categories: non-financial corporation, monetary financial institution, other financial intermediary, insurance corporation or pension fund, general government or supranational/international organisation;

ii) the programme: Short-term paper programmes based on the law of an EU Member State shall be eligible for the STEP Label. The documentation defining the programme shall be publicly accessible to any interested party;

iii) the notes: The programme shall include a description of the notes to be issued under the programme and the rights of the holders of such notes;

iv) book entry form and electronic settlement: The notes issued under the programme shall be issued in a securities settlement system (SSS) in book-entry form, be freely transferable, be settled electronically and be attributed an ISIN code;

v) currency of issue: The notes may be issued in any freely convertible currency permitted by the relevant authorities. The issuer shall ensure compliance with all applicable national currency and related rules;

vi) minimum issuance amount: The minimum issuance amount shall be €150,000. For non-euro denominated issues, compliance with this requirement shall be assessed using the euro foreign-exchange reference rates published on the website of the ECB on the date of issue;

vii) maturity: All notes under the programme shall have a minimum initial maturity of one day and a maximum of one year;

viii) the information memorandum: Issuers shall provide the STEP Secretariat with a completed information memorandum, whose form and content must be as described in the Market Convention and be submitted electronically in the English language. At least one authorised signatory of the issuer shall sign the information memorandum attesting to the completeness and accuracy of the information contained in it;

ix) multi-issuer programmes: When the programme has more than one issuer, each issuer shall provide the information requested in the standard information memorandum and its appendices. The information memorandum must clearly identify each entity entitled to issue notes under the multi-issuer programme;

x) global programmes: Global programmes (i.e., programmes for the issue of Notes in more than one jurisdiction) can in principle be STEP-compliant. However, the STEP Label shall only apply to the types of notes, issued under the global programme, which fulfil all the criteria and requirements. Consequently, the STEP statistics will only cover such notes;

xi) issuance and settlement: All the notes issued under a programme shall be issued in a SSS established in an EU Member State and has been declared as a STEP eligible SSS; and

xii) STEP statistics: The ESCB shall produce statistics on the STEP market and make them available on the ECB's website. The issuer shall arrange with and authorise the eligible data provider and the STEP Secretariat to receive, process and transmit to the ECB data concerning the issuer and its programme.

An application for the STEP Label for a programme should be accompanied by the requisite application form, the information memorandum with its appendices and a declaration of adherence to the Convention and should be submitted to the STEP Secretariat[8]. The STEP Label shall be granted for an indefinite period, as long as the programme complies with the Convention. In addition, the information memorandum for a programme and relevant appendices shall be updated and re-submitted to the STEP Secretariat annually, within 60 days of the approval of the annual accounts by the board of the issuer or its equivalent. The issuer shall also update the information memorandum and the relevant appendices and re-submit them to the STEP Secretariat every time there is a significant event which changes the substance of the programme.

The STEP Secretariat will be assisted in the labelling by the Eurosystem, following the decision by the Governing Council in July 2004 to support, in principle, the activities pertaining to the introduction of a STEP Label for the first two years after its launch. Specifically, the Eurosystem, including a number of National

8 Further details on these documentation requirements and the STEP standards are contained in the Market Convention on STEP (see also www.stepmarket.org). Applications to have a short-term paper programme awarded the STEP Label can be directed to the STEP Secretariat using the designated email address application@stepmarket.org.

Central Banks (NCBs), will provide technical support to the labelling process for the first two years of the STEP Label, with Eurosystem staff having already contributed to the formulation and discussions on the formation and procedures for the STEP Label framework through the Euribor ACI-STEP Task Force. However, this will not entail an NCB becoming responsible for taking a specific course of action, such as the awarding or the suspension of the STEP Label to a programme. All such responsibilities rest with the STEP Secretariat. In addition, the Governing Council also approved the role of the Eurosystem in the collection and publishing of STEP Statistics on yields and volumes on an ongoing basis, with the intention of fostering integration and reducing issuers' costs through greater market transparency (Trichet, 2005b). Such statistics will measure the size and activity of the STEP market and provide an overview of the structure of the market, while they will also be of value to analysts in ascertaining market sentiment and expectations.

While the STEP Label initiative is essentially a market driven one, the Eurosystem sees itself as having a role to play in helping to foster such initiatives to promote financial integration. In its role in the STEP Label, the Eurosystem aims to foster financial integration through the following two methods (Trichet, 2005b):

i) enhancing knowledge and raising awareness of the state of and need for European financial integration; and

ii) acting as a catalyst for private-sector activities by facilitating collective action and assisting with possible co-ordination problems.

The Eurosystem's support of the STEP Label process meets these objectives and helps to define the extent of the contribution which the Eurosystem will actually make to the process. Furthermore, to the extent that financial integration has important implications for financial stability and monetary policy, the Eurosystem has an obligation under the Treaty establishing the European Community for the safeguarding of financial stability, which in turn safeguards the financial system which is necessary for the transmission of monetary policy. In this regard, the Eurosystem is contributing to carrying out its mandated function in fostering financial integration through promoting the STEP Label.

5. Conclusions

Financial market integration and a 'level playing field' for all market participants are key features for a successful single currency area. While most financial market segments in the euro area have achieved these objectives, the least integrated segment remains that of short-term paper. While outstanding amount of issuance of CP in the euro area is gradually becoming comparative to the US, these figures mask the fragmented nature of the CP markets in Europe. While the US financial markets remain the benchmark for integration, the market for CP in Europe is dominated by fragmented domestic markets, with little in the way of cross-border listing and trading. The growth of the ECP market has increased cross-border conformity to some extent, yet the importance of domestic fragmented markets and their lack of standardisation has prevented the development of a truly single short-term paper market in the euro area.

Further financial integration is needed in the short-term paper market in order to achieve a single, more standardised, market. This is necessary in order for a single currency area to operate at its optimal level of efficacy. Financial integration is necessary for the even and smooth transmission of monetary policy to all elements of the economy, in an equal and timely manner. Financial integration also helps to create deeper and more liquid markets, allowing for greater investment and risk diversification on a cross-border basis. This facilitates improved risk management and diversification of risk exposures and thereby contributes to financial stability in the region. In addition, arising from the contribution to improved monetary policy transmission and financial stability, and in developing the financial sector and facilitating increased monetary flows, financial integration also contributes to improving the level of real activity and ultimately can have a positive effect on output and GDP.

As the Eurosystem's mandate is to facilitate the smooth transmission of monetary policy and to maintain price stability and has an obligation to safeguard financial stability, one important aspect of this is to support the STEP Label initiative. Further integration of the short-term paper market requires the convergence of market standards and practices. The STEP Label will attempt to improve conformity and standardisation in the short-term paper market by awarding the STEP Label to short-term paper programmes which voluntarily comply with the standards and criteria set down in the STEP Market Convention. This uniformity among short-term paper programmes across Europe will help foster financial integration by creating a standardisation and convergence in CP features and thereby facilitate increased cross-border listing and trading in what will become a more standardised type of financial product.

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