Financial integration

Bank of Finland Studies A:108 · 2004

Heikki Koskenkylä (ed.)

Financial integration

Bank of Finland Studies
A:108 · 2004

Heikki Koskenkylä (ed.)

Financial integration

Bank of Finland Studies
A:108 · 2004

The views expressed in this study are those of the authors and do not necessarily reflect the views of the Bank of Finland.

ISBN 952-462-164-9
ISSN 1238-1683
(print)

ISBN 952-462-165-7
ISSN 1456-5943
(online)

Vammalan Kirjapaino Oy
Vammala 2004

Abstract

Financial integration is key to the European Union's growth and competitive strategies – part of the Lisbon Strategy – which aims at raising the EU to be the most competitive economic area in the world. A European Commission report states that the growth and employment effects of broadening and deepening integration will be considerable. The effects will be seen in household and companies' access to both financing and other financial services at rates below those of today and from a broader and more reliable array of services.

Financial integration has advanced varyingly, hastened by market forces, technological development and the euro. Authorities play a crucial role in both the promotion of integration and stability, the maintenance of confidence in financial market activities, improved consumer protection, prevention of criminal misuse of the financial system and promotion of competitiveness.

Integration is most advanced in the European debt markets and in the wholesale market for short-term debt instruments. Development within the retail banking sector has been slower. Households and small and medium-sized companies are still modest users of cross-border financial services. Infrastructures already in place in financial markets, concerning large-value payments, operate effectively and reliably at the cross-border level. Systems handling small-value payments still must be improved in order to provide as rapid and reasonably-priced transfer of payments across international borders as now happens with domestic transfers. Cross-border securities clearing and settlement continues to be inefficient and expensive. However many EU-level fora are looking to solve the perceived shortcomings in access to cross-border financial services and trade.

The European Commission has actively furthered financial market integration, as too the ECB and the ESCB, both of which have made efforts to influence the development of an internal market within the financial markets, leading to close cooperation between the European Commission, European Council and ESCB.

Keywords: financial markets, integration, clearing and settlement systems, structural change, regulation and supervision, stability

Tiivistelmä

Rahoitusmarkkinoiden yhdentymisellä on keskeinen merkitys EU:n kasvu- ja kilpailustrategiassa. Tämä ns. Lissabonin strategia pyrkii nostamaan EU:n maailman kilpailukykyisimmäksi talousalueeksi. Euroopan komission selvitysten mukaan rahoitusmarkkinoiden integraation laajenemisen ja syvenemisen kasvu- ja työllisyysvaikutukset ovat huomattavan suuret. Viime kädessä ne ilmenevät siten, että kotitaloudet ja yritykset saavat rahoitusta ja muita rahoituspalveluita nykyistä halvemmalla ja että tuotteet ovat monipuolisia ja luotettavia.

Rahoitusmarkkinoiden integraatio on edennyt eri sektoreilla varsin eri tahtia. Viime kädessä integraatiota vievät eteenpäin markkinavoimat. Sitä jouduttavat tekninen kehitys ja yhteinen raha, euro. Myös viranomaisilla on keskeinen rooli integraation edistämisessä sekä siinä, että vakaus ja luottamus rahoitusmarkkinoiden toimintaan säilyvät. Tähän kuuluvat myös kuluttajansuojan edistäminen, rahoitusjärjestelmän rikollisen käytön estäminen sekä kilpailun edistäminen.

Integraatio on edennyt pisimmälle velkakirjamarkkinoilla ja erityisesti lyhyen rahan tukkumarkkinoilla. Vähittäispankkitoiminnassa kehitys on ollut selvästi hitaampaa. Kotitaloudet ja pienet sekä keskisuuret yritykset käyttävät toistaiseksi varsin vähän muista maista tarjottavia rahoituspalveluita. Rahoitusmarkkinoita tukevassa infrastruktuurissa suurten maksujen järjestelmät toimivat jo tehokkaasti ja luotettavasti maiden välillä. Pienten maksujen järjestelmissä on vielä paljon tehostamisen tarvetta ennen kuin maksut maasta toiseen kulkevat yhtä nopeasti ja edullisesti kuin kotimaiset maksut. Arvopapereiden kaupassa selvitys ja toimitus maiden rajojen yli on edelleen tehotonta ja kallista. Kaikkia näitä puutteita maiden välisten rahoituspalvelujen saatavuudessa ja kaupassa selvitellään tällä hetkellä aktiivisesti monella EU-tason foorumilla.

Euroopan komissio on ollut varsin aktiivinen rahoitusmarkkinoiden integraation edistämisessä. Myös Euroopan keskuspankki ja koko keskuspankkijärjestelmä ovat monin tavoin pyrkineet vaikuttamaan rahoitusmarkkinoiden sisämarkkinoiden syntyyn ja kehittymiseen. Yhteistyö komission ja neuvoston sekä keskuspankkijärjestelmän välillä on ollut tiivistä.

Asiasanat: rahoitusmarkkinat, integraatio, maksu- ja selvitysjärjestelmät, rakennemuutokset, sääntely ja valvonta, vakaus

Preface

Financial integration is vital to the growth and development strategies of the European Union. According to the findings of the European Commission, the positive effects of integration on overall growth and job creation are significant. The Commission's Financial Services Action Plan set up in 1999 is reaching completion. This has brought about increased discussion on the promotion of financial sector integration in the future. Integration aims at enhancing efficiency and thus improving the competitive standing of the financial sector of the European Union area. The need to ensure financial sector stability is also an aspect which is highlighted. To this end, increasing attention is being paid to the development of the regulation and supervision of the financial sector.

The aim of the publication is to provide fundamental information on the integration process within the financial sector to a broad reader base. The objective is also to promote discussion on the subject.

The publication has been the responsibility of the experts from the financial markets department at the Bank of Finland, with Heikki Koskenkylä, Head of the Financial Markets Department, bearing overall responsibility. The executive editorial team was made up of Tuomas Takalo, Marianne Palva and Tuomas Välimäki. The section on the insurance sector was commented on by Timo Laakso from the Insurance Supervision Authority. Finnish language revision and editing was undertaken by Kaisa Paasovaara and Raija Moilanen. Translation was made by the Language Services team at the Bank of Finland. Nina Björklund, Senja Kirjonen, Teresa Magi, Päivi Nietosvaara, Kati Salminen, Petri Uusitalo and Janne Villanen have been responsible for the technical preparation of the publication. The texts in the publication were written in the spring and early summer of 2004.

Helsinki, August 2004
Matti Louekoski

Contents

Chapter 1
Heikki Koskenkylä
Introduction 9

Chapter 2
Esa Jokivuolle – Kari Korhonen
Overview of financial integration 15

Chapter 3
Pertti Pylkkönen
Securities markets integration 41

Chapter 4
Jukka Vauhkonen – Pertti Pylkkönen
Integration of European banking and insurance 73

Chapter 5
Kirsi Ripatti
Integration of exchange operations and clearing and settlement systems 117

Chapter 6
Heli Snellman
Integration of payment systems 143

Chapter 7
Heikki Koskenkylä – Jenni Koskinen
Financial stability, regulation and supervision 169

Annexes 1–3 217

Chapter 1

Introduction

Heikki Koskenkylä

1 Introduction 10

1 Introduction

Integration of financial markets, coupled with the creation of an extensive and profound internal market within European Union is crucial to the financial sectors within the framework of the EU's growth and competitive strategies. These strategies form part of a renewal programme, known as the Lisbon Strategy, which aims at raising the European Union up to being the most competitive economic area in the world. According to a report issued by the European Commission, the effects of financial integration, on growth and employment will be considerable. Ultimately, the effects will become apparent in household and companies' access to both financing and various financial services at rates below those of today and from a broader, more up-to-date and reliable array of services.

Integration within the various sectors of the financial markets has progressed at a significantly different pace, although progress has been made in each. In general, market forces have driven the integration process forward, hastened by technological development and a common currency. Authorities also play a crucial role in both the promotion of integration and stability as well as maintenance of confidence in financial market activities. Consumer protection is a fundamental part of the integration process, along with the prevention of criminal misuse of the financial system and promotion of competitiveness. The extension of the financial sector's internal markets has brought about an increase in the size of the companies operating in the sector, growth which shows signs of continuing, resulting in the future significance of competitiveness being even more noticeable than in the past.

Integration is currently most advanced in the European debt markets and in the wholesale market for short-term debt instruments. There have also been signs of integration in capital markets. Meanwhile, development within the retail banking sector has been noticeably slower. Households, as well as small and medium-sized companies continue to be very low-level users of cross-border financial services. A situation that is also reflected in the insurance sector. Within the framework of infrastructures already in place in the financial markets, those whose functions concern large-value payments operate effectively and reliably at the cross-border level. Systems handling small-value payments still need to be improved in order to provide as rapid and reasonably-priced transfer of payments across international borders, as now happens with domestic transfers. Cross-border securities clearing and settlement continues to be

inefficient and expensive. However, there is a high degree of activity within many EU-level fora, looking into solving the perceived shortcomings in access to cross-border financial services and trade, as explained in detail in the book.

The European Commission has been particularly active and set up many initiatives to promote integration of the financial sector. This is also the case with the European Central Bank and the European System of Central Banks, both of which have made efforts to influence and support the creation and development of an internal market within the financial markets. To this end, there has been close and productive cooperation between the European Commission, Council and the ESCB.

The Commission's main initiatives in recent years have been concerned with bringing about the objectives of the Financial Services Action Plan, applying the so-called Lamfalussy Process, thus creating a more effective and flexible legislative framework. The European Parliament and the EU Council have supported the proposed changes and their implementation. Seeing the draft legislation through the Parliament and Council has been a crucial and time-consuming process over the last few years.

Recently two key issues have been highlighted regarding the continuing development of financial sector integration. First, is supervision with a national mandate adequate both for ensuring stability and reliability as well as being capable of providing adequate crisis management, when integration and structural change are moving forward as such a pace? Second, to what degree do the differences in the EU regulation process itself in addition to the differences in national supervisory practices present obstacles to the broadening and deepening of the financial integration process?

In terms of the first question, many consider that the completely different systems of monetary policy issues and financial market supervision are conflicting in nature and are thus problematic. The euro area's monetary policy is a united whole and its function is the responsibility of the Eurosystem. Therefore, the point of view taken is that of the euro area as a whole, rather than of the individual nations. The single monetary policy's objective is price stability throughout the entire euro area. Supervision of the financial sector, on the other hand, is completely in the hands of the respective national supervisory authorities, as too is crisis management. Stability and the promotion of financial institution capital adequacy are similarly the remit of the national authorities. At present, there is little sign of change to this set up in the near future. There is however, ongoing discussion among the

various authorities and the market participants, in particular, as well as academia on the issue.

The EU response to the structural difference between monetary policy and supervision has been to develop greater cooperation and coordination between supervisory bodies along with the development of multilateral crisis management. Cooperation has been extended on the one hand between central banks and supervisory authorities and on the other hand between the authorities themselves. The cooperative approaches have been through multinational committees and working groups as well as cooperative partnerships and in drawing up Memorandums of Understanding. Because the cross-border use of financial services is growing rapidly, along with a growth in trans-national infrastructures, and because large multi-national financial conglomerates are being established in the EU area there are tremendous pressures and challenges being placed on the supervisory system to maintain efficient operations and to develop itself to meet future needs. This is greatly due to the fact the probability of contagion of systemic risk between nations rises with the advance of integration.

The answer to the other, previously-mentioned, pressing question has been looked to from the Lamfalussy process and new supervisory committees. The Lamfalussy process aims at improving the legislative procedure and the overall harmonisation of the respective regulations. The new supervisory committees (CEBS, CESR and CEIOPS) all advise on the drafting of regulations and aim to bring about their efficient implementation at national level. Crucial to the objectives of the supervisory committees is the facilitation of cooperation and the convergence of supervisory measures. The facilitation and promotion of crisis management is also part of the committees' mandate. Supervisory measures vary considerably from nation to nation. In fact the significant differences that exist between measures now form obstacles to the integration process. There is considerable pressure being placed on the supervisory authorities by financial institutions and the Commission alike to harmonise the procedures used. If progress is not made in this area fairly soon, the structure of the EU's supervisory organisation will have to be reassessed.

In terms of the financial sector, policies concerning both regulation and supervision have to be increasingly aligned with the enlargement of the European Union and global developments. There is also the objective to support the competitiveness of EU area financial service firms in both their own and the global market. The larger EU nations in particular are already widely represented in global fora, but the Commission and the European Central Bank have their own roles to

play in many contexts, often as observer. The EU has initiated discussions in particular with the United States and Switzerland concerning regulation and supervision-related issues. The prerequisites for cooperation can only be expected to intensify and broaden in the coming years, as the internationalisation of the financial sector picks up pace.

This book aims at presenting a comprehensive view of the European Union's financial market integration and the challenges they face in the near future. Chapter 2 looks at the grounds for financial market integration, its history and perceives advantages. Chapters 3 to 6 examine the development of integration in the financial markets various sectors and regulatory progress in the respective sectors. Chapter 3 goes into detail concerning the securities markets, chapter 4 looks at the banking and insurance sectors, chapter 5 at stock exchanges and securities clearing, while chapter 6 goes into detail over payment systems. Chapter 7 examines the stability of the financial system in addition to looking at regulation and supervision issues.

Chapter 2

Overview of financial integration

Esa Jokivuolle – Kari Korhonen

2 Overview of financial integration... 16
2.1 Introduction... 16
2.2 Financial market integration in the EU................................ 17
2.2.1 General aims of integration 17
2.2.2 Background and history of integration..................... 20
2.2.3 Progress in EU financial integration......................... 24
2.3 Research on financial market integration 30
2.4 Challenges.. 33

References 37

2 Overview of financial integration

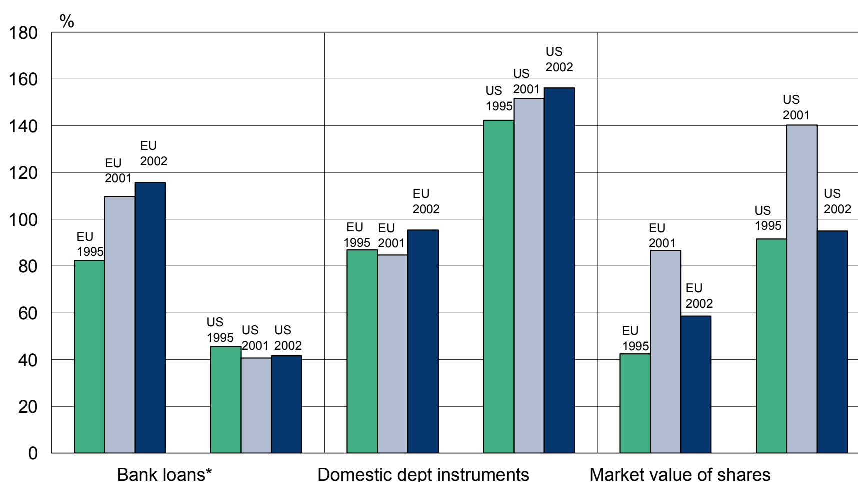
2.1 Introduction

The financial markets have been internationalising at a rapid pace ever since the 1970s. The key factors behind this trend are technological development and the rise of neoliberalism. International trade and the liberalisation of capital movements are seen as important tools for boosting economic efficiency and growth.

The process of financial market integration in the European Union should be viewed against the broader background of global financial market integration. Increasingly, issues relating to the development, regulation and supervision of the financial system require global solutions. The EU is an active protagonist in the development of the international financial markets, but also has to adapt and apply the results of international projects in its own legislation.

There remain considerable differences between the world's main economic regions in terms of financial sector structures. This means the internationalisation and integration of financial markets is still incomplete. Within the EU there are considerable differences across countries, and the EU's financial markets as a whole also differ considerably from the US market, which is generally considered the most highly developed in the world (figure). Research suggests the EU could still derive considerable benefits from more effective integration of financial markets and services. Good financial services along with ready availability and efficient allocation of capital are key requirements if the Union is to achieve more rapid growth and successfully implement the Lisbon objectives. According to the strategic goal set out at Lisbon, the European Union's objective for the present decade is: 'to become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion.'

Figure **Capital finance by type in the EU 15 and the United States, % of GDP**



* EU bank loans for 2002 do not include data on the United Kingdom.
Sources: ECB, BIS and OECD.

2.2 Financial market integration in the EU

2.2.1 General aims of integration

A key aim of the European Union is to create an integrated economic area in which trade in goods and services and movement of capital and labour between Member States are as frictionless as possible. An integrated economic area will provide a larger market for goods, allowing the benefits of scale economies to reduce average production costs. As competition increases, the prices of goods will come down, to the benefit of consumers. Increased competition will also force producers to develop more efficient production methods and processes, in turn boosting productivity. Another outcome of increased competition will be a broader range and better average quality of products. It will also be possible within the Union to agree common rules of conduct and minimum product standards, leading to a level playing field and a common foundation for consumer protection.

The lowering of obstacles to labour mobility will bring greater choice to the labour market and promote efficient utilisation of labour. Labour mobility will also ease the adjustment of economies in the area to regional shocks reflected in the volume and structure of output. On

the other hand, economic integration could also lead to an uneven allocation of economic resources and activities between Member States. If this were to occur, achieving a sufficiently even distribution of the overall benefits of integration would be a challenge, particularly if labour mobility were not fully realised, due eg to linguistic or cultural obstacles.

Integration of financial markets and services is fundamental to the broader process of market integration and will facilitate progress in other areas. A varied range of quality financial services and sufficiently low capital costs are vital to the functioning of all sectors of the economy. Better, more diverse and cheaper finance and related services through market integration also constitute a goal in themselves. Ultimately, a large, highly developed financial market will foster and stabilise economic growth.

On the other hand, the order in which measures to further financial market integration are implemented could have an impact on the stability of the financial system. The liberalisation of capital movements and the experiences gained from this around the world, including here in Finland, are a good example. Experience has shown that avoiding the financial crises that have often followed liberalisation would require simultaneous reform of supervisory institutions. The big challenge for the EU in financial regulation and supervision continues to be to seek out and establish workable solutions (chapter 7).

Integrated international financial markets would also appear to provide a channel for the rapid transmission of problems from one country to another. Contagion of this sort is not necessarily based on economic fundamentals. But to reject financial market integration for this reason would be short-sighted, as increased stability could actually be one of the long-term consequences of integration.

The financial markets' importance to economic development can be understood better if we first look at the basic functions of the financial system. These can be divided into four parts, as follows.[1] 1) *Accumulation of savings.* A developed financial market enables the efficient accumulation of savings from separate sources, irrespective of the volume of the individual sums involved. This, in turn, facilitates the financing of major investments. 2) *Spreading of risk.* On the other hand, the accumulated savings of private persons and corporate entities can be dispersed across different investment objects, so that individual investors need not bear unacceptably large individual risks.

---

[1] OECD (2003).

3) *Allocation of resources.* In developed markets, financial intermediaries specialise in the evaluation of investment projects. This is essential for efficient decision-making on credit and investment but is not cost-effective if done separately by each individual saver. In addition, the pricing of securities in an efficient market reflects the true values of companies and investment projects and provides guidance and incentives for sound finance and investment decisions.
4) *Corporate governance.* The monitoring and control of company managers can also be carried out more cost-effectively with the help of financial intermediaries and other financial professionals. A developed securities market also provides a market for corporate control, the ultimate form of exercising managerial discipline.

The expansion of the financial market and development of financial services through integration will further all the aforementioned objectives of the financial system. One example of this that is already clearly visible is a greater spreading of investment risk within the EU area (chapter 3). In other respects, evaluation of the impact of the financial integration that has already taken place is still in progress. (For more detail on the ongoing evaluations see section 2.2.3 below.)

Economic integration and removal of the obstacles by political action will allow the market to operate as freely as possible. The final forms of the new structures and operating methods of the different sectors of the economy in the new environment will be forged by the market mechanism. Therefore, full integration – for example the concentration of production in supranational units – cannot be an official objective as such. That would be contrary to the principle of a freely functioning market and, by extension, the fundamental idea behind economic integration. In some sectors there may be natural obstacles to integration – relating eg to the nature of demand and specific properties of goods – that keep output largely locally based.[2] Only in special cases where for special reasons the market is unable to achieve an optimal solution will there be cause for the authorities to intervene in the specific development of the market. Each such case will need to be considered separately on its own merits. On the other hand, an example of the need for constant dialogue between market development and regulation is in the role of the competition authorities, ie ensuring that individual operators do not achieve a

[2] Retail banking might be a case in point. Such features are discussed in more detail in chapter 4.

dominant position in the market. The financial market also requires constant, almost real-time monitoring (chapter 7).

The single currency, the euro, and the resulting removal of exchange rate risks within the euro area have created a unique opportunity for the integration of financial markets. The convergence of interest rates on government debt within the euro area serves as a good example of the dramatic impact of euro introduction on the financial markets (chapter 3, fig. 4). The euro in itself implies the total integration of cash payments within the euro area (chapter 6).

In comparison with other service sectors, the integration of financial services is well advanced. However, given the central importance of the financial sector to the overall development of the single market, the objective is for even deeper integration. The single currency alone has not been enough to foster financial market integration in the desired manner. Thus, much work has been done in the legislative arena in an attempt to provide a better legal framework for integration, while regulatory and supervisory structures have also been overhauled. The aim is to achieve a single, uniform legislative structure for the financial sector that will further financial integration and stability and ensure a level playing field. In addition, the role of the European System of Central Banks in fostering integration has extended beyond simply the introduction of the single currency (sections 2.2.2 and 2.2.3 and chapter 7).

2.2.2 Background and history of integration

The background to financial market integration within the EU is the general process of internationalisation and globalisation of economic activity. Globalisation is a broad and vague concept. It is generally used to refer to increasing economic specialisation between countries and a deepening international division of labour, as eg car production in Germany and paper production in Finland. This leads to increasing relations and interdependencies between national economies in connection with trade in goods and services, and especially cross-border corporate investments and financial flows.[3] These processes are fostered by the general advance of technology.

Indeed, one could say that globalisation really began with the reduction in transport and transaction costs that followed the invention of the steam engine and telegraph. Transport links and communication

[3] Köhler (2003).

systems, and nowadays the Internet, allow ever more rapid connections from one side of the globe to the other.[4] Thus, a company can locate its various operations wherever a given stage of production is most cost-efficient, in terms of taxation or access to skilled labour or raw materials. A particularly clear sign of globalisation is that the financial markets function practically 24 hours a day.

Globalisation gathered pace as liberalism, or more precisely neo-liberalism, gained favour in economic thought in the late 1980s. After the Great Depression of the 1930s the world economy experienced a long period of regulatory controls. Neo-liberalism later led to a fundamental shift in policy thinking by emphasising the importance of free competition, as competition was seen to ensure the most efficient allocation of productive resources. This led to an extension of free trade and extensive privatisation of economic activity, particularly since the 1980s. At the same time, government direction has been reduced, budget discipline tightened and regulatory controls relaxed. In other words, deregulation has become the dominant ideology.

These objectives and ways of thinking have solidified to form the ideological cornerstone of the key bodies of the Bretton Woods Institutions within the Washington Consensus, which has highlighted the birth of the international financial system and the spread of the market economy.[5] Agreements aimed at trade liberalisation and the removal of trade obstacles have subsequently emerged in different regions.

International organisations have also played an important role in promoting ideas, principles and agreements relating to market economy and free trade. Two recommendations on free movement of capital published by the Organisation for Economic Cooperation and Development in 1961 (OECD Codes of Liberalisation) made an important contribution to the development of the international financial markets. The World Trade Organisation (WTO) and its forerunners have also contributed to the development of international trade in financial services.

Although capitalism has won the ideological battle, the market economy, despite its indisputable benefits in terms of efficiency, has been found to have a tendency for periodic bouts of instability. The constant flux of mutual interdependencies can cause price bubbles that lead to overinvestment and foment hard-to-control crises when they burst.

---

[4] De la Garza (2002).

[5] Williamson (2003).

Thus, market forces alone are not sufficient to ensure economic wellbeing: the interdependencies referred to above mean there is a need for broadly based international cooperation to anticipate crises and prevent them from spreading. Public and academic debate has in recent years focused particularly on the social dimension of globalisation. For example, an International Labour Organisation (ILO) commission co-chaired by Finland's president, Tarja Halonen, has pointed out that, while the economy has become increasingly global, social and political institutions have remained primarily local, national or regional in scope.[6] International cooperation has, however, sought to develop joint modes of operation for global governance in areas such as reduction of systemic risk in financial markets, convergence of economic development in different countries, fostering the cultural identity of individual regions, and protecting the interests of the poor and excluded around the world. This work is, however, only just beginning. Across the world as a whole, the EU is the region most committed to the idea of global governance.

Alongside globalisation there is also the parallel phenomenon of regionalism, or regional integration, of which the EU is an example. While globalisation in effect reduces the significance of countries or nationality, regionalism increases regional cohesion. The interaction between the two is complex.[7] Although integration is aimed at the same efficiency benefits as globalisation, it is generally easier to achieve concrete results at the regional level, for example in the monetary economy, as cooperation is more organised and the shared interests are more obvious than in the broader international community. However, regionalism can, at its worst, erect border fences. This can be seen from time to time in, for example, protectionism between economic blocs. For instance, the initial phase of the EU, the European Economic Community (EEC), began in 1957 as a customs union. This involved the removal of customs duties and the reduction of other trade barriers between member states, but at the same time common customs duties were set on trade with non-members. The shared incentives meant it was possible to achieve this faster than the original objectives set out in the Treaty of Rome. The European Council decided as early as 1969 that the Community should gradually move towards economic and monetary union (EMU).

---

[6] Henderson (2000) and World Commission on the Social Dimension of Globalisation (2004).
[7] See Kumar (2000) and Kühnhardt (2002).

The integration of European financial markets began with agreement on a common currency system following the collapse of the gold standard. The main European currencies were then linked to each other. In order to allow the Community to concentrate on consolidating intra-Community trade, an attempt was made to hold exchange rates stable even during periods of difficulty for the world economy, as during the oil crisis in the 1970s. This process finally led in 1979 to the establishment of the European Monetary System (EMS), often referred to as the ‘currency snake’, after the less formal arrangement originally set up in 1972.[8] However, notable integration of European money markets did not begin until after the deregulation of capital movements in 1988.

Table **Milestones on the road to financial integration**

1957	Treaties of Rome: European Economic Community (EEC)
1977	First Banking Directive
1979	European Monetary System (EMS)
1985	European Commission’s White Paper on Completion of the Single Market
1988	Deregulation of capital movements within the EMS economies
1989	Second Banking Directive
1992	Maastricht Treaty, decision on Economic and Monetary Union (EMU)
1993	Investment Services Directive
1994	European Monetary Institute (EMI) (second stage of EMU)
1999	Introduction of the single currency, the euro, as scriptural money; European Central Bank begins operation (third stage of EMU)
	Financial Services Action Plan
2002	Common euro banknotes and coins
2003	New Legal Framework for Payments in the Internal Market
2004	Communication on an integrated EU clearing and settlement infrastructure
2005	Decision on addition of further measures to the Financial Services Action Plan

The pursuit of stable exchange rates coupled with the deregulation of capital movements in a situation where national financial markets remained highly regulated and supervision was inadequate meant problems were likely. The Nordic banking crises were in part an example of this.

[8] Eichengreen (1996).

The Treaty on European Union (Maastricht Treaty) of 1992 both established the EU itself and paved the way for the single currency. The second phase of Economic and Monetary Union (EMU) began with the establishment in 1994 of the European Monetary Institute, which carried out much of the preparation for the introduction of the single currency. The European Central Bank (ECB) began its work in June 1998, and the third phase of EMU began at the start of 1999 with the introduction of the euro as account money. This also laid the basis for the integration of wholesale money markets.

2.2.3 Progress in EU financial integration

On 1 January 1999, in accordance with Maastricht, the euro was introduced as scriptural money and euro area national currencies became national denominations of the single currency. Exchange rate risk between members of the single currency was thereby removed and the TARGET payment system operated by the central banks of EU member states was built to serve the needs of monetary policy and cross-border payments.

A systematic and comprehensive approach to the integration of the EU's financial services and capital markets was developed with the approval in 1999 of the Financial Services Action Plan (FSAP),[9] the main objective of which is to increase competition and freedom of choice so as to reduce the costs of capital for the Community's citizens and investors. The original intention for the FSAP was to achieve sufficiently flexible solutions that market developments would not render immediately out of date. It was, however, soon recognised that the formal approval of legislation takes time, and progress has been slow. At the Lisbon Summit in 2000 the Heads of State and Government recognised the importance of an efficient financial market to European competitiveness and economic development over the long term. The backdrop was that financial market integration had not yet progressed in the manner hoped. It was also proposed at Lisbon that the FSAP be implemented by 2005, and the Risk Capital Action Plan (RCAP) by 2003.

The FSAP, the general objective of which was to create a broader basis for an optimally integrated financial sector, is based on three strategic objectives embracing 42 specific measures (annex 2). The first strategic objective was to establish a single wholesale money

[9] European Commission (1999).

market for the EU, while the other two were to foster open and safe retail financial markets and elaborate new EU-level arrangements to ensure financial stability. The goal was to develop systematic cooperation between national supervisory authorities, both nationally and at EU-level. The security objective also covers consumer protection (chapter 7).

Many of the projects under the Financial Services Action Plan have been implemented only recently, but the FSAP has also functioned more generally as a catalyst for development. According to the European Commission, over 90% of the FSAP's original projects have already been approved by EU institutions. The results achieved will, however, depend a lot on the quality of the legislation, and it is still too early to assess the impact. Many key projects are still incomplete, and their implementation at national level is in many respects only just beginning.

Financial market integration has increased over the past 10 years, if at an uneven pace in the different sub-sectors of the market. The most progress has been in sectors that already have a common market infrastructure and standardised products. The only completely integrated market has emerged in unsecured euro area money market deposits. The money markets now also have common reference rates (Eonia and Euribor). In other money market sectors, for example the repo market, obstacles have inhibited progress. The situation is similar in other sectors of the wholesale market where products traded have not yet been successfully harmonised (chapter 3).

Market forces have led to much more rapid achievement of common infrastructure solutions in the wholesale markets, between banks and between banks and major investors, than in retail markets, as it is easier to achieve economies of scale at the wholesale level. One example is the concentration of government bond trading in electronic markets based on a common technology provided by the MTS Group. The euro-denominated government bond market is already 40% larger than the equivalent US market, although the corporate bond market is much smaller. The development of this market segment is treated in more detail in chapter 3.

Several integration initiatives under the FSAP have sought to further the development of securities markets in the EU area. Notable among these are a directive on listing particulars and public-offer prospectuses and another on takeover bids. The security of payments and trading has been improved by a directive on settlement finality. Harmonised rules for the use of collateral have also been created by directive.

A Council Regulation on European companies (*Societas Europaea*) aims to facilitate restructuring through mergers between limited companies and the cross-border transfer of business domicile. The first practical applications of this regulation would appear to be specifically in mergers between financial institutions.

The proportion of foreign investment in mutual funds' total investment has risen more than corresponding ratios for insurance companies and pension funds. Growth has been particularly strong since the introduction of the euro. Moreover, indicators show there has also been considerable stock market convergence in the euro area, although the efficiency of cross-border trading continues to suffer from the variety of IT systems used in transaction clearing and settlement and the range of different procedures relating to legal, tax and other local regulations.

Stock market integration has been slow, whether measured in prices or institutional structures. Significant restructuring of the ownership of infrastructure operators has not come about until the last couple of years. In key regulatory issues the necessary level of integration was not achieved until 2004. The different procedures and technical systems used in clearing and settlement systems have kept the costs of cross-border transactions high. Some central depositories have failed to exploit the opportunities provided by modern technology. The European Commission has stressed the importance of an integrated and efficient infrastructure in supporting both wholesale and retail markets. Moreover, in a communication published in May 2004 the Commission drew particular attention to legal integration and competition as the driving forces for innovation (chapter 5).

The Commission is also convinced of the importance of supporting integration in the field of retail financial services. A key example is payment services, where the Commission has used a regulation on prices to successfully promote price integration in respect of domestic and EU area payments in euro.

The deadline for implementing projects under the FSAP is now approaching, but some of the projects are still not completed. Instead of drawing up another large new programme of financial services legislation, the Commission has decided to concentrate on seeing through to completion any unfinished projects and additional measures that have already been announced. It has therefore been working on an extension to the FSAP (known as post-FSAP), implementation of which is due to begin in 2005. This will involve the monitoring of integration by means of special indicators. Also proposed is an assessment in 2004 of the progress of the Lamfalussy process, introduced to produce more effective regulation. In addition,

the Commission has assembled a working group of leading market experts from banking and insurance, securities markets and asset management to assess the benefits achieved, the obstacles to integration, and what still needs to be done vis-à-vis financial markets. These reports will then provide a basis for a thorough strategic debate on future regulation and supervision of EU financial markets. Also awaiting completion are the most important outstanding initiatives on the re-insurance sector, securities clearing and settlement, the legal framework for payments, corporate governance, and reform of auditing procedures and company law.

In addition, the new EU directive on capital adequacy regulation in respect of banks and investment service providers is being drafted side by side with the international work of the Basel Committee on Banking Supervision, and the text of the proposed directive should be published during the course of 2004. This is a key reform, as it will replace the present out-of-date and insufficiently precise regulations on capital requirements for credit institutions and investment firms. The new regulations are due to come into effect in stages during 2006–2007, in line with decisions of the Basel Committee.

Market developments have by no means been based solely on official initiatives; the integration projects of several self-regulatory organisations of market players have produced considerable integration benefits. However, these face serious challenges regarding coordination. The European Securities Forum, which represents the larger banks, has leant its support to the official process by identifying short-term targets for the removal of several obstacles in the securities markets. These include harmonisation and automation of the handling of corporate events and tax procedures, and promoting rules that enable remote membership. Market operators have launched the STEP (Short-Term European Paper) project to pursue harmonisation of the heterogeneous standards and practices pertaining to certificates of deposit and corporate paper, creating an integrated market for these financial instruments. It is hoped the ECB will participate in this initiative as a collector and distributor of prospectus and market statistics. The project should be up and running by 2007. In similar vein, the European Central Securities Depositories Association (ECSDA) has agreed a common standard on links between central depositaries, and its members have agreed to harmonise their opening hours by the end of 2004. Meanwhile, the Group of Thirty (G30) has concentrated on the removal of obstacles to a global financial market. It published its report ‘Global Clearing and Settlement: A Plan of Action’ in January 2003. This involves an extensive project to monitor and evaluate the adequacy of implementation measures. Another

globally influential organisation, the International Securities Services Association (ISSA), is also critically assessing the implementation of its 20 recommendations.

The original FSAP has also had a number of other supportive initiatives attached to it. These are discussed below.

An integrated financial market cannot become a reality without removal of the differences between countries in the taxation of interest paid on private deposits. Thus, integrated taxation of interest earnings on deposits is one of the FSAP's most important outstanding projects. A proposal on this was made already in connection with the deregulation of capital movements, but no agreement was reached.

The reliability of accounting and other corporate financial data is of vital importance in foreign investment. The Commission has sought to raise the level of confidence in the financial markets by setting minimum quality standards for statutory auditing in the European Union and increasing cooperation both between national supervisory authorities and with the authorities in third countries. Particular attention had been given to the auditing procedures applied in publicly quoted companies, credit institutions, insurance corporations and investment firms.[10] In 2001, the fair value directive approved the introduction of fair value accounting. In addition, in 2002 the Council approved the IAS Regulation, which requires the aforementioned companies to prepare consolidated accounts in conformity with adopted international accounting standards (IAS/IFRS standards). The new procedures will come into effect in 2005, but standards intended for global application may not be ready until late 2004.

Closely related to accounting and auditing are matters surrounding corporate governance. The corporate scandals of recent years, in both the United States and Europe, have underlined the importance of common recommendations on governance.

As already referred to above, the original FSAP has later had a number of other projects attached to it. These include 1) initiatives to reinforce securities settlement systems, 2) development of a new solvency system for insurance companies (Solvency II), 3) a new directive on money laundering, 4) guarantees relating to insurance, and 5) supervision of re-insurance.

The Commission has indicated that progress in the raising of venture capital is one of the keys to ensuring the competitiveness of the EU and favourable development on the employment front, as companies must be able to take risks if they are to pursue innovations.

[10] European Commission (2000) and (2004d).

However, the EU is still very heterogeneous in this area, with considerable differences from country to country. Particularly in the new Member States, the Commission believes there remains much to be done in regard to venture capital. This is despite the fact that the special Risk Capital Action Plan (RCAP)[11], referred to above, was already drawn up in 1998. Seed financing remains backward, despite continuous upgrading of public sector support for the venture capital sector. Public funding for research and development is guided by framework programmes lasting many years at a time. Also of key importance to corporate finance are two directives already completed in accordance with the FSAP, namely the Prospectus Directive and the UCITS Management Directive (investment funds).

Other measures with indirect implications for the financial markets have been included in other initiatives, such as the entrepreneurship action plan: The European agenda for Entrepreneurship.[12] In this, the Commission seeks to make it easier as of the beginning of 2004 for small and medium-sized enterprises (SMEs) in particular to gain access to debt and equity finance. The main measure envisaged in the action plan is the introduction of new forms of financing in 2006. In addition to promotion of collateral arrangements and further securitisation, the intention is also to stress access to capital for research-oriented and innovative SMEs. We shall look again at this action plan in section 2.4 on the challenges of integration.

One area of importance for furthering integration in the retail market is consumer protection. The EU's internal problems relating to remote provision of consumer services have actually increased as dishonest service providers have adopted state-of-the-art technology. The European Commission is seeking to make it easier for national consumer protection authorities to implement the relevant EU legislation so that dishonest service providers do not escape unpunished. The key proposal is for closer cooperation between authorities.

The European Central Bank has also played a key role in furthering financial integration, as required in its founding statute. In addition to direct action, the ECB has sought to actively support market participants' own projects for furthering integration. The ECB also works to spread awareness of the need for financial integration and to promote the discovery of ways to achieve this end (see also chapter 7).

---

[11] European Commission (2003a).

[12] European Commission (2004b).

2.3 Research on financial market integration

Economic research on financial market integration can be divided into at least the following four broad areas.

1) Finance and related services can be seen as one industry among others, so that the effects of integration can be approached from the perspective of traditional industrial economics. Integration can boost competition and thereby reduce prices. In addition, a larger market enables economies of scale and scope and thus reduces average production costs. The resulting lower capital costs and financial service prices can in turn boost economic growth.

2) Another area of research is stimulated by the direct impact of Economic and Monetary Union on financial risks and hence on capital costs. The single currency has removed exchange rate risk from the euro area, thereby reducing the risks of doing business and leading to lower capital costs.[13] The removal of exchange rate risk has also made cross-border portfolio diversification more attractive, and the consequent better portfolio diversification could reduce investors' required rates of return and hence in this way also lower companies' capital costs.[14]

3) The impact of integration on the overall development of the financial system and hence on economic growth is another area of research. Most researchers believe there is a strong correlation between the size of the financial system and an economy's level of development.[15] Another important issue is the impact of integration on financial stability, which is in turn essential to stable development of the economy as a whole[16] (see also section 7.2).

---

[13] Bris et al (2004).

[14] Hardouvelis et al (2004).

[15] Levine (1997).

[16] When studying the impact of financial market integration on the stability of the financial system we should bear in mind that traditional research results concerning eg the benefits of increased competition may not hold (chapter 4). In theory, one could argue that increasing competition could lead banks to take excessive risks, in which case the costs from thus endangering the stability of the banking system could exceed the benefits of lower interest rates on loans and easier access to finance brought by competition. The latest research does, however, suggest that it is possible to increase competition without endangering stability (eg Carletti and Hartmann (2003)).

4) The development of the financial markets can also be examined from the perspective of the geographic concentration of economic activity. This relates to a scenario where integration can potentially lead to a deepening division between core and peripheral areas. Integration could thus have considerable implications for the geographic distribution of wealth.

For its part, the European Commission has begun to identify a number of indicators that can be used to monitor the progress and impact of financial integration.[17] These can be extended and honed in line with research results. The Commission has divided the indicators into three groups: 1) Direct measures of integration, which include interest rate convergence between Member States and the volume of cross-border financial activity. 2) Efficiency indicators, which include measures of financial institutions' cost-effectiveness, profitability and market power. 3) Indicators of financial stability, such as intra- and intersectoral (eg banking and insurance) mergers.

A study conducted for the Commission[18] analyses indicators of the progress of financial integration according to type and quality. It identifies the best measures for price comparisons and eg interest rate margins, because it is easy to get high-quality, regularly updated data and because price and margin convergence are direct indicators of progress towards the concrete objectives of integration. In contrast, quantitative data on stocks and flows involve much greater problems in terms of accessibility and reliability of data. On the other hand, only such data can give a picture of important issues like the distribution of wealth and hence changes in the spread of household and corporate risk.

Other studies on behalf of the Commission investigate the relationships between financial integration, the macroeconomy and economic growth.

The London Economics group examined the impact of trading costs on the EU's capital costs, using for comparison corresponding data on the United States.[19] Integration of the stock and bond markets

---

[17] European Commission (2003b) and (2004c) and Baele et al (2004). The latter study, carried out at the European Central Bank, examines the progress of financial market integration, with the main focus on the euro area. It provides support for earlier results suggesting integration has so far progressed at a different pace in different areas of the financial market.

[18] Adam et al (2002).

[19] London Economics (2002).

would lead to cost savings, while a reduction in capital costs affects consumption, investment, employment and hence economic growth. The results, which have been calculated by simulating a macroeconomic model including several countries, indicate that the level of EU's real GDP would, as a result of these integration effects, be raised by about a percentage point in the long-run. This is, however, only the finding of a single study, and it is important that other similar studies be carried out in order to improve our understanding of the effects of financial integration. The London Economics study has been criticised on the grounds that it probably underestimates the overall impact, as it does not take account of all cost structures, financial sectors and possible productivity effects of integration.

Another study[20] examined a scenario in which integration enables the EU's financial market to achieve the same level of development as the US market. Particular attention was given to the impact of integration on corporate finance and the resulting output growth. Because the financial services of Member States are at different stages of development, the benefits are not evenly spread. The study nevertheless indicates that it is possible for all to gain some benefit from integration.

A third study[21] concentrates particularly on trading costs due to securities settlement systems. Compared with the situation in the United States, these systems are still very decentralised in the EU, and their costs are high, particularly in cross-border trading. Integration of the financial market infrastructure can be expected to provide considerable cost savings that will benefit the operation of the integrated financial market. This study also looked at the cost effects of more efficient cross-border payments. The results indicate that lowering the costs of cross-border payments to the lowest current level would produce savings of up to about 40%. The study also showed that, with the exception of investment funds, the integration of financial institutions has not so far progressed very far (more on this in chapters 3 and 4).[22]

As well as the European Commission, other bodies have also been actively involved in integration research. These include the well-known Center for Economic Policy Research (CEPR), which offers membership to respected European economic researchers. The Center

[20] CEPR (2002) and Guiso et al (2004).
[21] IVIE (2003).
[22] Flood and Rose (2003) have proposed a theory-based method for examining integration in terms of share-price formation in different markets.

for European Policy Studies (CEPS) also conducts studies on the financial markets. For its part, the European Central Bank has established a research network in cooperation with the Center for Financial Studies, the aim of which is to promote European research on capital markets and financial integration. As part of the work of this network, the ECB and many of the national central banks have produced several studies dealing with integration. The Bank of Finland has been particularly active in research on payment and settlement systems, cost-effectiveness of stock exchanges, and supervision and regulation.[23]

The integration of the European financial market and financial services has been studied from the perspective of the banking sector and securities markets, but so far there has been less research on the insurance sector, for example. Admittedly, there has been some growth of interest in financial conglomerates formed by mergers between banks and insurance corporations.

In addition to research commissioned by the European authorities and studies carried out by research institutes and partly funded by the authorities, it is of vital importance that completely independent research on the impact and progress of integration is also carried out. Interest in the issues surrounding financial market integration would indeed appear to be growing among academic researchers.

2.4 Challenges

Although a lot of work has already been done on financial services, in the form of both official initiatives and development projects carried out by market operators, the single market is still incomplete and there remain obstacles to integration. The financial markets are in fact one of the key areas in which integration has progressed too slowly, and crucial development proposals are threatened with delay or dilution for a variety of reasons, including a lack of political will.

Financial market integration is expected to boost growth considerably in the EU. Realisation of these expectations is the central challenge facing the whole process.

Another challenge lies in the area of regulatory and supervisory procedures. To date, the convergence of Member States' supervisory procedures has been supported by a bilateral system of memoranda of understanding between financial supervisory authorities. However, the

[23] http://www.bof.fi/fin/6_julkaisut/index.stm

future will bring new challenges, as the increased contacts at institutional level brought about by integration will require the careful management of systemic risk. In order for supervision in itself not to form an obstacle to the benefits of integration, it will be essential to explore more appropriate procedures to simplify licensing systems, centralise related decision-making, and intensify cooperation between supervisory authorities (chapter 7).

It will also be necessary to examine the division of labour between supervisory authorities in the service provider's home country and country of location – or host country – to enable supervisors in the host country to properly perform their tasks and responsibilities. The present principle of supervisory responsibility lying with home country authorities can no longer be considered to meet current requirements. Crisis management also carries its own requirements for integration (chapter 7).

The Lisbon Council conclusions emphasised that formal regulation is not always the best approach. The alternatives of self-regulation, agreements between market participants, and market discipline in a broader sense can sometimes be more effective. The challenge is to achieve quality protection without over-regulation. Simplifying and streamlining the present regulations is important at Community level, but it is even more important for most individual members of the public and companies at national and local level. The creation of appropriate regulatory systems is part of the broader debate on the operating procedures of European Union institutions.[24] In 2001, the Committee of Wise Men chaired by Alexander Lamfalussy prepared a recommendation on improving the regulation and supervision of EU securities markets. This gave rise in 2002 to the Lamfalussy process. This four-stage procedure was intended to accelerate the regulatory process and make it more flexible. The Lamfalussy process was extended in scope in 2004 to include the banking and insurance sectors. Regulatory and supervisory committees, which are discussed in greater detail in chapter 7, are a fundamental part of the process. The cumbersomeness of the procedure is, however, expected to make it something of a burden: the extensive consultation it requires demands such resources of market participants that it could render them unwilling, or simply unable, to respond to all enquiries. The success of the Lamfalussy process is to be assessed for the first time already in 2004.

[24] European Commission (2001).

The global dimension of financial services regulation will become more important as the international deregulation of these services gathers pace under the auspices of the World Trade Organization (WTO). For this reason, dialogue particularly between the EU and the United States on issues relating to this sector has become an important component of global integration.

Because the role of financial markets is to facilitate the development of a robust real economy, many of the challenges of integration lie in the area of ownership and copyright protection as well as corporate finance. The results of consultations on how to further entrepreneurship[25] indicate a need for a genuine reduction and simplification of bureaucratic and regulatory burdens in areas of key importance to the business community, such as taxation. However, there has so far been little progress on taxation issues. The question is further complicated by the fact that there is no common definition of taxable income and the EU also lacks common accounting rules for business enterprises. The broad acceptance of International Financial Reporting Standards (IFRS) could make it easier for company groups to operate in several Member States. Under present plans, all listed companies are to be required to apply these standards as of the beginning of 2005.

The European Commission sees broader unification of the corporate tax base as only a long-term goal. In contrast, the Commission has announced its intention to launch a pilot system before the end of 2004 for simplifying and easing compliance with national obligations relating to taxation. Under this, SMEs will be able to apply for taxation according to their home country. Member States participating in this system would in turn agree to recognise the different national procedures used in calculating profit.

Another major step forward has been taken by extending the scope of the directive concerning dividend payments and other distribution of profits between parent companies and their subsidiaries. Issues relating to value-added tax on financial services represent another important challenge.[26]

Access to finance is crucial at many stages in the development of a new business. In the aforementioned European Commission consultations[27] the importance of finance was seen to have grown even more as a result of the new reliance on rating agencies and the new capital adequacy rules proposed for the banking sector. The

---

[25] European Commission (2004b).

[26] European Banking Federation (2004).

[27] European Commission (2004b).

Commission's key objective is to ensure adequate finance and collateral for the financing of all viable businesses – in compliance with Basel II capital adequacy requirements – and more even-handed tax treatment of the different forms of finance.

In the assessment of Commissioner Bolkestein[28], too often efforts to improve the EU's competitiveness have foundered because of protection of national interests via official action or market standards. This should be seen as a key challenge for further work in this area. Another possible challenge to the progress of integration may be a natural preference among consumers for using locally provided services. Familiarity with domestic regulations and suspicion of foreign service providers both tend to favour the use of domestic services. Consumers may also be concerned about how to deal with problems, for example in remote trading. Access to services in their own mother tongue is a basic requirement for many groups of consumers.

Important challenges also come from the concentration of operations in the large financial centres. The departure of services and jobs from a country can be experienced as a problem, as it could affect the availability of some financial services in crisis situations. Even under normal conditions, the availability of some financial services could in the future depend on consumers' ability to use information and communication technology.

The security and reliability of the technological solutions used to provide access to remote operation and services could be a significant source of uncertainty from the angle of the continuity of integration. For example, security gaps in infrastructure solutions implemented using this technology could undermine public confidence in the financial markets. Such solutions should be designed to ensure they do not hamper integration. The European Commission has already responded to the issue of Internet data security. As an example, the data security directive places special requirements on network operators. But legislation alone is not enough; broader action is required.[29] The contingency planning requirements imposed on the various types of service provider – banks, investment firms and central securities depositories – will depend in part on what sort of community the EU aspires to be: a federation of independent states or a sovereign federal state.

---

[28] Bolkestein (2004).
[29] Liikanen (2004).

References

Adam, K, Jappelli, T, Menichini, A, Padula, M and Pagano, M (2002) **Analyse, compare and apply alternative indicators and monitoring methodologies to measure the evolution of capital market integration in the European Union.** Center for Studies in Economics and Finance (CSEF). University of Salerno.

Baele, L, Ferrando, A, Hördahl, P, Krylova, E and Monnet, C (2004) **Measuring financial integration in the euro area.** ECB Occasional Paper No. 14.

Bolkestein, F (2004) **Progress on Financial Services Action Plan and Taxation.** Address to European Parliament Committee on Economic and Monetary Affairs Brussels. SPEECH/04/136, 16 March 2004.

Bris, A, Koskinen, Y and Nilsson, M (2004) **The euro and corporate valuations.** Yale University – International Center for Finance, Stockholm School of Economics and Stockholm Institute for Financial Research (SIFR).

Carletti, E and Hartmann, P (2002) **Competition and stability: what's special about banking?** ECB Working Paper No. 146.

CEPR (2002) **Financial market integration, corporate financing and economic growth.** November 2002.

Eichengreen, B (1996) **Globalizing Capital. A History of the Intenational Monetary System.** Princeton, NJ: Princeton University Press.

European Banking Federation (2004) **The European Single Market for Financial Services: Assessment and Future Priorities.** March 2004.

European Commission (1999) **Financial Services: Implementing the Framework for Financial Markets: Action Plan.** Commission Communication COM(1999)232, 11 May 1999.

European Commission (2000) **Recommendation C(2000)3304 on quality assurance for the statutory audit in the European Union: minimum requirements.** 15 November 2000.

European Commission (2001) **The Final Report of the Committee of Wise Men on the Regulation of European Securities Markets.** 15 February 2001.

European Commission (2003a) **Communication from the Commission to the Council and the European Parliament on Implementation of the Risk Capital Action Plan (RCAP).** COM(2003) 654 final.

European Commission (2003b) **Tracking EU financial integration.** Commission Staff Working Paper. SEC(2003)628.

European Commission (2004a) **Commissions finalises modernisation of the EU antitrust enforcement rules.** Press release IP/04/411, 30 March 2004.

European Commission (2004b) **Action Plan: The European agenda for Entrepreneurship.** Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions. Brussels, 11.02.2004, COM(2004) 70 final.

European Commission (2004c) **Financial Integration Monitor 2004.** Commission Staff Working Document.

European Commission (2004d) **Audit of company accounts: Commission proposes Directive to combat fraud and malpractice.** Press release IP/04/340, 16 March 2004.

Financial Services Committee (2004) **Interim Report on Financial Integration.** FSC Interim Report.

Flood, R P and Rose, A K (2003) **Financial Integration: A New Methodology and an Illustration.** NBER Working Paper No. 9880.

Guiso, L, Jappelli, T, Padula, M and Pagano, M (2004) **Financial market integration and economic growth in the EU.** Centre for Studies in Economics and Finance Working Paper No. 118.

Hardouvelis, G, Malliaropulos, D and Priestley, R (2004) **The impact of globalization on the equity cost of capital.** CEPR Discussion Paper No. 4346.

Henderson, D (2000) **Anti-Liberalism 2000.** Wincott Lecture, IEA, 28 September 2000.

IVIE (2003) **The Monitoring of Structural Changes and Trends in the Internal Market for Financial Services.** Valencian Institute for Economic Research (IVIE), January.

Köhler, H (2003) **Toward a Better Globalization.** Inaugural Lecture on the Occasion of the Honorary Professorship Award at the Eberhard Karls University in Tübingen, 16 October 2003.

Kumar, T (2000) **Politics of Globalism: A Hegemonic Discourse on Nation, Community and Humanity.** Presentation at the Limits of Cultural Globalization workshop. Jawaharial Nehru University & Albert-Ludwigs University, Freiburg, 26 June – 3 July 2000.

Kühnhardt, L (2002) **Implications of globalization on the raison d'être of European integration.** Rheinishe Friedrich-Wilhelms-Universität, Bonn. ARENA Working Papers, WP 02/37.

Levine, R (1997) **Financial development and economic growth: views and agenda.** Journal of Economic Literature 35(2).

Liikanen, E (2004) **European Network Security.** SPEECH/04/148, CeBIT, 18 March 2004.

London Economics (2002) **Quantification of the macro-economic impact of integration of EU financial markets.** November.

OECD (2003) **European banking and stock market integration.** Financial Market Trends, No. 84, March 2004.

Williamson, J (2000) **What Should the World Bank Think about the Washington Consensus?** The World Bank Research Observer. Vol. 15, No. 2 (August), 251–264.

World Commission on the Social Dimension of Globalization (2004) **A Fair Globalization: Creating Opportunities For All.** International Labour Organisation. February 2004.

On-line references:

http://www.bof.fi/fin/6_julkaisut/index.stm
http://www.tekes.fi/eu/fin/ajankohtaista/rahoitusnakymat.html

Chapter 3

Securities markets integration

Pertti Pylkkönen

3 Securities markets integration 42
 3.1 Introduction 42
 3.2 Securities markets regulation in Europe 43
 3.3 Securities markets integration in Europe 47
  3.3.1 Money markets 47
  3.3.2 Bond markets 53
  3.3.3 Stock markets 57
  3.3.4 Derivatives 60
  3.3.5 Mutual funds and other institutional investors 62
 3.4 Challenges of securities market integration 67

References 70

3 Securities markets integration

3.1 Introduction

This chapter looks at the integration currently under way in the European financial markets, particularly the securities markets, and the progress made in different sectors of the money and securities markets. According to the European Central Bank, financial integration may be defined as a situation whereby there are no frictions that discriminate between economic agents in their access to – and their investment of – capital, particularly on the basis of their location.[1]

This chapter looks first at actions taken by authorities concerning regulation, legislation and supervision of markets to promote integration of the money and securities markets. It also examines the benefits being sought through the promotion of money and securities markets integration as well as the ways in which these benefits are expected to be channelled to different economic agents.

European financial integration has progressed at different speeds in different sectors of the securities markets. Integration of the wholesale financial markets got off to a quick start at the beginning of 1999. It can be said that parts of the euro area money markets, especially the market for unsecured interbank short-term money, have reached full integration and are functioning virtually without friction throughout the euro area. The general public has probably best witnessed this in the emergence of a yield curve for the euro area money market, ie for instruments with less than one-year maturity. Euro area short-term interest rates, from overnight to one-year, show no marked differences across countries.

For other sectors of the money markets, however, the degree of integration varies. In repo markets[2] – the fastest-growing sector –, integration still has to surmount barriers in taxation and national legislation that hamper, or may even prevent, cross-border transactions. Integration of markets for money market instruments also continues to encounter numerous obstacles such as differences in market practices, tax treatment and legislation.

---

[1] ECB (2003b).

[2] For example ECB (2002). Repo (repurchase agreement) refers to the sale of securities and simultaneous agreement on their repurchase at an agreed price and date.

Integration of markets for long-term instruments, ie bond markets, took off fastest in the euro area wholesale market for government bonds. Competition over the most inexpensive long-term financing alternatives has harmonised market practices in the euro area government bond markets since the start of EMU. The current price differences of euro area government bonds are primarily due to differences in liquidity and various risk factors. Private sector loan markets, particularly those targeted at small investors, are still largely national, despite the single currency.

This chapter also looks at the impact of Stage Three of EMU on integration of the stock markets. These effects are in many ways indirect and so difficult to distinguish from other mainstream influences on the stock markets or that emerged before the introduction of the euro.

The creation of the euro area quickly influenced, for example, the stock indices in use. In addition to the old country-specific indices, indices covering the entire euro area were introduced. At the same time, investors' interest has shifted from country-specific stock markets to euro area-wide operations. Furthermore, integration is reflected in the increased mergers of marketplaces and clearing houses and enhanced cooperation throughout Europe (see also chapter 5).

The introduction of the euro also broadened the scope of institutional investors in particular, as exchange rate risk disappeared. This chapter briefly reviews the impact of the euro on derivatives markets and examines the influence of EMU from the perspective of institutional investors – mutual funds, pension funds and life insurance companies.

Finally, the chapter seeks to evaluate the challenges still ahead in the pursuit of securities markets integration.

3.2 Securities markets regulation in Europe

The regulatory and legislative process affecting the financial and securities markets dates back to the Treaty of Rome, signed in 1957, which had the objective of introducing not only a single market for goods, services and labour but also a common capital market. Another important milestone was the Single Market Programme of 1985 and its section on the financial markets. The Single Market Programme of 1992 introduced the single licence principle for financial service providers, ie for entities providing banking, insurance and investment services. This meant that a licence granted to a financial services

provider in one EU member state allows for the same services to be provided in another member state. However, the final impetus for deeper integration of the capital markets was the introduction of the euro in 1999.

The single currency removed exchange rate risk from investment and finance activities in the euro area, and cross-border provision of financial services started to pick up. However, there are still a number of impeding factors concerning regulation, taxation and markets that affect the provision of cross-border financial services, particularly from the point of view of private investors. Market-determined factors include distribution systems, which in practice slow down the provision of various cross-border financial services. Electronic networks such as the Internet have not yet markedly increased the provision of cross-border financial services in Europe. For example, EuropeLoan, a mortgage provider with operations in many countries, turned out to be unprofitable and closed down.

The introduction of the single currency also painfully revealed other barriers to financial integration and the need for their removal. At its meeting in Cardiff in June 1998, the European Council asked the Commission to prepare a framework for action in order to establish a single European financial market. As a result, the Financial Services Action Plan (FSAP) was published at the Council meeting in Vienna in May 1999. It comprises several legislative and other measures aimed at realising a single financial market and introducing regulatory and supervisory principles (see chapters 2 and 7).

In 1998, before the Financial Services Action Plan, the Commission published the Risk Capital Action Plan (RCAP). The RCAP highlighted certain regulatory actions included in the FSAP and designed to remove barriers to growth in European capital investment activity: reform of the prospectus directive and directives on mutual funds and on the functioning and supervision of additional pension funds, as well as amendment of the financial statement directive and oversight of corporate governance.[3] The RCAP was implemented in 2003.

Originally the FSAP consisted of 42 initiatives. Another five have been subsequently added. According to the 9th follow-up report published by the European Commission in 2003, a total of 36 initiatives had thus far been realised. The rest of the initiatives are scheduled for implementation by 2005. Several other public and private sector initiatives have been introduced for the money and

[3] Risk Capital Action Plan. See eg Niemi (2003).

securities market, to compliment the FSAP, all of which are designed to deepen and complete establishment of the single financial market.

However, integration of securities markets regulation began much earlier than the FSAP process. The first directive on securities markets was the directive on the requirements for the admission of securities to stock exchange listing, which was adopted in 1979 (see chapter 7). Furthermore, a number of other directives on the securities markets were adopted before implementation of FSAP (see table 1). The most important of these was the directive on investment services in the securities field, adopted in 1993, which introduced a reciprocity procedure such that an investment firm licensed by the authorities of its home country could provide services throughout the EU. Of the more recent directives, the most important are the directive on insider trading and market manipulation as well as the directive on prospectuses, which lays down the principles governing the publication of prospectuses in connection with offering securities to the general public or applying for listing on a stock exchange.

Another important initiative complementing the FSAP in deepening integration of the financial and securities markets is the Lamfalussy process, which had the initial objective of creating a single capital market in Europe. The so-called 'Committee of the Wise Men' (Lamfalussy Group) published its report in February 2001, proposing a new decision-making model aimed at improving legislative work on financial and capital markets.

Other important reports for the advancement of securities markets integration were the Giovanni reports of 2001 and 2003. These reports contain, among other things, proposals for action to develop and improve cross-border securities clearing and delivery (see chapter 5).

Legislative work at EU level in support of the deepening of financial and securities markets integration is also reflected in the respective Finnish legislation. Adopted directives have been implemented or their implementation in the national legislation is underway. For example, Finland did not previously have a separate act on investment services firms. Some laws on securities markets have also been harmonised with EU legislation.

Table 1. **Key securities markets directives and selected decisions by the European Commission**

Directives
Council Directive 79/279/EEC on the requirements for the admission of securities to stock exchange listing.
Council Directive 80/390/EEC the requirements for the drawing up, scrutiny and distribution of the listing particulars to be published for the admission of securities to official stock exchange listing.
Council Directive 82/121/EEC on the regular reporting requirements of issuers of securities admitted to official stock exchange listing.
Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as well as the amending directives 2001/107/EEC and 2001/108/EEC.
Council Directive 89/298/EEC on the coordination of the requirements for the drawing up, scrutiny and distribution of a prospectus when transferable securities are to be offered to the public.
Council Directive 89/592/EEC on the coordination of provisions and regulations on insider dealing.
Council Directive 93/6/EEC on the capital adequacy of investment firms and credit institutions.
Council Directive 93/22/EEC on investment services in the securities field.
Directive 97/9/EC of the European Parliament and of the Council on investor compensation schemes.
Directive 98/26/EC of the European Parliament and of the Council on settlement finality in payment and settlement systems.
Directive 2001/34/EC of the European Parliament and of the Council on the admission of securities to official stock exchange listing and on information to be published on those securities. This directive (known as the directive on prospectuses) collated the above mentioned directives 79/279/EEC, 80/390/EEC and 82/121/EEC.
Directive 2002/47/EC of the European Parliament and of the Council on financial collateral arrangements.
Directive 2003/6/EC of the European Parliament and of the Council on insider dealing and market manipulation (market abuse).
1) Directive 2003/71/EC of the European Parliament and of the Council on prospectuses to be published in connection with offering securities to the general public or applying for listing on a stock exchange and on the modification of directive 2001/34/EC.
Directive 2004/39/EC of the European Parliament and of the Council on markets in financial instruments (known as investment services directive II).
Directive 2004/??/EC of the European Parliament and of the Council on the harmonisation of reporting requirements concerning securities issuers operating on regulated markets. Issued but not yet published in the Official Journal.
Decisions of the European Commission
Commission Decision 2001/527/EC on the setting up of the Committee of European Securities Regulators (CESR).
Commission Decision 2001/528/EC on the setting up of the Committee of European Securities Regulators (CESR).

3.3 Securities markets integration in Europe

The pace of European securities markets integration has varied a great deal. Progress has been fastest on the money markets. Unsecured money markets in particular are already fully integrated. This is reflected eg in a yield curve that is uniform from overnight to one-year maturity. During this process, national monetary markets have expanded to cover the entire euro area.

In the bond markets, interest rates in euro area countries have also converged. However, private sector bond markets are still dispersed and a single trading place for corporate bonds has not yet been established.

Regarding securities markets, integration has been primarily reflected in increased cooperation among stock exchanges as well as mergers.

Investors have also started to reallocate investments from national markets across the entire euro area. This has been most apparent in the flow of mutual fund and pension fund investments into the greater euro area.

3.3.1 Money markets

The creation of the euro area brought numerous changes to the European money market. Stage Three of EMU ushered in the single monetary policy and a new operational framework.[4] The new operating environment was quickly reflected in the development and integration of euro area money markets. The operational framework of the euro system has partly contributed to the progress of money market integration in Europe. The core elements of the operational framework are open market operations, standing facilities and the minimum reserve system.[5]

Unsecured money markets

Since the creation of the euro area, the fastest growth has been registered in unsecured deposits and collateralised repo markets and

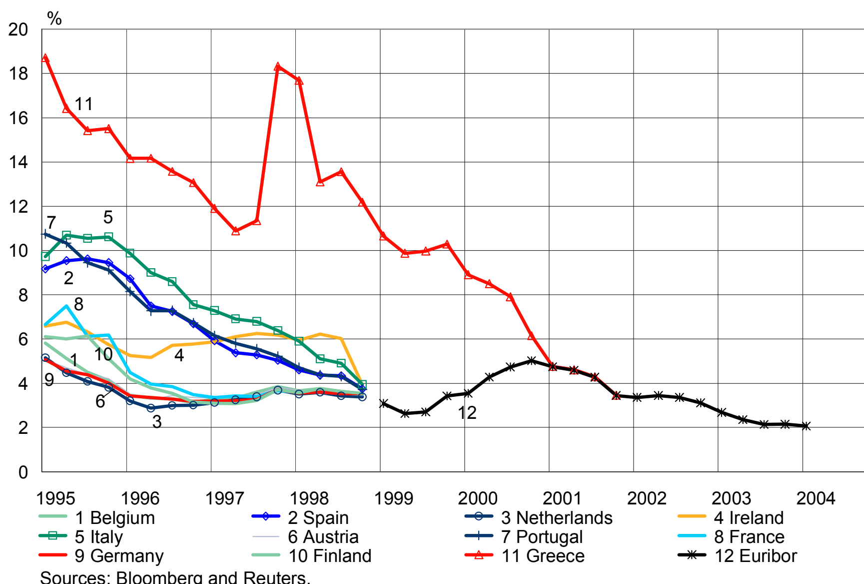
[4] A description of monetary policy can be found eg in 'The Implementation of Monetary Policy in the Euro Area' (2004a) and 'The Monetary Policy of the ECB' (2004b).
[5] For further information, see Salavirta (2002), ECB (2004a).

the slowest in the market for securitised money market instruments, such as Treasury bills, commercial paper and certificates of deposit.

As regards money market integration, the markets for unsecured deposits among large banks have been integrated so as to form a single euro area-wide market. This market has the distinctive feature that the same price (interest rate) prevails throughout (see fig. 1). There are no systematic variations by country between money market interest rates in the euro area, albeit small differences can be found among individual banks due to eg differences in banks' risk classifications. Calculation of short-term money market reference rates – EONIA and EURIBOR – is based on euro area wide data. EONIA is the weighted average interest rate for unsecured interbank overnight deposits in the euro area, calculated on the basis of quotations of 48 banks. This 'panel bank group' is made up of at least one bank from each euro area country and one from each non-euro area old EU member state as well as of four other major international banks. EURIBOR is the interbank offered rate for euro-denominated lending. This rate is applied to maturities of one, two and three weeks, as well as 1–12 months. The panel banks involved in the calculation of the EURIBOR are the same as those for the calculation of the EONIA.[6] The European Banking Federation and ACI Financial Markets Association are responsible for the calculation principles and publication of the EONIA and EURIBOR rates. EONIA is calculated by the European Central Bank and Moneyline Telerate.

[6] http://www.euribor.org

Figure 1. **3-month interest rate in euro area countries**



Sources: Bloomberg and Reuters.

Unsecured interbank deposit markets concentrate on short maturities with the focus on maturities ranging from overnight to two weeks. For longer maturities, the players favour secured money market instruments.

From the point of view of financial market stability, the creation of unsecured deposit markets for the entire euro area changed the banking market in that potential liquidity problems in any major European bank may spread to other banks in the euro area much faster than before, thereby causing problems for smaller banks that operate mainly in national markets.

For the Finnish money market, the euro changeover meant that securitised certificates of deposits became less important while the unsecured deposit markets have developed into a key sector of the money market.

Secured money markets

Euro area secured money markets, ie repo markets, have grown rapidly since the introduction of the single currency.[7] As with

[7] ECB (2003c).

interbank deposit markets, calculation of a separate reference rate EUREPO for euro area-wide secured deposit markets began on 4 March 2002. EUREPO is the rate at which 'repo banks' offer secured euro-denominated loans to each other. The bank panel for the repo market reference rate consists of 38 banks, whose quotes are used to calculate the daily interest rate for the following maturities: T/N, 1–3 weeks as well as 1, 2, 3, 6, 9 and 12 months.

Despite rapid growth, integration of secured money markets has progressed very slowly. One of the key problems for the euro repo market has been the lack of euro area-wide collateral markets. The situation is expected to improve, however, when the directive on financial collateral arrangements is adopted in all the EU member states.

Because different securities can be used as collateral in the repo markets, one of the key tasks in developing these markets is to remove barriers to deeper integration with respect to collateral arrangements. Integration of the repo markets would further improve the liquidity of both the money and bond markets.

Despite increased use of repos between different countries since the introduction of the euro, markets still operate primarily as national markets. This is mainly due to the fact that the clearing of repo transactions has been decentralised in different clearing houses. That is why cross-border transactions can be complex and expensive.

The incoherent nature of euro area repo markets is heightened by the fact that the tax treatment of securities eligible as collateral has not yet been harmonised. There can also be other differences among securities used as collateral. Integration of repo markets has also been hampered by differing documentation practices and jurisdictions. The common objective of both markets and the euro system is to create a shared code of conduct and increase market integration. It is in the euro system's interests to improve operating conditions in the repo markets, as the repo is one of the key instruments in the implementation of its monetary policy. Central banks' interest in deepening the integration of euro area-wide repo markets is also reflected in the fact that wide and liquid repo markets consolidate their efforts to maintain stability of the financial markets.

Banks use repos in liquidity management because being secured financial instruments, they diminish credit risk and reduce banks' capital requirements compared to unsecured money market instruments.

Short-term money market securities

A third important segment of the money markets is that of securitised money market instruments. These are used to raise short-term financing mainly via treasury bills but also via certificates of deposit, issued by the private sector, as well as commercial paper. The growth and integration of securitised money markets in the euro area has been much slower than that of unsecured deposits and repo markets.

In Europe, national securitised money markets are less important than in the USA, for example. Moreover, market practices vary from country to country, which is why money market instruments are sold primarily to domestic investors. Due to their narrowness, the secondary markets are also fairly illiquid.

Several private sector initiatives have been launched in order to deepen money market integration. The most important of these was the setting up of ACI Short-Term European Paper Task Force (ACI STEP). The purpose of this initiative is to harmonise practices and standards in the European money market and create European wholesale markets. The task force published its proposal and recommendation in December 2003.

The most important specifications were:

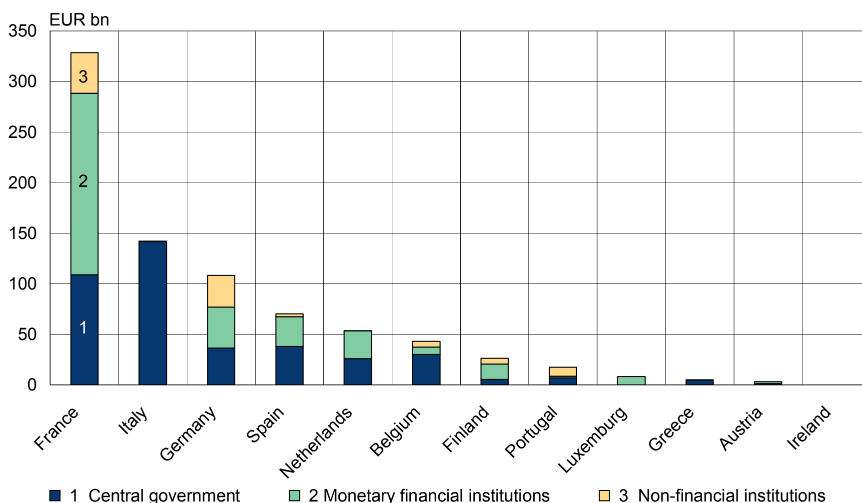
1) money market instruments that meet agreed standards are labelled according to the STEP labelling system
2) preparation of a standardised information memorandum, its annual updating and availability
3) preparation of statistics on the STEP market and publication of an index illustrating issuance activity
4) clearing of transactions on the trade day
5) setting up of a STEP market committee
6) STEP instruments' eligibility as collateral in the European System of Central Banks
7) approval of STEP instruments as investment material for mutual funds.[8]

The total value of money market instruments issued in the euro area (see fig. 2) amounted to more than EUR 800 billion in March 2004, which is about a tenth of the corresponding countries' bond market. Half of this amount was issued in France, where the private sector accounts for just over half of the market. The second largest money

[8] EURIBOR ACI STEP (2003).

market is in Italy, totalling EUR 142 billion in March. In Italy, the money market is completely government controlled, and the private sector has issued hardly any instruments. In Germany, outstanding money market instruments totalled more than EUR 100 billion for the same period. The shares of nonfinancial corporations, financial institutions and government were almost equal.

Figure 2. **Value of short term debt instruments issued in euro area countries in March 2004**



Source: ECB 2004.

In most other euro area countries, the core of the money market is made up by treasury bills. More than half of the money market instruments issued in the euro area are treasury bills.[9] Special financial institutions accounted for just over a third of the market. The market for commercial paper issued by corporations is narrow in Europe, their share having been only slightly more than 10% of the euro area money market in March 2004. This is partly a reflection of the dominant role of banks in the financial markets. Companies raise short-term funding mainly through financial institutions, not from the market, in contrast to the USA, for example.

Major European nonfinancial corporations also acquire short-term funding through different Euro Commercial Paper Programmes. In

[9] ECB (2004c).

2002, the euro became the most important issue currency in the ECP market, outperforming the US dollar.[10]

3.3.2 Bond markets

European bond markets are dominated by government issues, but a few countries, including Germany, Sweden and Denmark, also have fairly large markets for mortgage-backed bonds designed for housing and real estate financing.

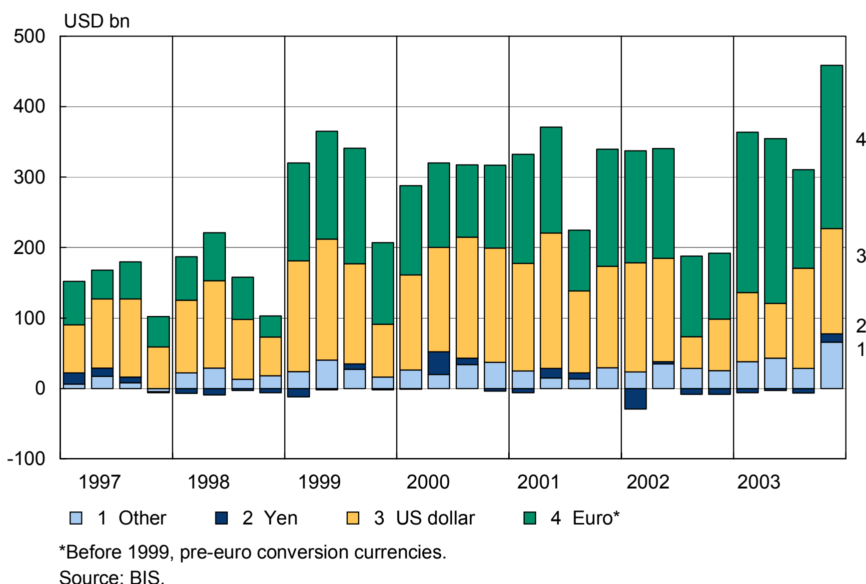
Following the launch of the euro, the expansion of euro area bond markets clearly picked up, particularly for private sector issuance. In addition to the single currency, market expansion was driven for example by the considerable investment financing needs of European telecommunications operators and by several mergers and acquisitions across Europe. The growth of European bond markets has also been reflected in a surge in risk-rated bonds. In 1990, there were less than 100 European issuers with a Standard & Poor's rating. The number increased to more than 500 in response to the introduction of the euro and exceeded 900 by the end of 2003.[11]

In international bond markets, the euro has grown into the second most widely used currency in bond issues, next to the US dollar (fig. 3). Before 1999, the currencies of the countries to join EMU accounted for less than a fifth of international bond issuance. Since the introduction of the euro, this proportion has been steadily increasing, standing at around 30% in the first quarter of 2003.[12] Although the share of the US dollar has declined somewhat over the past ten years, nearly half of international bond issues are still denominated in the US dollar.

---

[10] ECB (2003c).
[11] Standard & Poor's (2004).
[12] ECB (2003d).

Figure 3. **Net issuance of international debt securities**



*Before 1999, pre-euro conversion currencies.
Source: BIS.

Despite robust growth, domestic bond markets in the euro area are still much smaller than for example those of the United States. This difference is most apparent in corporate bond markets.

European bond markets differ from those of the United States above all in that, contrary to US companies, European companies raise most of their debt financing from financial institutions rather than money and bond markets. In Europe, corporate bond issuance is most widespread in France, which has a longstanding tradition of corporate bond markets.

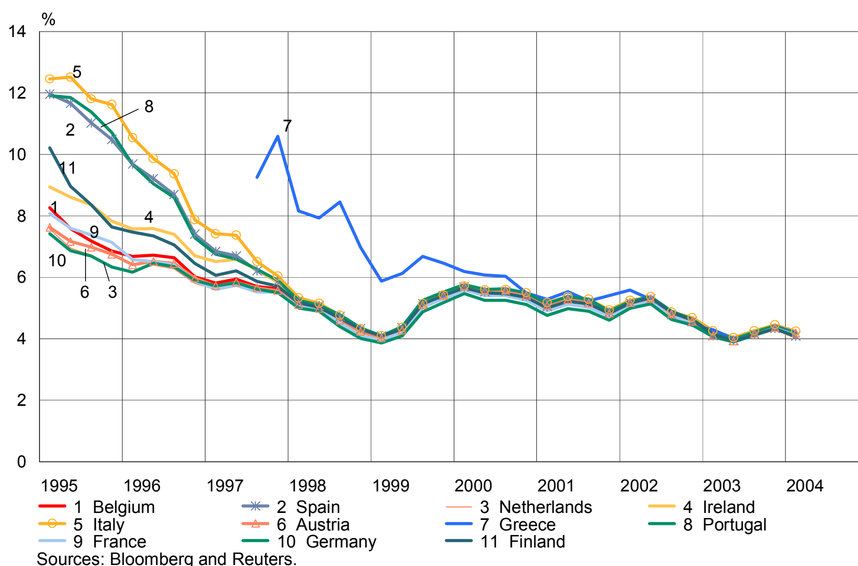
By contrast, government bond markets are also very highly developed in Europe. This is also the sector of the bond market where integration has been most advanced. Competition for investors brought about a harmonisation of market practices for long-term government bonds in the euro area as soon as the euro was introduced in 1999. Interest rates converged, governments started to release issue calendars and measures were taken by small countries in particular to concentrate government issuance in a few benchmark bonds in order to ensure sound liquidity. Such concentration of government bond issuance, along with integration of markets, has also been encouraged by centralised trading of euro area government bonds in EuroMTS

trading systems operating in all euro area countries except Germany.[13] Admission to the EuroMTS system has a minimum issue size of EUR 5 billion.

Market liquidity is also enhanced by the market making system operating in the government bond markets of all euro area countries except Germany. Many large banks act as market makers in nearly all euro area countries, which has also stimulated the operation of markets and harmonised issue practices.

Despite the closer convergence of government bond markets in the euro area, obstacles to full integration still exist, and no euro-area harmonised yield curve has been established for bonds, in contrast to the money market. The introduction of a single monetary policy has nonetheless brought about fairly close convergence of long-term yields across euro area countries. Yield spreads vary between 20 and 30 basis points, depending on risk factors, liquidity differences and some other factors (fig. 4). In the market for long-term instruments, the 'swap curve' is used as the benchmark curve.

Figure 4. **10-year government bond yields in the euro area**



Sources: Bloomberg and Reuters.

[13] For example, trading in Finnish government benchmark bonds is concentrated in MTS Finland.

In addition to the government bond market, the housing bond market is another sector in which integration has progressed favourably. For example, in Germany bonds issued by mortgage banks have been used for more than a century to finance housing and real estate transactions. The German *Pfandbriefe* legislation has therefore already served as a model for reforms of financial market legislation undertaken by several member states. At the same time, the legislation, including that of Germany, has been amended in respect of the collateral requirement so that the real estate pledged as collateral for the bond must be situated in an EU country, whereas the former requirement was that is should be situated in the home country.

European corporate bond markets are still small and fragmented, varying in importance across countries (table 2). In France, the volume of outstanding corporate bonds accounts for approximately a sixth of the entire domestic bond market, whereas corporate bond issuance by Finnish companies represents a little over 10% of the total stock of bonds.

Table 2. **Domestic bond issuance, March 2004**

	Total EUR bn	Corporate bonds, %	Financial institutions, %	Government, %
Belgium	306.4	7.0	19.1	73.9
Spain	485.3	1.9	38.1	60.1
Netherlands	724.0	5.6	68.9	25.4
Ireland	29.7	n/a	n/a	n/a
Italy	1,572.1	2.4	33.9	63.6
Austria	234.0	5.4	45.3	49.3
Greece	138.3	0.6	0.7	98.6
Luxembourg	29.3	n/a	98.6	1.4
Portugal	96.5	7.7	31.0	61.2
France	1,329.2	16.7	27.4	55.9
Germany	2,367.3	2.5	58.2	39.2
Finland	61.2	12.7	17.5	69.8
Euro area	7,373.3	5.7	43.3	51.0
United States	17,487.5	20.0	n/a	n/a

n/a = not available.
Sources: ECB and Bond Market Association.

In Continental Europe corporate financing has traditionally been channelled through financial institutions. With the emergence of a euro area-wide corporate bond market in connection with the introduction of the euro, corporate interest in market financing has picked up. Sales of large corporate bonds have spread from domestic

markets across the entire euro area. Consequently, the number of corporate risk ratings in euro area countries has grown considerably over the past five years, thus providing better scope for bond issues.

From the investor perspective, the euro area has created opportunities for institutional investors to diversify their domestic fixed income investments across the entire euro area. Several euro area countries used to apply very strict regulations for example on the foreign holdings or amount of exchange rate risk of pension funds. Consequently, pension fund investments in fixed income instruments were long exclusively domestically oriented. As the situation changed, investments have increasingly been diverted into the entire euro area.

The greater diversification of European corporate bond markets can also be seen in the increasing volume of high-yield corporate bonds. For example Standard & Poor’s has rated more than 180 new issuers of high-yield bonds during the past five years, compared to less than 100 in the years prior to the euro.

As in Finland, the annual volume of corporate issuance is modest in several other euro area countries, as well, with corporate bond markets playing only a minor role for example in investment financing. In March 2004, corporate bonds accounted for less than 6% of all long-term bond issuance in the euro area. The equivalent share for the United States was nearly a fifth of the total stock of bonds.

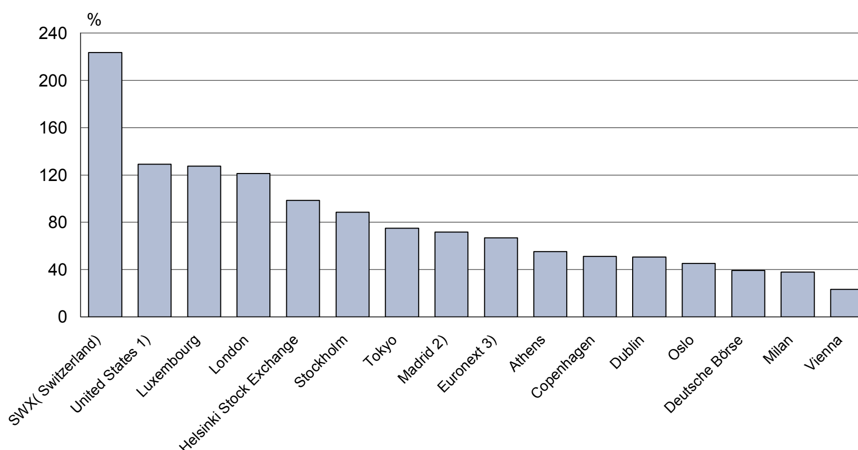
Heterogeneous market practices and the absence of a common marketplace are some of the barriers to euro area-wide integration of corporate bond markets. At least so far, EuroMTS has not developed into a marketplace for corporate bonds. The EUR 5 billion threshold is one of the main reasons why trading in corporate bonds has not started on EuroMTS.

3.3.3 Stock markets

The liberalisation of capital movements and removal of restrictions on institutional investors, technological development, growing international trade and business globalisation, together with a number of other factors, have reduced the role of domestic phenomena in stock markets, while the introduction of the euro has spurred euro area-wide integration of stock markets.

Like the other securities markets, stock markets too have benefited from the single currency and expanded since its introduction. Although European and euro area stock markets are still much smaller in volume than for example those of the United States, the rate of growth has been clearly faster in Europe than in the United States.

Figure 5. **Stock market capitalisation at 30 April 2004, % of GDP***



1) NYSE and Nasdaq.
2) Market capitalisation of the Madrid stock exchange, March 2004.
3) Market capitalisation of Euronext relative to aggregate GDP of Belgium, Netherlands, France and Portugal.
*) GDP figures are European Commission estimates for 2004.

Sources: World Federation of Exchanges, Eurostat and Bank of Finland.

There have been a number of factors influencing the growth and development of European stock markets. During the years of heavy stock market expansion witnessed at the turn of the millennium, several new marketplaces were set up in Europe. In particular, the number of New Markets designed for small companies increased over those years. In Stage Three of EMU, the activities of traditional stock exchanges have been marked by closer cooperation and networking rather than actual mergers, although there have been a few major mergers since the launch of the euro. In 2000, the stock exchanges of Belgium, the Netherlands and France merged to form the Euronext Stock Exchange, which was later joined by the Lisbon stock exchange. Another major project was the emergence of Clearstream built around Deutsche Börse. Finally, the third broader merger was that of the Helsinki and Stockholm stock exchanges in spring 2003 (chapter 5).

In the stock exchanges, the expansion and integration of stock markets has been reflected for example in the internationalisation of securities brokerage. The Europe-wide approach to investment operations, technological progress and particularly the cross-border provision of investment services within the EEA area has given remote brokers a more prominent role in European stock exchanges. This trend can be illustrated by the internationalisation of securities

brokerage on the HEX Helsinki Exchanges. Nokia, which attracts international investor interest, has brought several remote brokers operating from abroad to HEX. At the end of May 2004, 28 of the 44 brokers operating on HEX were remote brokers, already accounting for more than 50% of total turnover.

The consequences of the launch of the euro for stock markets are perhaps most clearly visible in the increasingly pan-European approach to investment operations. The regulations governing the investments of institutional investors, such as pension funds, have been or are being revised (IORPs Pensions Directive) to the effect that former restrictions on foreign holdings are being lifted, at least for the euro area. This has been reflected in a lower degree of home bias in the investments of the pension funds of smaller countries in particular.[14] The same trend can also be seen for example in the investments of life insurance corporations.

Following the launch of the euro, the portfolio diversification strategies have at least partly changed from country risk diversification to greater sectoral diversification. This worldwide trend was immediately reinforced by the establishment of the single currency area.[15] The calculation of new euro area-wide sectoral stock indices also started immediately upon the launch of the euro. The implications for Finnish companies have been that only the shares of companies with the largest market capitalisations are included in these new euro area-wide overall or sectoral indices. Euro area-wide stock indices are calculated for example by Bloomberg, Dow Jones, FT, Morgan Stanley Capital International and Standard & Poor's.

There is evidence indicating that the risk premia demanded by investors is lower in the euro area-wide stock markets than in domestic stock markets.[16] In their study, Adjaouté and Danthine showed that share price volatility is considerably higher in domestic markets than in euro area-wide stock markets. The closer integration of stock markets has resulted in lower capital costs and has improved growth prospects for euro area economies. In their study, Hardouvelis et al found that capital costs have declined by 0.3–3 percentage points in Europe, depending on the sector.[17]

The degree of integration of euro area stock markets can also be measured by shifts in portfolio composition since the introduction of the euro. According to the Federation of European Securities

[14] Adam et al (2002).
[15] ECB (2001).
[16] Adjaouté and Danthine (2003).
[17] Hardouvelis et al (2004).

Exchanges[18], the importance of nonresident investors has increased at the expense of resident investors in most European countries. The trend towards greater internationalisation of equity investments strengthened already in the 1990s and was reinforced by the introduction of the single currency in Europe. The equity portfolios of institutional investors resident in the euro area have been increasingly reallocated from domestic markets across the entire euro area. By contrast, nonresident institutional investors, eg in the United Kingdom and Sweden, do not appear to be diversifying across the euro area.[19] Although households' interest in stock market participation in the euro area has increased, direct investment by households is still largely confined to domestic markets. Private investors are deterred from participating in foreign stock markets for example by the cost and effort involved in collecting information on foreign holdings, as well as the high cost of investing abroad.[20] Higher taxes on direct share investment abroad may also be a contributory factor in some countries. Thus, from the private investors' point of view, at least the cost of holdings constitutes a barrier to deeper integration of stock markets. The largest brokers, which also operate on most European stock exchanges, have not yet showed much interest in the business of private investors. This is likely to slow the decline in the costs of cross-border investment and the pace of stock market integration from households' perspective (chapter 5).

3.3.4 Derivatives

The introduction of the single currency has brought significant changes to the derivatives market. With the establishment of EMU, trading in euro area-wide derivatives listed on the derivatives exchanges has become concentrated in the largest derivatives exchanges, ie Euronext, Eurex and Liffe. Following the elimination of euro area national currencies, the market for currency derivatives contracted considerably in both the derivatives exchanges and OTC markets.

The disappearance of national reference rates has in turn reduced the range of interest rate derivatives products available in the euro

[18] FESE (2002).
[19] Hartman et al (2003).
[20] Guiso et al (2003).

area, while trading on most domestic derivatives exchanges in the euro area has fallen significantly, or stopped altogether.

While the elimination of national interest rates and currencies has reduced interest rate and exchange rate risks, other risks, such as credit risks, have taken on greater importance. This has paved the way for new derivatives products in both the euro area and the global financial markets. One example of these new products is the credit derivative the market for which has been growing rapidly also in Europe. A credit derivative is a contract whose value is tied to the credit risk of the underlying company or financial institution. These contracts may be swaps, futures or options that are used for shifting credit risk on assets and returns on assets between participants without change of title to the asset.

Interest rate derivatives

With the establishment of monetary union, the market for both short and long-term interest rate derivatives has become highly concentrated. In the short-term derivatives markets, EURIBOR-based interest rate derivatives were introduced immediately at the beginning of 1999.

In the OTC market for euro-denominated interest rate derivatives, interest rate swaps[21] are the most actively traded instruments, and the market for euro interest rate swaps has expanded strongly. EONIA has emerged as the prime reference rate used in interest rate swap trading, thus succeeding EURIBOR, which was the major reference rate in the early days of the euro. The yield curve for interest rate swaps of various maturities has replaced the government bond rate as the benchmark curve for euro area long-term interest rates of various maturities.

The EONIA-based interest rate future listed on both Eurex and Liffe is the most recent new derivative product. In the derivatives exchanges, trading in long-term interest rate derivatives, which in practice are interest rate forwards based on 10-year-government bond rates, is concentrated in products based on German and French government bonds.

The markets for interest rate forwards and futures based on short-term rates have also expanded rapidly in the context of monetary union, while domestic markets have practically lost their importance.

[21] ECB (2003c).

Trading in standardised derivative contracts on the European derivatives exchanges has strongly focused on euro-denominated contracts, while market shares for other currencies, such as sterling, have fallen significantly, from levels close to that of the euro. In 2002, the euro accounted for approximately three-quarters of the market for interest rate forwards and futures traded on the Liffe.[22]

The market for bond derivatives changed in response to the introduction of the euro, in much the same way as did the short-term derivatives market. Domestic long-term derivatives markets lost their position to either German or French 10-year government bond derivatives. In most countries, including Finland, trading in standardised or exchange-traded long-term derivative instruments completely switched over to Eurex, Euronext or Liffe.

Stock derivatives

The new euro area-wide stock market indices, such as Dow Jones Euro Stoxx 50, were immediately introduced by the derivatives exchanges as bases for stock index derivatives, while domestic indices, with a few exceptions, were set aside. Trading in derivatives based on individual shares has also been strongly concentrated in Eurex, Euronext or Liffe. Like the underlying markets, European markets for stock derivatives are clearly smaller in volume than US counterparts. Domestic derivatives exchanges host mainly trade in derivatives based on the shares of small companies. In recent years, warrants based on the shares of individual companies have been admitted to trading on several domestic exchanges.

3.3.5 Mutual funds and other institutional investors

The financial assets of European households have traditionally been channelled into bank deposits and, in several countries, also into bond markets. Mutual fund investing has not been very widespread in Europe, with a few exceptions, such as the United Kingdom, France and Sweden. Similarly, savings in personal pension plans have also on average remained modest in Europe, as households have confidence in the sustainability of statutory pension schemes. These factors, together with moderate savings in equities, are the reason why savings in

---

[22] ECB (2003c).

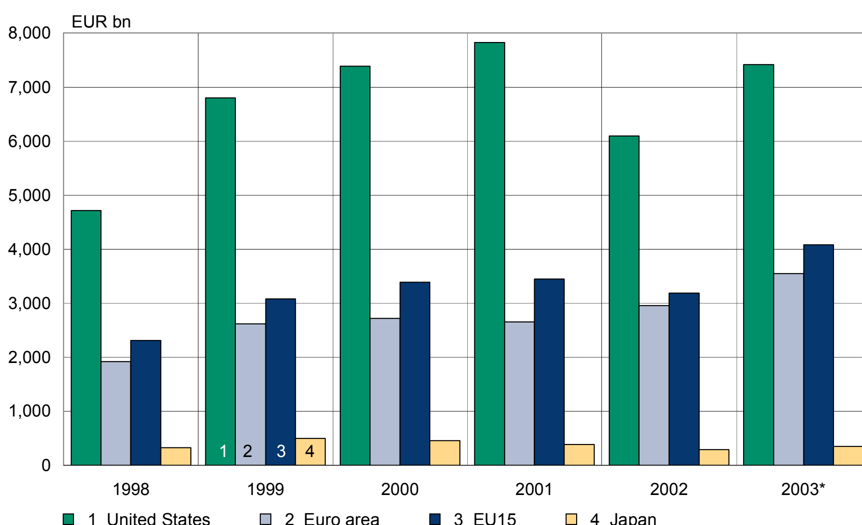
mutual and pension funds have been undertaken on a much smaller scale in Europe than in the United States.

However, savings behaviour has been changing in Europe over the past few years, which is reflected in a higher rate of growth of both mutual and pension funds. This change has also been driven by the ageing of the European population. The debate on the sustainability of statutory pension schemes, together with reductions in retirement benefits, has encouraged households to make increasing provision for future retirement spending, which has in turn stimulated long-term savings by households.

Mutual funds

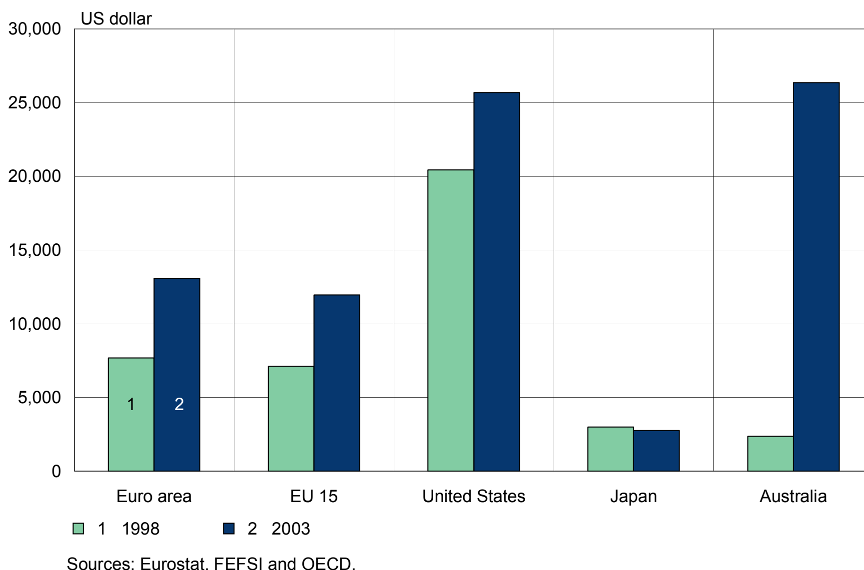
Mutual funds have grown at a clearly faster rate in Europe than in the United States over the past five years (fig. 6). In many European countries, including Finland, mutual fund investing has gained rapidly in popularity, and what used to be a narrow market has expanded at a considerably faster rate than the economy. In the United States, mutual fund markets go back several decades, which is illustrated eg by the fact that the mutual fund growth has stabilised in line with real GDP growth (fig. 7).

Figure 6. **Mutual funds' investment capital for the United States, the EU 15, the euro area and Japan**



* 2003 data for the Netherlands is missing from EU data.
Source: FEFSI.

Figure 7. **Funds' investment capital per inhabitant for the euro area, the EU 15, the United States, Japan and Australia**



The importance of mutual funds varies considerably across Europe. At the end of 2003, the size of mutual funds domiciled in the euro area was roughly half of euro area GDP. Two-thirds of the assets of euro area mutual funds are concentrated in Ireland, Luxembourg and France. Nonresident investors have invested large amounts of assets in Irish and particularly Luxembourg funds. The robust growth of the mutual funds in these two countries is largely attributable to more favourable tax regimes, as well as to regulatory clarity, but it is also partly a reflection of growing internationalisation and integration of investments within the euro area in the wake of the single currency.

Of the other countries, mutual funds have long played a significant role in France, where the ratio of mutual fund assets to GDP was on level with that of the United States in 2003.

In Europe mutual fund investing is more focused on different kinds of fixed income funds, which is a clear difference versus the US mutual fund markets. However, equity funds in the euro area grew rapidly at the turn of the millennium, as interest in equity investments began to build up following a surge in share prices. With growing stock market participation, investment activity in Europe has become increasingly international in that the relative share of investment

capital held in pure domestic equity funds has clearly declined in the context of monetary union.

The Europe-wide integration of mutual fund investment is nonetheless still in an early stage, and future prospects for mutual fund markets look bright in many respects. Measured by the volume of cross-border investment in mutual funds, the European mutual fund market cannot, however, yet be regarded as integrated, considering that the bulk of mutual fund investment is still domestically focused. Domestic mutual fund markets remain highly fragmented in Europe, as demonstrated eg by the fact that although the total investment capital of European mutual funds only amounts to a little over half of the investment capital of US funds, there are more than three times as many mutual funds within the European Community as there are in the United States. Average capital size is therefore much smaller for European than for US mutual funds. This means that the costs of the mutual fund markets, which are still characterised by domestic fragmentation, are relatively high in Europe. Mutual fund markets have remained largely domestic partly because of branch networks giving banks and insurance corporations operating in domestic markets a strong position in marketing funds to the public. On line investment for example via the Internet into funds domiciled in another country is only taking its first steps. Tax treatment of mutual fund investment varies considerably across Europe, and therefore cross-border investment in mutual funds has become concentrated in Ireland and Luxembourg, where tax rates are more favourable.

Further integration of mutual fund markets in the future will provide various benefits to fund investors. First of all, costs are reduced, as average fund size increases. Second, as for example Internet-based investments grow, competition in European mutual fund markets will tighten considerably, also reducing the costs involved in mutual fund investment. Third, increasing cross-border provision of mutual funds will offer investors a wider range of choice. There are no major regulatory obstacles to deeper integration of mutual fund markets. There is, however, still room for further development for example in the area of harmonisation and clarification of consumer protection.

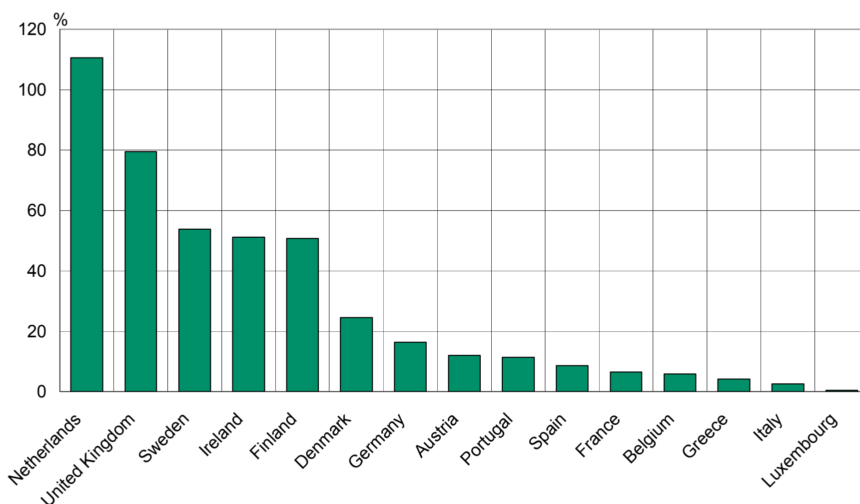
Pension funds and life insurance corporations

The assets accumulated in pension funds are modest in most member states of the European Union. As the pension schemes of most European countries operate on pay-as-you-go, pension funds remain

small, except in a few countries. In 2000, the pension funds of euro area countries accounted for only 16% of the total euro area economy (GDP). An exception is the Netherlands, which has a longstanding tradition of pension funding and has pension fund assets exceeding GDP (fig. 8). Finnish pension funds are also much larger than the euro area average. In 2000, the assets of Finnish pension funds accounted for more than half of GDP. Population ageing and rising pension costs have increased provision for future pension expenditure in Europe over the past few years. The growth of pension funds has also stimulated investment in securities markets and thus increased the market liquidity. The growth of pension funds is expected to continue in Europe.

In the old member states of the European Union (EU 15), the ratio of pension fund assets to GDP (31%) is clearly higher than in the euro area overall, because of the long tradition of pension funding in both the United Kingdom and Sweden (fig. 8).

Figure 8. **Pension fund assets in 15 EU countries, % of GDP**



Sources: European Federation for Retirement Provision, Eurostat, Finnish Pension Alliance TELA and Bank of Finland.

Save for a few exceptions, the holdings of pension funds are domestically focused. This has been due mainly to strict investment regulations under which for example foreign holdings are subject to low limits. This situation is now changing. The European Parliament and Council have already adopted the IORPs Pensions Directive,

which provides that investments will in the future be subject to the 'prudent man principle' and no portfolio percentage limits will be applicable.

In those euro area countries where the restrictions on the foreign holdings of pension funds have only applied to exchange rate risk, the home bias of investments has diminished rapidly since the introduction of the single currency. In particular in the small euro area countries with small securities markets, euro area-wide portfolio allocation has become increasingly common in the context of monetary union. In the larger euro area countries, by contrast, euro area-wide integration of pension fund investment is still sluggish.

The pension fund business does not rank high in internationalisation, considering that cross-border provision of pension fund services is still rare in Europe.

Life insurance corporations are a major group of institutional investors in Europe. Their portfolio structures vary by both company and country. The proportion accounted for by foreign holdings in the total portfolio of life insurance corporations is in line with that of pension fund holdings. Before 1999, foreign holdings played only a minor role in most countries due to the exchange rate risks involved. The single currency, together with growing investment in equities at the turn of the millennium, encouraged European life insurance corporations to diversify their investments beyond the home country to elsewhere within the euro area and to an extent outside of the euro area.

3.4 Challenges of securities market integration

From the perspective of the national central banks of the Eurosystem, promoting deeper integration of money markets poses a major challenge. The existence of a large and smooth functioning money market has been found to facilitate an effective monetary policy transmission mechanism. Another approach to the development of a euro-area wide money market has been the extension of the range of instruments eligible as collateral in the European System of Central Banks (ESCB), to include money market paper. To this effect, the ECB and market participants have cooperated with the aim of harmonising the terms and conditions of short-term debt securities.

Calculation of the EONIA rate by the ECB is one example of the ECB's involvement in promoting the operation of the money market. The ECB has also cooperated extensively with market participants

within the framework of the ACI STEP working group, with a view to developing a securitised money market.

Speeding up the legislative process poses one of the main regulatory challenges in the securities markets. The Lamfalussy process (for more detail, see chapter 7) was first applied to the drafting of securities market legislation in 2002. In the course of 2004, the process has been expanded to include banking and insurance legislation. Although representing a step towards greater efficiency of legislative drafting, the Lamfalussy process has been criticised for being rigid and slow. The success and viability of the framework will be reviewed for the first time in the course of 2004.

Several of the directives adopted by the European Parliament and Council have come into existence slowly and as a result of various compromises. They are therefore very broad in wording and still offer national legislation much scope for flexibility. Consequently, national securities market regulations remain highly heterogeneous, even after implementation of the directives, thus slowing the process of securities market integration. Securities market integration would benefit from greater harmonisation of national legislation.

The fragmentation of Europe-wide financial services is also due to factors other than heterogeneous regulations. One of the key factors is cross-country differences in tax regimes, which may distort capital flows. If persisting, these differences may give rise to tax competition, which would slow the pace of financial market integration and economic growth. One issue of taxation that needs to be settled is whether to introduce value added taxation for financial services.

From the perspective of the users of financial services, the integration of European financial markets has progressed slowly, considering that financial service provision to retail customers is still nationally based. There are many reasons for this, most of which are beyond the control of the authorities. The users of financial services participating in retail markets continue to show a preference for the services available in the domestic market. Familiarity with the service provider is an important consideration for consumers. The heterogeneity of consumer protection in Europe also weakens households' interest in global financial services. Europe-wide harmonisation of consumer protection regulations is therefore a prime concern. It would raise private investors' confidence in cross-border investment services and stimulate competition in the field.

The high cost of most of the financial services provided outside of the home country is a further disincentive to their use. Finally, aspects of culture and language also impair the integration of retail markets.

The emergence of a European or euro area-wide market in securities trading and settlement is still a long way off. Despite a few stock exchange mergers and closer cooperation between stock exchanges, there is still much work to be done in order to achieve greater integration of marketplaces. The elimination of national stock exchanges may also be a problem to small companies. In centralised markets, small and hence less well known companies may not attract much investor interest, which makes it more difficult for quoted companies to raise capital or for new small businesses to be quoted on stock exchanges. The integration of securities marketplaces and the operation of an effective stock market for small, domestically oriented businesses may prove to be a long enduring challenge.

References

Adam, K, Japelli, T, Menichini, A, Padula, M and Pagano, M (2002) **Analyse, compare and apply alternative indicators and monitoring methodologies to measure the evolution of capital market integration in the European Union.** Centre for Studies in Economics and Finance (CSEF). Department of Economics and Statistics. University of Salerno.

Adjaouté, K and Danthine, J-P (2003) **European financial integration and equity returns: a theory-based assessment.** Research Paper No. 84. FAME – International Centre for Financial Asset Management and Engineering.

ECB (2001) **The Euro Equity Markets.** August.

ECB (2002) **Main features of the repo market in the euro area.** Monthly Bulletin. October.

ECB (2003a) **Recent developments in financial structures in the euro area.** October.

ECB (2003b) **The integration of Europe's financial markets.** Monthly Bulletin. October.

ECB (2003c) **Money Market Study 2002.** November.

ECB (2003d) **Review of the international role of the euro.** Frankfurt.

ECB (2004a) **The implementation of monetary policy in the euro area.** General documentation on Eurosystem monetary policy instruments and proceedings. Frankfurt.

ECB (2004b) **The monetary policy of the ECB 2004.** Frankfurt.

FESE (2002) **Share ownership structure in Europe.** The Federation of European Securities Exchanges. Economics and Statistics Subcommittee.

Guiso, L, Haliassos, M and Jappelli, T (2003) **Household stockholding in Europe: where do we stand and where do we go?** Economic Policy, 36.

Hardouvelis, G, Malliaropulos, D and Priestley, R (2004) **The impact of globalization on the equity cost of capital.** CEPR Discussion Paper No. 4346.

Hartmann, P, Maddaloni, A and Manganelli, S (2003) **The euro area financial system: structure, integration and policy initiatives.** ECB Working Paper No. 230.

Niemi, J (2003) **Pääomarahoituksen tarjonnan lisääminen Suomessa.** ('How to increase the supply of venture capital in Finland') Ministry of Finance. Research and studies, 1/2003.

Salavirta, E (2002) **Money and capital markets.** In Koskenkylä, H. (ed.) Finnish financial markets 2002. Bank of Finland Studies A:105. Helsinki.

Standard & Poor's (2004) **EU 2003 Annual Default Study & Rating Transitions.** February.

On-line references

http://www.euribor.org. 30 April 2004.

Chapter 4

Integration of European banking and insurance

Jukka Vauhkonen – Pertti Pylkkönen

4 Integration of European banking and insurance 74
4.1 Introduction 74
4.2 Integration of European banking: objectives and authorities' measures 76
4.2.1 Economic benefits of integration............................. 76
4.2.2 Key principles of EU integration policy for banking.. 78
4.2.3 Authorities' measures for removing barriers to banking sector integration 79
4.3 Progress on integration in banking 84
4.3.1 Wholesale banking.. 84
4.3.2 Capital market-related banking activities................. 85
4.3.3 Retail banking 88
4.3.3.1 Price indicators for integration in retail banking... 88
4.3.3.2 Indicators of the extent of cross-border retail banking.. 92
4.4 Impact of integration on interbank competition and bank's efficiency.. 101
4.4.1 Competition in banking 101
4.4.2 Banks' efficiency 103
4.5 Integration of European insurance business 105
4.5.1 European insurance sector..................................... 105
4.5.2 Regulation of insurance in Europe 108
4.6 Summary 111

References 112

4 Integration of European banking and insurance

4.1 Introduction

This chapter[1] examines the development of a single banking market in the EU based on several indicators. The three main areas of banking[2] are examined: wholesale, capital market-related and retail. The chapter also discusses authorities' measures for promoting a single banking market and the barriers remaining. This is followed by a brief examination of the current situation regarding the single insurance market.

Integrated financial markets are often defined as markets in which providers and users of financial services in a certain economic area can without barriers provide and acquire financial services across the geographical borders of the area. In a fully-integrated financial market the price of identical financial instruments should be the same everywhere. Moreover, there should be no systematic differences[3] within the area in finance sources or geographical portfolio allocations of economic agents such as companies and consumers. More narrowly defined, integration refers to a situation in which, from previously segmented markets for a product, a single coherent market is created in which a uniform price obtains. Markets are fully integrated when this law-of-one-price holds.[4]

The integration of financial markets is not an end in itself. The reason for promoting integration is to bolster European economic growth. In banking, the underlying goal of integration measures is to improve the conditions for cross-border interbank competition. Increased competition is expected to result in better banking services and lower service prices, which will benefit the end-users – companies and consumers.

Based on the above definitions and objectives of integration, progress in banking sector integration can be examined from three complementary perspectives. The first involves measures taken by authorities to remove obstacles to integration. The second is the

---

[1] Jukka Vauhkonen is the author of sec. 4.1–4.4 and sec. 4.6, and Pertti Pylkkönen is the author of sec. 4.5.

[2] In this chapter, 'bank' refers to all credit institutions that have the right to provide financial services within the EU in accordance with the 'single license' principle.

[3] Hartmann et al (2003), p. 17.

[4] Cabral et al (2002), p. 7.

assessment of progress in integration based on various types of price and quantitative indicators. The third perspective is the assessment of integrations' impact on interbank competition and on banks' efficiency and hence on customers' welfare. This chapter assesses integration of the EU banking sector from these three perspectives.

The chapter first examines the measures taken by the authorities to further a single European banking market. Another area of focus is the objectives of promoting integration and how the benefits of integration are expected to be channelled to end-users of banking services, ie companies and consumers.

Secondly, the chapter gives an overview of the development of various indicators of banking integration over the past few years. Due to the explicitness of the law-of-one-price, price indicators are regarded as the primary indicators of integration. However, only a few systematically compiled and uniformly defined price indicators are available for the banking sector, among which are indicators of certain loan and deposit interest rates and fees. Due to the shortage of reliable price indicators, quantitative indicators have been used as complementary indicators of progress in the single banking market. The chapter also discusses the development in recent years of key quantitative indicators of the scale of banks' cross-border operations, such as cross-border loans and deposits, as well as mergers and acquisitions (M&A).

Also included in the chapter are assessments, based on price and quantitative indicators, of whether the current level of integration in banking has increased interbank competition and improved efficiency, which are the underlying reasons for promoting integration in banking. The chapter also examines existing obstacles to the single banking market.

Finally, the chapter assesses integration of the insurance sector, and authorities' measures for promoting integration.

4.2 Integration of European banking: objectives and authorities' measures

4.2.1 Economic benefits of integration

According to some assessments[5], the deepening of integration in European financial markets can boost European economic growth significantly. Deeper integration of banking activities, for at least two reasons, can have a potentially large positive impact on European economic growth. Firstly, the relative importance of banks in providing finance to companies and households is greater in Europe than eg in the United States.[6] Bank financing is important especially for SMEs, which are important in terms of employment. Secondly, especially retail banking is still fairly inefficient in many European countries[7] and there are major differences in banks' efficiency. For instance, studies on the so-called X-efficiency[8] of European banks, ie the cost structure of banks in comparison to the most efficient banks in the local market, show that the costs of the most inefficient banks are on average 20 to 30% higher than those of the most efficient ones.

Overall, studies seem to indicate that there is still room for improvement in the efficiency of European banking, especially for retail banking. And more importantly, strengthening interbank competition and improving banks' efficiency by measures aimed at promoting integration in the banking sector may even generate considerable macroeconomic benefits.

It is important to note that interbank competition and banking integration are two different things. Interbank competition refers to banks' pricing power in a certain (local) market, whereas banking integration is the expansion of banks' markets from local to wider market. The deepening of banking integration does not in itself guarantee that interbank competition will increase. For instance, entry into the market of a foreign bank through acquisition of a local bank does not necessarily strengthen interbank competition. Competition will not tighten if the acquired bank continues to operate as before and if the banks' pricing behaviour does not change as a result of the acquisition. Moreover, the impact of integration on competition may be difficult to measure. For instance, removing the barriers to cross-

[5] Gianetti et al (2002), London Economics (2002).
[6] Hartmann et al (2003).
[7] Eg Koskenkylä (2002).
[8] Eg Vander Vennet (2002).

border operations may affect the pricing behaviour of domestic banks if there is a growing threat of foreign banks entering the market. This increasing contestability does not, however, show up in quantitative indicators of the deepness of integration. When using quantitative indicators for assessing the deepness of integration, it is therefore recommended that several different indicators be used, so as to reduce the chance of erroneous conclusions.[9] Section 4.3 discusses recent developments in quantitative indicators.

Banking integration is expected to generate economic benefits in a number of ways. Firstly, removing barriers to competition exposes inefficient domestic banks to pricing competition with more efficient foreign banks and forces them to cut costs and raise profitability. Secondly, financial market integration can help banks achieve possible economies of scale[10] and scope[11] in the single market which is larger than the domestic market.[12] The earlier literature[13] in particular emphasises the importance of these economies. Thirdly, an expanding market area may facilitate the spread of risk. Fourthly, the possible tightening of competition as a result of integration may accelerate the development of financial products. Fifthly, integration may improve the transmission of the single monetary policy if changes in central bank interest rates are translated into bank interest rates faster and more fully than before.[14]

Section 4.4 assesses whether banking integration has generated any of the above-mentioned benefits.

---

[9] Manna (2004).

[10] The production of a commodity entails economies of scale if increasing production lowers average costs. With economies of scale large organisations can produce a commodity cheaper than smaller ones.

[11] Economies of scope refer to cost savings gained when eg related products are sold through the same distribution channel. For instance, selling banking and insurance products through one branch instead of two may produce economies of scale.

[12] Realisation of economies of scale requires increasing the company size. This, on the other hand, increases concentration in the sector. Based on studies, it is not clear how concentration in the banking sector affects interbank competition (eg Amel et al 2003). The more competition is reduced by concentration, the smaller the share of achieved economies of scale that will go to consumers.

[13] Eg Cecchini (1988).

[14] Measures included in the FSAP and implemented by May 2004 and other measures are listed in chapter 7, annex 2/7.

4.2.2 Key principles of EU integration policy for banking

The EU's objective of establishing a single banking market is part of a broader mandate to create an EU-wide single market for services. In the single market for banking services a provider of banking services can operate in any of the EU countries or acquire banks of other EU countries. A bank can establish in another EU country either subsidiaries, which are supervised by the authorities of the host country, or branches, which are supervised by the authorities of the bank's home country. Consumers, on the other hand, can acquire financial services from any bank in the EU.

The problem in establishing a single banking market has been that banking has traditionally been heavily regulated. Therefore, establishing a single banking market involves finding a way of eliminating barriers to trade and investment which are typical to all sectors and taking decisions on the regulation of banks' foreign operations.

There are three alternative key principles in regulating banks' foreign operations.[15] The first alternative is to aim at full harmonisation within the EU. The second is to apply the national treatment principle, meaning that foreign providers have free access to national markets and are subject to the same kind of supervision as domestic providers. The third alternative – on which EU legislation is largely based – is to follow the mutual recognition principle.

According to the principle of mutual recognition, each country acknowledges the regulation of another country in the sense that, also foreign banks that are subject to foreign regulation and foreign supervision can operate in the domestic market by either providing services directly or through subsidiaries that they establish. When the principle of mutual recognition is applied, banks from different countries compete subject to different regulatory constraints. As a result, regulatory constraints that are tighter than those in a competing country undermine the competitive position of domestic banks vis-à-vis foreign banks. It is thus evident that applying the principle of mutual recognition will in practice largely prevent national legislation that increases the costs of domestic banks compared to foreign banks. Hence mutual recognition can significantly encourage countries to harmonise their regulation.

Legislation based on the principle of mutual recognition may entail the threat of member states competing for foreign banks by easing

[15] Eg Gual (2004).

national regulations. To prevent this kind of harmful competition, EU legislation includes minimum requirements on certain key regulations concerning the stability and capital adequacy of the banking system. These regulations relate eg to banks' capital adequacy requirements and definitions of equity, large exposures, deposit guarantee schemes, etc (chapter 7).

The principle of complete mutual recognition has been discarded also in EU legislation on consumer protection. Legislation on consumer protection is enacted on a national level, and in the supervision of banks' foreign operations the host country principle is applied instead of the home country principle. In practice, national authorities can prevent entry into the domestic market of foreign providers or banking services that can be considered a threat to the public good.

All and all, EU legislation includes three key elements for banking integration: the principle of mutual recognition, the harmonisation of key minimum regulations on the stability and capital adequacy of the banking system, the application of the host country principle as regards consumer protection. According to several assessments[16], policies based on the above-mentioned elements have been more successful in promoting integration of EU banking than complete harmonisation of regulation would have been.

4.2.3 Authorities' measures for removing barriers to banking sector integration

EU legislative measures for integration of the EU banking sector can be divided[17] into five periods: deregulation of entry into domestic markets (1957–1973), harmonisation of banking regulations (1973–1983), completion of the internal market (1983–1992), the single currency (1999), and the Financial Services Action Plan (1999–2005).

The deregulation of entry into domestic markets began with the Treaty of Rome in 1957. The objective of the Treaty was to transform the highly segmented national markets into a single European market. The Council Directive of 1973 (73/183/EEC) on the abolition of restrictions on freedom of establishment and freedom to provide services in respect of self-employed activities of banks and other financial institutions ensured equal regulatory and supervisory

---

[16] Eg Gual (1999) and (2004).
[17] Dermine (2003).

treatment for foreign and domestic banks. However, the directive did not increase the internationalisation of banks because differing restrictions on capital movements reduced international competition between banks. Furthermore, banking supervision had not been harmonised and therefore banks operating abroad could often be subject to several, possibly quite different, sets of regulations.

In the next stage (1973 to 1983), the main objective was to harmonise banking regulations to lower the barriers to market entry. The First Banking Directive, which entered into force in 1977 (First Council Directive 77/780/EEC on the coordination of the laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions), established the principle of home country control. The Directive can be considered the first step in gradually shifting the responsibility of supervising banks operating in several countries from host country supervisors to home country supervisors. The directive did not include specific provisions; instead it was a guideline for later directives.

Even after the First Banking Directive, the European banking markets were very fragmented for a long time. There still remained many barriers to expansion of banks' foreign operations. For instance, a foreign bank wishing to operate in a host country had to be authorised by the supervisors of the country, and its foreign operations remained subject to the regulations and supervision of the host country. Moreover, in many countries, banks' foreign branches had to have earmarked capital, which increased the costs of foreign banking operations. In addition, restrictions on the free movement of capital were applied in many EU countries until the early 1990s.[18]

By the 1980s, drafting harmonised financial market legislation turned out to be very difficult. National legislation was used to heavily restrict banks' domestic competition (interest rate and credit regulation, barriers to market entry, restrictions on M&As, and restrictions on capital movements) and the banks' possibilities of achieving economies of scale and scope (restrictions on expanding the branch network, restrictions on setting up foreign offices, restrictions on banks' product ranges). Moreover, regulations put in place to ensure the stability of the banking system differed across countries (reserve and capital adequacy requirements and deposit guarantee schemes).

Due to the fragmentation of banking markets and differences in national legislation, the EU decided in the mid-1980s to completely

[18] Eg Gual (1999), p. 37.

change its approach on promoting integration of financial markets. The key principles of the new approach were presented in 1985 in the Commission's White Paper on the completion of the internal market. The White Paper called for mutual recognition, single banking license and home country control as the key principles of banking integration.

The principles of the White Paper were incorporated into the Second Banking Directive of 1989, which is considered the most important banking directive. Based on the principle of mutual recognition, a bank authorised in an EU country would be able to provide banking services or set up branches in other EU countries without further authorisation from host country authorities. Based on the home country principle, the banking supervisor of the home country, who has granted authorisation to the bank, is responsible for controlling its foreign operations.

The Second Banking Directive was expected to increase banks' cross-border operations and interbank competition. Increasing competition has often made banks take excessive risks in their operations. The Second Banking Directive thus called for new directives on consumer protection and on banks' disclosure obligations. Moreover, the directive harmonised and called for later harmonisation eg of some capital adequacy standards and large exposure rules for banks.

The EU's Internal Market Programme and Second Banking Directive seem to have had a key role in speeding up integration in the banking sector. They also promoted integration in the banking sector by fostering a deregulation competition in the EU countries.[19] According to a study by Economic Research Europe Limited (1996), the number of banks' foreign branches increased by 58% in the three years following the Second Banking Directive.

Global harmonisation of banks' capital adequacy requirements in 1988, based on the work of the Basel Committee on Banking Supervision under the aegis of the Bank for International Settlement (BIS), was very important in providing a level playing field for banks. The European Company Statute (chapter 7), which entered into force in October 2004, may also prove to be important in reducing barriers to cross-border interbank competition. With this statute, we should see a new European cross-border corporate structure which will facilitate banks' cross-border restructuring.

A milestone in the integration of the European banking sector was the establishment of the Economic and Monetary Union (EMU) in

[19] Gual (1999), De Avila (2003).

1999. Introduction of the single currency in particular contributed to the integration of wholesale banking (see sec. 4.3.1).

Soon after the introduction of the euro it became evident that having a single currency was not a sufficient prerequisite for the complete integration of financial markets because Economic and Monetary Union is based mainly on macroeconomic objectives: price stability and a single monetary policy. Therefore, the European Council in 1999 launched a Financial Services Action Plan (FSAP)[20] to speed up the integration of financial markets (chapter 7). Initially, the action plan included 42 legislative measures which were to be implemented by 2005. The majority of these measures have either been approved or implemented into EU legislation, and hence the focus is shifting to national implementation.

For banks, some of the most important FSAP action points that have been implemented are the Regulation on the application of International Accounting Standards (IAS) in publicly quoted companies as of 2005, regulations European companies, Directive 2001/24/EC on the reorganisation and winding up of credit institutions, and Directive 2002/87/EC on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate. However, some of the most important FSAP action points concerning banks and financial conglomerates are yet to be implemented. These unfinished action points include, in particular, revision of the capital adequacy regulations and supervision applicable to credit institutions and investment firms, approval of the International Accounting Standard (IAS 32/39), and revision of the solvency regulations of insurance companies (Solvency II).

Table 1 shows the most important directives on banks preceding and included in the FSAP from the period 1973–2002.

[20] The measures included in the FSAP that had been completed by May 2004 and the other measures are listed in chapter 7, annex 2/7.

Table 1. **The most important directives concerning the banking sector**

Directive
Council Directive 73/183/EEC on the abolition of restrictions on freedom of establishment and freedom to provide services in respect of self- employed activities of banks and other financial institutions.
First Council Directive 77/780/EEC on the coordination of the laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions.
Council Directive 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions..
Council Directive 89/117/EEC on the obligations of branches established in a Member State of credit institutions and financial institutions having their head offices outside that Member State regarding the publication of annual accounting documents.
Council Directive 89/299/EEC on the own funds of credit institutions.
Second Council Directive 89/646/EEC on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC.
Council Directive 89/647/EEC on a solvency ratio for credit institutions.
Council Directive 92/30/EEC on the supervision of credit institutions on a consolidated basis.
Council Directive 92/121/EEC on the monitoring and control of large exposures of credit institutions.
Council Directive 91/308/EEC on prevention of the use of the financial system for the purpose of money laundering.
Directive 94/19/EC of the European Parliament and of the Council on deposit-guarantee schemes.
Directive 2000/12/EC of the European Parliament and of the Council relating to the taking up and pursuit of the business of credit institutions.
Directive 2001/24/EC of the European Parliament and of the Council on the reorganisation and winding up of credit institutions.
Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate.

Another major recent project for promoting integration in the banking sector has been the introduction of the Lamfalussy 4-level model (chapter 7) into the EU's legislative process on banks. The mandate of the working group chaired by Alexandre Lamfalussy was to assess how the legislative process concerning EU securities markets, in particular, could be speeded up and how to improve the cooperation of securities regulators in the EU.

The Lamfalussy Group found that the legislative process of the EU as a whole is too slow, rigid and complex for a rapidly changing operational environment, and even a barrier to the full integration of

financial markets. The working group proposed a new 4-level structure for EU legislative process. Directives should focus only on the most important regulations (level 1), whereas detailed and frequently changing technical regulations could be issued in a lower level procedure, a so-called comitology procedure (level 2). The new third-level committees work with the Commission in implementing legislation and seek to promote the consolidation of supervisory methods of EU countries (level 3). The responsibility of the European Commission in particular is to monitor enforcement of EU legislation (level 4). The comitology structure of the Lamfalussy group was introduced first in securities market legislation and on 1 January 2004 it was introduced also in financial and insurance sector legislation.

4.3 Progress on integration in banking

4.3.1 Wholesale banking

Wholesale banking refers here to credit, deposit or derivatives markets, in which banks or other financial institutions transact. In many countries, bank deposits have not increased as much as lending, which has increased the importance of wholesale markets as one of the complimentary sources of financing for banks. The wholesale market has an important role in banks' liquidity management, ie in the banks' ability to grant financing and fulfil their obligations. In the wholesale market, banks that have excess liquidity make loans to banks that lack liquidity. The efficiency of the wholesale market is important also for companies and consumers because banks' funding costs are reflected in the price of bank loans and other banking services.

The wholesale banking market is part of the money market[21], in which the instruments traded have maturities ranging from overnight to twelve months. The most important segments of the wholesale banking market are banks' unsecured deposit markets and the secured repurchase agreement markets, in which assets that are eligible as collateral are purchased or sold under repurchase agreements.

It is important to note that ECB monetary policy, via its key interest rates, has a major impact particularly on shorter-term money market rates.[22] Even before 1999, transition to Stage Three of the

[21] Eg Salavirta (2002), chapter 3, and ECB (2003a).
[22] Eg ECB (2004).

Economic and Monetary Union was expected to significantly speed up integration of the money market, because with the single monetary policy, refinancing costs are the same for all the banks in the euro area.

The interest rates on interbank deposits converged quickly with the introduction of the single monetary policy in January 1999. During the first weeks of January 1999, the difference in average overnight rates in the euro area fell to around 2 basis points. Also cross-country differences in rates on euro-denominated loans between the highest-rated large banks, which are used to calculate EURIBOR reference rates, narrowed quickly after the introduction of the euro. Overall, based on the convergence of cross-border interest rates, the unsecured short-term interbank money market can be considered almost fully integrated. In the secured repo market, the convergence of interest rates has been slower, and barriers to integration still exist regarding eg taxation and national legislation.[23]

4.3.2 Capital market-related banking activities

Capital market-related banking activities are mainly provision of corporate banking services, such as securities underwriting and other corporate banking services, syndicated lending, corporate restructuring and corporate consulting services, and asset management and trading services for institutional investors. Demand for capital market-related banking services has increased considerably in recent years with European companies acquiring ever larger volumes of finance from expanding European capital markets.

Nowadays, capital market-related banking is mainly global business conducted by international investment banks. For instance, in 2001 the combined market share of the 20 largest participants in securities underwriting and syndicated loans in the euro area was over 90%.[24]

The introduction of the euro in 1999 eliminated almost overnight many of the economic, regulatory and psychological barriers that had led to extensive segmentation of European markets for stocks and corporate bonds. These barriers included exchange rate risks, and regulations and practices restricting geographic and currency-based

[23] Cabral et al (2002), chapter 3, and ECB (2003a).
[24] Cabral et al (2002).

diversification of holdings of institutional investors (chapter 3).[25] Before introduction of the euro, companies acquired market-based financing mainly from domestic financial markets. Market segmentation gave domestic banks a clear competitive edge in capital market-related banking. Lack of competition was evident eg in the banks' underwriting fees for securities issues, which were significantly higher in Europe than in the United States.

Euro introduction significantly reduced the economic barriers to cross-border investment and gave companies access to Pan-European money and capital markets. The integration indicators for capital market-related banking activities clearly show that markets for these services have converged significantly since 1999.

The integration of prices of capital market-related banking services can be assessed eg by comparing banks' fees on securities and corporate bond issues. According to a study conducted by Santos and Tsatsaronis in 2003, the average underwriting fees[26] for corporate bond issuance have decreased drastically since the introduction of the euro (table 2, three right-hand columns). The study assesses average underwriting fees for corporate bonds (in per cent of amount raised) issued for the international market by European and American companies between 1994 and 2001. In Europe, these fees were still in 1998 nearly twice as high as in the United States, but the gap has disappeared since 1999.

Banks' underwriting fees for equity issuance and commitment fees on syndicated loans have also declined, but not as much as underwriting fees for corporate bond issues.[27]

---

[25] Santos and Tsatsaronis (2003), p. 1–5.
[26] Underwriters typically purchase and resell issued securities. The underwriting fee is the difference between purchase and resale price (eg Brealey and Myers 2003, chapter 15).
[27] Cabral et al (2002).

Table 2. **Underwriting fees for corporate bond issues in Europe and in USA, 1994–2001**

Year	Number of issues			Total proceeds (USD bn)			Average gross fees (in % of amount raised)		
	USD	Euro	Total	USD	Euro	Total	USD	Euro	Total
1994	82	77	244	19.3	10.7	40.8	1.299	1.553	1.377
1995	116	77	304	25.3	11.6	51.9	1.516	1.797	1.533
1996	116	78	352	30.8	16.9	66.3	1.082	1.543	1.306
1997	148	52	330	47.8	13.6	82.3	1.134	1.732	1.222
1998	175	86	389	67.5	23.5	110.8	0.860	1.664	1.086
1999	239	176	591	93.5	83.0	213.8	0.748	0.803	0.768
2000	192	173	546	105.1	70.9	217.5	0.583	0.685	0.579
2001	131	123	354	96.9	80.0	197.9	0.586	0.426	0.512
Total	**1,199**	**842**	**3,110**	**486.2**	**310.2**	**981.3**	**0.816**	**0.888**	**0.851**
1994–1998	422	289	1,213	114.3	54	237	1.096	1.654	1.259
1999–2001	634	520	1,703	322.1	246.2	682.4	0.636	0.638	0.622

Source: Santos and Tsatsaronis 2003.

Other indicators also suggest that capital market-related banking has converged quickly, following introduction of the euro.[28] For instance, a comparison of nationalities of companies that have issued corporate bonds or shares and of underwriters shows that the importance of domestic underwriters has decreased rapidly. Yet in 1995, domestic banks were involved in all of the large corporate bond issuances, but in 2000 only in 60%.[29] Particularly large American investment banks have rapidly taken market shares from European banks. A large part of capital market-related banking can be considered to be quite integrated even on a global scale.

Overall, capital market-related banking has become highly integrated in recent years, and service fees have declined as a result of intensive competition. It is interesting that the number of operators providing capital market-related banking services has not increased in recent years. Instead, the markets have become concentrated. The markets for capital market-related banking services seem to exemplify well markets involving considerable economies of scale[30] and in which increased global competition or contestability has lowered service prices.

[28] Eg Cabral et al (2002), Galati and Tsatsaronis (2003), Santos and Tsatsaronis (2003).
[29] Eg Cabral et al (2002).
[30] Santos and Tsatsaronis (2003).

4.3.3 Retail banking

Retail banking is often seen as the traditional business of banks. A bank's retail customers are mainly households or small companies. Typical products include consumer credit and housing loans, loans to SMEs, transaction and term deposit accounts, and payment services. Recently, long-term savings-related services, such as mutual funds, asset management, and insurances have also gained importance in retail banking. European banks have traditionally been universal banks, which provide a wide range of retail banking services. Especially larger banks have also provided capital market-related banking services, whereas eg in the United States general banks are not as common as in Europe.[31]

Retail banking differs from wholesale and capital market-related banking in two important ways. Firstly, knowledge of local conditions is very important in retail banking. The banks' clients are scattered and typically not highly mobile, so that the banks need to know the local conditions and have a local branch network. However, the importance of a branch network is likely to decrease gradually with the development eg of electronic distribution networks. Secondly, banks' products differ considerably across countries. There may be major cross-country differences eg in the interest rage linkages, average maturities, and collateral requirements of housing loans.[32]

These differences in retail banking, compared to wholesale and capital market-related banking, are evident also when assessing progress and integration indicators for retail banking. Due to the highly local nature of retail banking, it is in principle more difficult to achieve integration in retail banking than in wholesale and capital market-related banking. The diversity of banks' products is one consideration that makes it more difficult to measure integration. Recent literature has thus paid a considerable amount of attention to developing statistical indicators of integration.[33]

4.3.3.1 Price indicators for integration in retail banking

As stated above, price indicators are the most unambiguous indicators of integration for the financial markets. Based on the law-of-one-price, the markets of the same product are integrated when price

[31] Cabral et al (2002).
[32] Cabral et al (2002).
[33] Adam et al (2002), Manna (2004).

differences across local markets are not *permanent* but over time approach their equilibrium levels. Another characteristic of integrated markets is that *dispersions* of product prices across markets at a given time are small or nonexistent.

Hence price integration indicators for banking are used to assess the *speed* of integration in banks' product prices – such as lending and deposit rates – as well as the *depth* of integration at a given time.

The most important price indicators for retail banking services are average interest rates and interest rate margins for household and corporate lending in different countries. Of these, interest rate margins give a better picture of integration and the tightness of interbank competition, since lending rates largely reflect macroeconomic developments, ie movements in market interest rates. Moreover, lending and deposit rate statistics may differ considerably across countries due to differences in statistical practices.

Thus, in assessing integration of retail banking, it is more useful to look at the time paths of interest rates and interest rate margins. The convergence of country-specific margins indicates that markets are becoming integrated, whereas shrinking margins may reflect tightened interbank competition.

Cabral, Dierick and Vesala in 2002 compared average interest rates on household and corporate lending in euro area countries in 1998–1999 and 2001–2002 (table 3) by calculating country-specific annual average interest rates and interest rate margins versus market interest rates over the same period, using ECB monthly interest rate data.

Table 3. **Average household and corporate lending rates and margins in euro area countries, 1998–1999 and 2001–2002**

	Household lending rates				Corporate lending rates			
	Average (May 1998–May 1999)		Average (May 2001–May 2002)		Average (May 1998–May 1999)		Average (May 2001–May 2002)	
	Rate	Lending margin	Rate	Lending margin	Rate	Lending margin	Rate	Lending margin
Austria	6.33	2.35	6.42	1.70	6.11	2.69	6.07	2.21
Belgium	5.36	1.38	6.37	1.65	4.98	1.57	5.64	1.78
Germany	6.25	2.27	6.74	2.03	6.23	2.83	7.05	3.19
Finland	5.24	1.25*	5.24	0.53*	4.31	0.89	4.71	0.85
France	7.16	3.18	7.23	2.52	4.52	1.12	5.31	1.45
Greece	12.56**	6.55**	7.65	2.94	16.44	5.61	8.09	4.23
Ireland	7.49	3.43	6.84	2.12	8.68	5.28	8.67	4.81
Italy	6.71	2.67	6.31	1.60	6.13	2.50	5.64	1.77
Luxembourg	5.18	1.19	5.12	0.40	n/a	n/a	n/a	n/a
Netherlands	5.29	1.31	5.81	1.09	3.67	0.29	4.35	0.49
Portugal	6.36	2.34	6.09	1.38	6.36	2.83	5.51	1.65
Spain	5.85	1.83	5.78	1.06	6.06	2.53	6.20	2.34
Euro area	**6.65**	**2.48**	**6.30**	**1.58**	**6.68**	**2.56**	**6.11**	**2.25**
Std. dev.	**2.01**	**1.48**	**0.76**	**0.76**	**3.50**	**1.67**	**1.34**	**1.34**

* In the study by Cabral et al (2002), used here as a source, long-term rates have apparently been used as reference rates in the calculation of housing loan interest rate margins. Contrary to most other euro area countries, in Finland the reference rates on housing loans are mainly short-term market interest rates, particularly the 12-month EURIBOR and banks' own prime rates. Consequently, the figures for Finland are not fully comparable.

Using the 12-month EURIBOR as reference rate for Finnish housing loans, the average lending rate margins on household lending for the review period are as follows:

May 1998–May 1999: 1.95 percentage points

May 2001–May 2002: 1.50 percentage points.

Here, the interest rate margin on housing loans is the monthly average rate on banks' new housing loans minus the 12-month EURIBOR (HELIBOR). Average rates were calculated from the monthly figures. Source: Financial Markets, statistical review of the Bank of Finland (periods: May 1998–April 1999 and May 2001–April 2002).

** January 1999–May 1999.

Source: Cabral et al 2002.

n/a = not available.

The margins particularly on household lending narrowed notably in most of the countries in 1998–1999 and 2001–2002 (table 3). Also the differences across countries in household lending margins narrowed, as reflected in the 50% decrease in standard deviation. The interest rate margins on corporate lending also decreased and converged somewhat across countries, albeit clearly less than on household lending.

The European Commission's data[34] covers a longer period (1993–2003) than that of the above-mentioned study by Cabral, Dierick and Vesala. Based on the Commission's data, interest rates on short-term corporate lending, medium- and long-term corporate lending, and housing loans converged in the EU countries between 1993 and 2001. Since 2001, convergence has continued only in the interest rates on

[34] European Commission (2004a), (2004b) and (2004c).

medium- and long-term corporate lending, whereas interest rates on housing loans and short-term lending started to diverge in 2001. Interest rates on consumer lending, on the other hand, did not converge at all between 1993 and 2002.

Overall, despite this convergence, there are still major differences across countries in lending rates and margins. Thus, based on price indicators, the retail lending market can still be considered geographically segmented to a large extent.

In contrast to the retail lending market, the retail deposit market does not appear to have converged, based on price indicators (table 4). The increase in deposit rate margins, ie the gaps between market and deposit rates, seems to indicate that banks' competition in deposits has not increased in most countries in recent years.

Overall, price indicators show that household and corporate lending rates and margins still differ considerably across euro area countries. In a fully-integrated market, competition would eliminate such price differences. Based on indicators, the retail banking services markets have either economic (natural) or regulation- and control-related (chapter 7) barriers to competition, which hinder cross-border banking competition. Section 4.4 discusses these barriers.

Table 4. **Average retail deposit interest rates and margins in the euro area, 1998–1999 and 2001–2002**

	Average (May 1998–May 1999)			Average (May 2001–May 2002)		
	Rate	Deposit margin*	Overall margin**	Rate	Deposit margin*	Overall margin**
Austria	2.18	1.24	4.04	2.17	1.69	4.09
Belgium	2.31	1.10	2.81	2.37	1.49	3.57
Germany	2.46	0.94	3.78	2.49	1.37	4.39
Finland	1.20	2.21	3.60	1.59	2.27	3.40
France	2.65	0.75	3.04	2.68	1.18	3.48
Greece	8.48	2.35	7.77	2.06	1.80	5.89
Italy	2.26	1.37	3.94	1.72	2.14	4.02
Luxembourg	2.50	0.91	2.67	2.54	1.32	2.58
Netherlands	2.33	1.06	2.55	2.32	1.55	3.18
Portugal	2.44	1.08	3.91	2.45	1.41	3.33
Spain	2.08	1.46	3.89	2.32	1.54	3.68
Euro area	**2.81**	**1.32**	**3.82**	**2.25**	**1.61**	**3.78**
Std. dev.	**1.92**	**0.52**	**1.42**	**0.34**	**0.34**	**0.85**

* The deposit rate margin is the gap between reference market rate and average retail interest rate (compiled by the ECB).
** The overall margin is the gap between average lending and deposit rates.
Source: Cabral et al (2002).

Another commonly used price indicator of progress in integration of retail banking is eg the price of cross-border credit transfers.[35] Earlier, these credit transfers were very expensive in most European countries compared to domestic credit transfers. Therefore, the European Commission in December 2001 issued the highly-debated Regulation (EC) No 2560/2001 on cross-border payments in euro. Under this Regulation, as of 1 July 2003, the charges levied for cross-border credit transfers must be the same as those for corresponding domestic credit transfers (chapter 6).

The reliability of price indicators as integration measures requires that the products compared be as similar as possible. In retail banking, compiling uniform data is challenging because the products of retail banking differ across countries eg in terms of interest rate-linkage and maturities. Hence an alternative way of assessing the integration of retail banking would be to assess whether interest rate-linkages and maturities of retail loans have become integrated with the introduction of the single monetary policy. However, such a study has not yet been conducted.

4.3.3.2 Indicators of the extent of cross-border retail banking

In an integrated financial market, banks and consumers can without obstacles provide or acquire financial services across the geographical borders of a given area. Moreover, a fully-integrated market should not have systematic differences in the geographical diversification of banks' lending and funding. Thus, the progress of integration in financial markets is measured not only by price indicators by also by different types of quantitative indicators, which measure the extent of banks' foreign retail banking operations and banks' domestic and foreign lending and funding.

Indicators of the extent of banks' foreign operations can be divided into two categories. Indicators of the *provision of cross-border banking services* measure especially the integration of corporate banking services, since companies are the main users of these services. For households, the most important indicators are the numbers of *foreign banks' branches and subsidiaries* and *M&As*, since households typically acquire very limited amounts of banking services directly from abroad.

[35] Adam et al (2002).

When interpreting quantitative indictors the inherent problems should be taken into consideration. The use of quantitative indicators as integration measures is a controversial area of economic theory, since most quantitative indicators lack a clear theoretical benchmark. For a price indicator, the benchmark is based on the law-of-one-price. The depth of integration can be assessed quite unambiguously by comparing the price indicator value with the price corresponding to the law-of-one-price.

Quantitative indicators must be interpreted cautiously for two reasons. Firstly, the law-of-one-price may in principle apply even if banks do not have any cross-border trading. Thus markets can be integrated even if cross-border trading volumes are small. Potential competition does not necessarily require entry into a market. Instead, the mere threat of market entry can keep competition tight. It has been suggested, for instance, that the concentration of banking in various countries in recent years can be explained largely by the increasing threat of foreign competition.[36] Secondly, a large volume of cross-border trading does not necessarily guarantee that markets are integrated. Even major trade flows do not necessarily reduce cross-country interest rate differentials, although this is often the case in practice. These reservations should be taken into consideration when interpreting such indicators.

Domestic and foreign lending of euro area banks

An assessment of the balance sheets of euro area banks shows that direct cross-border provision of retail banking services is quite limited, though it has increased in recent years (table 5). The share of cross-border loans of euro area financial institutions in total loans to non-financial institutions in 2002 was only 3.6%, compared to 2.2% in 1997. In deposits, the corresponding shares were 5.2% in 2002 and 5.4% in 1997.

In a fully-integrated retail banking market, domestic customers should not receive special treatment in banks' lending, funding, or other business activities. In statistical terms, banking business in an integrated financial market does not have a home bias. Due to the mainly local nature of retail banking, home bias is expected to be considerable in retail banking, and therefore its total elimination

[36] European Commission (2004a) and (2004b).

cannot be considered realistic or desirable. Assessment of the degree of home bias is nonetheless a useful indicator of integration.

Examination of banks' balance sheets alone indicates that home bias is considerable in retail banking.[37] Using advanced statistical indicators, Adam et al and Manna have shown that in retail banking, home bias is extensive in lending and deposits and that it has not decreased significantly during the period 1997–2002. However, aside from home bias, the importance of the geographic location of the counterparty has diminished in recent years.[38]

Table 5. **Domestic and foreign assets and liabilities of euro area banks, 1997–2002**

	Dec 1997	Dec 1998	Dec 1999	Dec 2000	Dec 2001	Mar 2002
Total loans to non-banks, EUR bn	5,905	6,349	6,867	7,491	7,952	8,046
Domestic business. %	91.6	91.6	90.4	89.9	88.9	88.7
Business with other euro area countries. %	2.2	2.6	3.0	3.2	3.4	3.6
Business with the rest of the world. %	6.2	5.8	6.6	6.9	7.7	7.7
Total deposits from non-banks, EUR bn	5,104	5,444	5,740	6,090	6,576	6,586
Domestic business. %	88.0	87.8	86.2	85.1	84.3	83.7
Business with other euro area countries. %	5.4	5.5	5.3	5.2	5.0	5.2
Business with the rest of the world. %	6.6	6.7	8.5	9.7	10.7	11.1

Source: Cabral et al (2002).

The development eg of Internet banking has been expected to increase cross-border retail banking. Thus far the use of the Internet and other new distribution channels has increased mainly in domestic retail banking services. It is therefore evident that uncertainties, real and perceived, concerning particularly data security and consumer protection are slowing the spread of cross-border Internet banking.

Banks' foreign branches and subsidiaries

The above figures show that local distribution channels are still essential in retail banking services. Banks' geographic proximity and good reputation are particularly important for retail customers, and customers are still reluctant to acquire financial services directly from abroad. For instance, real and perceived shortcomings in consumer protection on cross-border trading reduce acquisitions of foreign

[37] Adam et al (2002), Manna (2004).
[38] Manna (2004).

financial services. Hence local branches have a natural competitive edge over banks that provide retail banking services directly from abroad. Success in a foreign retail banking market thus requires – at least at this stage of integration – building or acquiring local distribution networks. Therefore the number of banks' foreign branches and subsidiaries and their relative importance in the domestic markets, as measured by balance sheet size, are the most common indicators of integration in retail banking.

During the period 1997–2002, the number of foreign *branches* of credit institutions from EEA countries in the euro area countries increased from 349 to 460, and in the EU countries from 470 to 571 (table 6). Measured by total assets of foreign branches of credit institutions, the relative importance of foreign branches has, however, not increased as much. The ratio of total assets of foreign branches of credit institutions from EEA countries in the euro area countries to euro area GDP increased from 8% in 1997 to 9% in 2002. The corresponding figure for the whole EU increased from 19 to 24% (table 7).

Table 6. **Number of foreign branches of EEA-country credit institutions in EU countries, 1997–2002**

	Country	1997	1998	1999	2000	2001	2002
	Belgium	25	25	30	34	35	36
	Denmark	7	8	9	9	9	8
	Germany	46	53	57	62	59	64
	Greece	14	14	13	13	13	14
	Spain	35	36	41	42	49	51
	France	52	53	56	59	55	51
	Ireland	18	20	26	28	32	31
	Italy	62	65	70	82	94	91
	Luxembourg	61	61	60	55	54	48
	Netherlands	9	10	16	18	19	19
	Austria	6	9	12	13	15	15
	Portugal	15	15	17	23	23	21
	Finland	6	6	7	5	18	19
	Sweden	14	17	16	19	19	18
	United Kingdom	100	100	99	95	87	85
EU12	**Monetary Union**	**349**	**367**	**405**	**434**	**466**	**460**
EU15	**European Union**	**470**	**492**	**529**	**557**	**581**	**571**

Source: ECB (2003b).

Table 7. **Total assets of foreign branches of EEA-country credit institutions relative to host country GDP**

	Country	1997	1998	1999	2000	2001	2002
	Belgium	26	19	16	16	12	10
	Denmark	9	14	9	13	11	12
	Germany	2	3	4	4	4	4
	Greece	10	9	9	10	7	8
	Spain	8	8	7	6	8	9
	France	7	6	7	9	8	8
	Ireland	46	50	56	55	51	47
	Italy	6	7	6	7	6	6
	Luxembourg	643	632	577	565	609	496
	Netherlands	5	6	6	8	6	6
	Austria	2	2	2	2	2	2
	Portugal	10	11	11	11	12	12
	Finland	8	7	9	7	8	10
	Sweden	22	46	42	67	88	99
	United Kingdom	73	78	77	81	86	78
EU12	**Monetary Union**	**8**	**8**	**8**	**9**	**9**	**9**
EU15	**European Union**	**19**	**21**	**21**	**24**	**25**	**24**

Source: ECB (2003b).

The number of foreign *subsidiaries* of credit institutions from EEA countries in euro area and EU countries (table 8) increased between 1997 and 2002 by less than the number of banks' foreign branches, but their relative importance (table 9), as measured by total assets, increased more than that of banks' foreign branches.

Table 8. **Number of foreign subsidiaries of EEA-country credit institutions in EU countries, 1997–2002**

	Country	1997	1998	1999	2000	2001	2002
	Belgium	16	17	21	21	22	21
	Denmark	2	4	5	5	7	7
	Germany	31	32	23	22	21	22
	Greece	1	1	1	2	2	2
	Spain	46	40	36	38	44	40
	France	48	54	54	66	70	64
	Ireland	21	24	26	26	27	27
	Italy	4	5	6	7	7	10
	Luxembourg	97	96	99	96	89	86
	Netherlands	9	9	9	12	14	14
	Austria	20	11	10	11	13	13
	Portugal	6	8	8	10	9	9
	Finland	0	0	0	0	0	0
	Sweden	3	2	2	2	2	1
	United Kingdom	21	15	15	16	17	17
EU12	**Monetary Union**	**299**	**297**	**293**	**311**	**318**	**308**
EU15	**European Union**	**322**	**319**	**316**	**336**	**334**	**333**

Source: ECB (2003b).

Table 9. **Total assets of foreign subsidiaries of EEA-country credit institutions relative to host country GDP**

	Country	1997	1998	1999	2000	2001	2002
	Belgium	43	44	46	46	58	54
	Denmark	0	0	0	0	18	20
	Germany	4	4	4	4	5	11
	Greece	2	4	6	14	15	17
	Spain	7	7	6	7	8	8
	France*	11	10	9	21	20	19
	Ireland	73	93	114	118	130	91
	Italy	3	4	4	2	2	0
	Luxembourg	2,154	2,177	2,269	2,111	2,322	2,348
	Netherlands	7	6	4	19	23	21
	Austria	4	2	2	2	49	52
	Portugal	21	43	24	46	56	54
	Finland	0	0	0	0	0	0
	Sweden	4	4	6	1	0	n/a
	United Kingdom	5	4	5	4	5	4
EU12	**Monetary Union**	**14**	**15**	**15**	**19**	**23**	**23**
EU15	**European Union**	**12**	**13**	**13**	**16**	**19**	**n/a**

* For France, the sum of assets of subsidiaries from both EEA and non-EEA countries.
N/a = not available.
Source: ECB (2003b).

Overall, the relative importance of foreign branches and subsidiaries of banks from EEA countries in the domestic markets of most EU countries is still quite limited (tables 7 and 9). Another important finding is that banks' foreign subsidiaries, as measured by total assets, are more important than banks' foreign branches (tables 6 and 8). This is mainly due to the fact that banks' foreign branches often focus on certain services aimed at selected customers, such as corporate and private banking services. It is, however, somewhat surprising that the relative importance of branches is not greater, since the purpose of the single banking license principle of EU legislation is to facilitate the establishing of banks' foreign branches. The relative advantages and disadvantages of subsidiary and branch structures have not been extensively studied[39], and it is not clear why branch structures have not been more popular.

[39] Dermine (2003), Huizinga (2003).

Banks' cross-border M&As

Building a local branch network and other distribution channels can be slow and expensive for a foreign bank. A faster way to enter new local markets is via M&As with local financial institutions. Hence the number and value of cross-border M&As is a commonly used indicator of integration. One can also argue for the use of the number of banks' domestic M&As as an indicator of integration in the banking market. Banks may react to the lowering of barriers to cross-border interbank competition and to increasing competition by increasing their size in the domestic market.[40] Hence, we turn to recent years' developments in financial institutions' domestic and foreign M&As.

Concentration has taken place in the banking sectors of most EU countries already since the early 1990s (table 10). The number of credit institutions has decreased considerably since the early 1990s in most EU countries, particularly in the larger ones. This has happened for several reasons. Particularly in the early 1990s, concentration was motivated mainly by the need to reduce over-capacity and cut costs that had been building up since the heavy regulatory period of the financial markets.[41] At first, M&As involved mostly small national savings and cooperative banks. Cross-border M&As have become more frequent. In recent years, banks have not only grown in size, but expanded into new business areas, particularly insurance.

---

[40] Eg European Commission (2004a).
[41] Eg Koskenkylä (2002).

Table 10. **Number of credit institutions in the EU, 1997–2002**

	Country	1997	1998	1999	2000	2001	2002
	Belgium	134	120	119	119	113	111
	Denmark	100	212	210	210	203	178
	Germany	3,577	3,238	2,992	2,742	2,526	2,363
	Greece	53	59	57	57	61	61
	Spain	411	402	387	368	367	359
	France	1,273	1,226	1,159	1,099	1,050	1,011
	Ireland	70	78	81	81	88	85
	Italy	935	934	890	861	843	822
	Luxembourg	215	212	211	202	189	177
	Netherlands	100	634	616	586	561	539
	Austria	995	898	875	848	836	823
	Portugal	235	227	224	218	212	202
	Finland	375	348	346	341	369	369
	Sweden	124	148	148	146	149	216
	United Kingdom	480	521	496	491	452	440
MU12	**Monetary Union**	**8,373**	**8,379**	**7,955**	**7,521**	**7,214**	**6,922**
EU15	**European Union**	**9,077**	**9,260**	**8,809**	**8,368**	**8,018**	**7,756**

Source: ECB (2003b).

Assessment of cross-border M&As of European banks is hampered by a lack of harmonised statistical data compiled by the authorities. There is little statistical data on numbers of M&As by banks in the EU and particularly on their average size. However, data compiled by a private consultation company indicates strongly that the average size of bank M&As increased manifold between 1988 and 2001, compared to 1990–1997 (tables 11 and 12).

Table 11. **Annual M&A values involving euro area banks in 1990–2001 and relative shares of intra- and inter-industry M&As in total industry M&As**

	Total	Intra-industry		Inter-industry		Total
		Domestic	Cross-border	Domestic	Cross-border	
	EUR bn	%	%	%	%	%
1990	15.4	45	7	45	3	100
1991	8.7	76	2	10	12	100
1992	5.2	17	4	19	60	100
1993	12.0	22	3	17	58	100
1994	6.1	73	5	22	0	100
1995	11.0	39	26	32	3	100
1996	6.4	74	1	6	19	100
1997	27.9	74	2	5	19	100
1998	72.4	70	3	17	10	100
1999	70.9	79	13	3	5	100
2000	49.7	38	42	12	8	100
2001 (Aug)	31.3	31	1	67	1	100
1990–2001	**316.9**	**60**	**11**	**18**	**11**	**100**

Source: Cabral et al (2002) (original source:Thomson Financial).

Table 12. **Average size of M&As involving euro area banks, 1990–1997 and 1998–2001**

		1990–1997	1998–2001 (Aug)	1990–2001 (Aug)
Average size		273.5	1,116.9	549.6
of which:	domestic / intra-industry	315.4	1,279.5	648.8
	domestic / inter-industry	205.8	1,075.3	413.5
	cross-border / intra industry	163.6	1,011.7	456.8
	cross-border / inter industry	38.5	575.2	429.5

Source: Cabral et al (2002).

In the euro area, 70% (value terms) of cross-border M&As between 1990 and 2001 took place after 1998. It thus seems that the importance of cross-border M&As is increasing, even though there was a temporary slowdown in internationalisation in 2002, probably due to the sluggish economy.[42]

The average value of cross-border M&As involving euro area banks in 1990–2001 was only 11% of the value of domestic M&As.[43] Large cross-border M&As have taken place especially in the Nordic and Benelux countries, whereas in the large European countries, restructuring has involved mainly domestic parties.

[42] ECB (2003b).

[43] Eg Buch and DeLong (2003).

The above-stated quantitative indicators may underestimate the long-term impact of integration in the banking market. It has been suggested that banks react to increasing interbank competition and the threat of interbank competition brought on by integration by forming large national players via domestic M&As. In the next possible stage of integration, large national banks and financial groups form large regional financial conglomerates to succeed even in competition with larger international and globally operating banks.[44] This view is consistent in particular with developments in the Nordic banking sector in recent years. The European Company Statute (chapter 7), which was adopted in October 2001 and which entered into force in October 2004, may in future be one of the major factors boosting banks' cross-border restructuring.

4.4 Impact of integration on interbank competition and banks' efficiency

This section examines the impact of banking sector integration on interbank competition and the efficiency and pricing behaviour of banks. In addition, an assessment is made of measures that have been proposed for promoting integration in banking, particularly retail banking.

4.4.1 Competition in banking

According to the European Commission, integration in the financial sector significantly strengthens concentration in the sector.[45] However, the progress of concentration varies across the different areas of banking. According to the Commission, competition and concentration are separable into three distinct levels.

On the first level, banks and their customers operate mainly within national borders. Integration in the other financial sectors will, however, boost interbank competition, speed up the concentration process, and encourage the entry of local companies into local markets.

[44] European Commission (2004a), FitchRatings (2004).
[45] European Commission (2004a) and (2004b).

On the second level, banks' customers still acquire banking services mainly from national markets. Foreign banking services are either not available or are not used extensively. Domestic markets are dominated by a few, large financial groups. Many of these financial groups have significant business operations in several countries. The distribution channels for banking services are national. However, many of the operations of banking groups, such as liquidity management, and 'back office operations' are conducted in one location. M&As happen mainly on a cross-border basis, and result in increased concentration at Pan-EU level. Nordic banking is an example of this kind of development.

On the third level, markets are either fully or almost fully integrated, and competition is tight. Financial institutions operate in several EU countries, either through branches or directly via cross-border provision of banking services. Barriers to market entry are low, and new operators can fairly quickly gain significant market shares. This level of integration has been reached in investment banking.

Based on indicators and other findings, retail banking in the EU is mainly on the first level of competition and concentration. The number of credit institutions and their branches has decreased considerably in recent years, mainly as a result of national M&As. Consequently, the average size of credit institutions has grown: in the past five years, the average size of credit institutions has grown by as much as 50% in many EU countries and more than doubled in the United Kingdom, Netherlands, Spain, and Ireland.[46] The growth in average size of credit institutions has resulted in concentration of national markets. In most of the EU countries, markets are dominated by a few large, and mostly national, banks.

Integration in the European banking sector has clearly strengthened competition in retail banking and capital market-related banking, whereas the impact of concentration in banking systems on competition in retail banking is not unambiguous. Indicators of integration suggest that the sector has not integrated significantly: there are considerable cross-country differences in prices of retail banking products, and the entry of foreign banks into markets, either directly via cross-border provision of banking services or through branches or subsidiaries, is relatively insignificant. However, integration may have in part increased efficiency and concentration in the national banking sectors, which has benefited the banks' customers in at least some countries. For instance, in the Nordic

[46] European Commission (2004a), p. 31.

countries, competition for retail banking customers is tight despite the high level of market concentration, and customers have benefited from increased banking efficiency, especially through narrower lending margins. However, it is difficult to distinguish the impact of integration from other factors which have at the same time increased efficiency in banking and boosted interbank competition.

4.4.2 Banks' efficiency

The integration of banking has been expected to strengthen interbank competition, increase efficiency, and reduce cross-country differences in efficiency. This has indeed happened in retail banking and capital market-related banking. In retail banking, efficiency has not improved as much as expected, even though banks' average efficiency, as measured eg by cost-to-income ratio, has improved in the EU countries since 1994.[47] European banking is nevertheless less efficient than US banking, and the cross-country differences in efficiency are significant. Moreover, cross-country differences in efficiency have not decreased but have actually increased.[48] In an integrating market, banks' efficiency should improve and efficiency differences across banks should decrease. The EU's objective has been to remove barriers to market entry, to enable banks to improve their operations by utilising presumed economies of scale in a large single market. The persistence of differences in efficiency thus indicates that some barriers to market entry hinder foreign competition in retail banking.

According to most assessments, the key factors hindering integration in retail banking are economic ones. There are several reasons why domestic banks have a competitive edge over foreign competitors in domestic markets. Firstly, it is evident that domestic banks know local customers and conditions better than foreign banks. This information asymmetry can be a barrier to market entry for foreign banks even if there are no legal obstacles to market entry. Secondly, domestic banks usually have branch networks covering the whole country. Building a competing branch network can be extremely expensive. Thirdly, a customer may incur a 'switching cost' in changing banks. Business relationships between bank and customer are often longstanding. Therefore, it may be difficult and expensive for a competing bank to attract a customer from a long-term banking

[47] European Commission (2004c), section IV, chart 2.1.2.
[48] European Commission (2004c), section IV, chart 2.1.3.

relationship. Moreover, a competitor entering a market may succeed mainly in attracting only the worst customers from the banks that are already in the market.[49] Fourthly, local banks may have a better reputation than foreign banks among retail customers. Fifthly, the economies of scale and scope of retail banking may not be as significant as expected in the most optimistic estimates.[50]

For all these reasons, the entry of foreign banks into the retail banking market, particularly by providing direct cross-border financial services, can be very difficult. Removing all the regulatory and supervisory barriers between countries does not guarantee that the predominantly national character of retail banking would change.[51] The United States is a good case study of the difficulties of integrating retail banking markets. US banks are able to engage in interstate retail banking activities. However, no banking group has major operations in all regions of the country, and only 6% of banks operate in more than one state.[52]

The Expert Group on Banking[53], which has assessed the progress of the European Commission's Financial Services Action Plan (FSAP) and the prospects for banking, recommends that realistic objectives be set for the integration of retail banking. It also recommends that legislative measures pay particular attention to harmonisation of consumer protection because it is a prerequisite for the expansion of cross-country banking. Moreover, the group recommends that the focus of promoting integration should be on retail banking services for which integration can be achieved most easily. According to the group, such possible services are consumer loans, leasing, and various kinds of savings products. In addition, the group stresses that the entry of foreign banks into the market may improve the efficiency of a domestic market even if their market share remains small. Foreign banks may eg introduce new practices and products which improve efficiency.

---

[49] Broecker (1990).
[50] Eg Cecchini (1988), Amel et al (2003), Boot (2003).
[51] Eg Padoa-Schioppa (2004).
[52] Rosengren (2003), p. 109.
[53] European Commission (2004d).

4.5 Integration of European insurance business

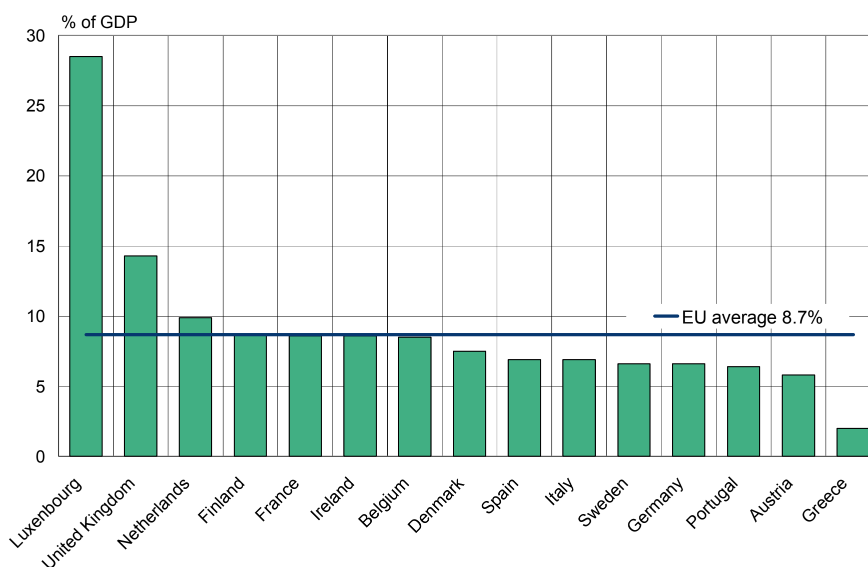
4.5.1 European insurance sector

This section examines the development of a single European insurance market. The European insurance sector has experienced robust growth. Insurance premium income in the EU member states (EU15) has grown much faster than GDP, as indicated by the ratio of premium income to GDP. In 1990 total premium income of EU member states was almost 6% of their GDP. By 2002 it had increased to almost 9% of GDP.

Growth of life and pension insurance premium income in particular has significantly outpaced economic growth. This can be explained eg by measures taken to prepare for population ageing and the growth of total wealth, some of which has been allocated to life and pension insurance savings. In Europe, the growth of non-life insurance premium income has only slightly exceeded GDP growth.

The importance of the insurance sector varies considerably across the European countries (fig. 1). As in other segments of the financial sector, insurance companies have established a considerable number of subsidiaries and branches in Luxembourg in the past ten years. This is demonstrated eg by the robust increase in premium income of insurance companies operating in the country relative to GDP. In Luxembourg, the premium income-to-GDP ratio was in 1990 approximately 8%, and by 2002 it had increased to almost 29%. A considerable amount of premium income is collected from foreign customers. Luxembourg's attractiveness to insurance companies is primarily due to low taxation. In addition, the extensive presence of banks that provide investment services to insurance companies, as well as other companies, has increased the willingness of insurance companies to locate in the country. The United Kingdom is another country in which the insurance sector has an important role in the financial market. In Finland growth in insurance premium income since 1990 has been slightly faster than in other European countries, and in 2002 the premium income-to-GDP ratio was the same as the European average, 8.7%. However, without employee pension insurance premium income, the ratio is clearly below the European average of 4.2%.

Figure 1. **Premium income of insurance companies in Europe, 2002**



Sources: European Commission (2004c) and Comité Européen des Assurances.

Over the past decade, growth in the European insurance market has been fastest in Spain, Italy and Portugal, where the insurance market was still small in the early 1990s. Currently, the smallest European insurance market is Greece.

Growth in European life and pension insurance has been based mainly on premium income generated in the home country of the institution providing insurance services. Cross-border provision of life insurance services is still quite limited, and in that sense integration of the life insurance market is still in its early stages. Life and pension insurance companies have expanded their operations to other countries, primarily by locating in target countries.

Many barriers to insurance integration have been removed and cross-border provision of insurances has been deregulated. However, several still-present barriers are slowing the deepening of insurance integration and cross-border provision of insurances. For instance, consumer protection and contract legislation have not been harmonised in Europe, which diminishes customers' interest in services provided by foreign companies. But the most important factor slowing the deepening of integration in the life and pension insurance market is taxation based on national practices. Taxation practices and tax rates concerning insurance contracts can differ considerably across

the European countries. In addition, voluntary pension insurance may often include terms and conditions that in practice force customers to purchase insurance services from domestic insurance companies. Insurance companies that have established operations in national insurance markets have succeeded well in some European countries and have already acquired significant market shares (table 13). These companies have established themselves mainly through acquisitions or subsidiaries; the importance of branches is still muted.

Table 13. **Shares of life and non-life insurance premium income of foreign-owned companies, subsidiaries and branches, in selected countries, 2001**

	Life insurance, %	Non-life insurance, %
Spain	23.7	29.1
United Kingdom	25.8	57.8
Austria	33.1	44.6
Luxembourg	61.2	22.0
Germany	15.4	14.3
Finland	4.0	35.4
Denmark	17.5	37.4

Source: OECD.

One of the key changes in recent years in the European financial services sector has been the increasing link-ups between banking and insurance. In Europe, this is reflected eg in the numerous mergers between banks and insurance corporations (financial conglomerates). Another way in which these ties have increased is where a bank establishes an insurance corporation so as to utilise its own existing branch network also for selling insurance products. Several insurers have also established banks as a way of expanding their offering of financial services. The key objective of financial groups is optimal use of the customer base.

In Europe, the mergers of banks and insurance corporations started in the Netherlands in the early 1990s, when the country's largest insurance company, Nationale Nederlanden, and NMB Postbank merged to form the financial conglomerate ING. Thereafter, many banks and insurance corporations have merged to form financial conglomerates in the Benelux countries. Mergers quickly spread to France and the Nordic countries, and to a few other European

countries such as Spain and Italy.[54] In the United States, forming a financial conglomerate has been possible only since November 1999 when the 'Gramm–Leach–Bliley law' entered into force.

In some countries, banks have thus become the most important channel for selling life and pension insurance products. The market share of bank-owned insurance corporations in total premium income from these products has increased to over 50% in, eg Spain, Italy and Finland.[55]

In many European countries, the purchase of non-life insurance services from a foreign insurance corporation is more common than for life insurance, which is more retail than wholesale oriented. For instance, internationally active companies often purchase non-life insurance services from abroad. That corporate customers obtain services from international non-life insurers is also demonstrated by the fact that particularly in the smaller countries, the market share of foreign non-life insurers has already become quite considerable. Also in non-life insurance, it is evident that foreign companies gain premium income primarily by locating in target countries, rather than via cross-border provision of services.

Reinsurance and retrocession involve wholesale market operations between insurers, and these markets became internationalised and integrated already with the liberalisation of capital movements. Internationalisation has resulted in many very large reinsurance companies in Europe, and the reinsurance market is highly concentrated.

4.5.2 Regulation of insurance in Europe

Insurance market legislation has a long history in the European Community. The first directive concerning insurance business, which entered into force in 1964, liberalised operating conditions in the Community reinsurance market. Despite early adoption of this first insurance directive, the harmonisation of life and non-life insurance legislation has made slow progress.

Moreover, legislation on life and non-life insurance has come in stages. In the 1970s, the first directives on life and non-life insurance were adopted. Their key objective was to remove obstacles to

[54] For more information on developments in Finland, see Bank of Finland Bulletin, special issue (2003), p. 38.
[55] Fitch (2002).

provision of insurance services between member states. An insurance company operating in one member state was thus allowed to establish a subsidiary or branch in another member state. Host country authorities were made responsible for controlling operations (host country control).

In the second stage, the key goal was to guarantee the free cross-border provision of insurance services. After the adoption of the Second Life Assurance Directive and the Second Non-Life Insurance Directive, insurers were allowed to provide insurance services from home country across the entire Community without having to establish operations in another country. Host country control still applied.

One of the key changes brought by the Third Life Assurance Directive and Third Non-Life Insurance Directive, which entered into force in 1992, was the adoption of the 'single license principle'. In other words, a license granted by the home country enables a company to operate across the entire Community. Consequently, the principle of home country control was introduced in the control of insurance companies. Minimum capital adequacy requirements were set for insurers operating in the European Community.

Although the third generation life assurance and non-life insurance directives laid the foundation for deepening integration of the insurance market, there are still several barriers that are slowing the progress of integration in insurance. Some of these barriers involve market functioning, as eg consumers' preference for domestic services, because of language or cultural differences. The information asymmetry is also an important reason why foreign insurance services are used so sparingly in the retail market. Comparing insurance service prices and coverage among different countries is difficult. Moreover, the tax treatment of insurance products is based on national practices, which vary considerably.

Integration in insurance is also hampered by a lack of harmonisation of consumer protection and contract legislation.

The Financial Services Action Plan (FSAP), adopted in 1999, also included recommendations for measures concerning the insurance sector.[56] Nearly all the measures proposed in the original FSAP have been adopted by the European Parliament and the Council. However, not all the measures have been implemented in national legislation.

Preparations for several of the insurance projects included in the FSAP had commenced already before the action plan was announced.

[56] European Commission (2004e). FSAP is discussed in detail in chapter 7 and annex 2/7.

From the perspective of the insurance sector, the most important directives included the Directive on the supplementary supervision and capital adequacy of credit institutions, insurance undertakings and investment firms in a financial conglomerate, which was adopted in 2002 (table 14). The Directive on the reorganisation and winding up of insurance undertakings was adopted in 2001. Another key directive is the Directive on the activities and supervision of institutions for occupational retirement provision. The Directive sets out the requirements for capital adequacy and investment activities of institutions providing occupational retirement. Other proposals for directives concerning the insurance sector included the Proposal for amending the Directive on insurance mediation. The insurance-related directives being prepared or waiting adoption include the Proposal for a Directive on reinsurance supervision, and the reform of solvency requirements of insurance directives (Solvency II). The ongoing reform of international accounting standards (IAS) will also have a considerable impact on insurers' activities in the coming years.

Table 14. **Key directives for the insurance sector**

Council Directive 64/225/EEC of 25 February 1964 on the abolition of restrictions on freedom of establishment and freedom to provide services in respect of reinsurance and retrocession.
First Non-Life Assurance Directive 73/239/EEC.
First Life Assurance Directive 79/267/EEC.
Second Non-Life Insurance Directive 88/357/EEC.
Second Life Assurance Directive 90/619/EEC.
Third Non-Life Insurance Directive 92/49/EEC.
Third Life Assurance Directive 92/96/EEC.
Directive 2001/17/EC of the European Parliament and of the Council of 19 March 2001 on the reorganisation and winding up of insurance undertakings.
Directive 2002/83/EC of the European Parliament and of the Council of 5 November 2002 concerning life assurance. The Directive repealed the First, Second and Third Life Assurance Directive.
Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate.
Directive 2002/92/EC of the European Parliament and of the Council on insurance mediation.
Directive 2003/41/EC of the European Parliament and of the Council on the activities and supervision of institutions for occupational retirement provision.

4.6 Summary

Indicators show that wholesale and capital market-related banking are highly integrated in the EU countries. In wholesale banking, integration occurred mainly with the introduction of the euro and immediately thereafter. Moreover, the introduction of the euro removed many of the barriers to integration of capital market-related banking. The prices of several capital market-related banking services have thus been reduced to the level of US prices, whereas prior to 1999 they were almost twice as high.

In retail banking, integration has progressed at a considerably slower pace than in wholesale and capital market-related banking. Lending and deposit rates and the prices of other banking services still show large differences across EU countries, and the volume of banks' cross-border business activities is relatively small, despite an increase in recent years. Nevertheless, various indicators show that interbank competition, both national and cross-border, seems to have tightened in recent years. It is thus evident that removal of barriers to cross-border banking has increased the threat of foreign competition and hence forced local banks to improve their efficiency. Banks have reacted to increased competition mainly by forming even larger national entities. The next stage of integration may see an increase in banks' cross-border M&As. Consumers, on the other hand, are still quite reluctant to acquire retail banking services directly from abroad, which will slow the growth of direct cross-border retail banking services.

In insurance, the progress of integration has been slower than in banking. Integration of life and pension insurance markets is still in its early stages. The premium income of life and pension insurers is based mainly on premium income from the home country, while cross-border provision of services is still very limited. The progress of integration has been faster in the non-life insurance market because eg companies purchase non-life insurance also in the international market. The most integrated insurance market is in reinsurance, which involves wholesale market operations between insurance companies.

References

Adam, K, Jappelli, T, Menichini, A, Padula, M and Pagano, M (2002) **Analyse, compare and apply alternative indicators and monitoring methodologies to measure the evolution of capital market integration in the European Union.** Centre for Studies in Economics and Finance (CSEF). Department of Economics and Statistics. University of Salerno.

Amel, D, Barnes, C, Panetta, F and Salleo, C (2003) **Consolidation and efficiency in the financial sector: A review of the international evidence.** Journal of Banking and Finance. Forthcoming.

Bank of Finland Bulletin (2003) **Financial stability.** Special issue. Bank of Finland. Helsinki.

Boot, A (2003) **Restructuring in the banking industry with implications for Europe.** EIB Papers, Vol. 8, No. 1.

Brealey, R and Myers, S (2003) **Principles of corporate finance.**

Broecker, T (1990) **Credit-worthiness tests and interbank competition.** Econometrica 58, 429–452.

Buch, C and DeLong, G (2003) **Cross-border bank mergers: What lures the rare animal?** Journal of Banking and Finance. Forthcoming.

Cabral, J, Dierick, F and Vesala, J (2002) **Banking integration in the euro area.** ECB Occasional Paper No. 6.

Cecchini, P (1988) **The European challenge in 1992: The benefits of a single market.** Aldershot.

De Avila, J (2003) **Finance and growth in the EU: new evidence from the liberalisation and harmonisation of the banking industry.** ECB Working Paper No. 266.

Dermine, J (2003) **Banking in Europe: Past, present and future.** In Gaspar et al (eds.) The transformation of the European financial sector (Second ECB Central Banking Conference).

ECB (2003a) **Money market study 2002.**

ECB (2003b) **Structural analysis of the EU banking sector.**

ECB (2004) **The implementation of monetary policy in the euro area.**

European Commission (1985) **The completion of the internal market.**

European Commission (2004a) **Financial Integration Monitor 2004.** Commission Staff Working Document. SEC (2004) 559.

European Commission (2004b) **Financial Integration Monitor 2004: Background Document.** Internal Market DG. Working paper.

European Commission (2004c) **Financial Integration Monitor 2004: Annex to the Background Document.** Internal Market DG. Working paper.

European Commission (2004d) **Financial Services Action Plan: Progress and Prospects.** Expert Group on Banking. Final Report. May.

European Commission (2004e) **Financial Services Action Plan: Progress and Prospects.** Expert Group on Insurance and Pensions. Final Report. May.

Fitch (2002) **Bancassurance overview.** July.

FitchRatings (2004) **M&A activity in the European banking sector: Is cross-border consolidation finally on the cards?** Special report. 15 March 2004.

Galati, G and Tsatsaronis, K (2003) **The impact of the euro on Europe's financial markets.** Financial Markets Institutions & Instruments, 12(3), 165–222.

Gaspar, V, Hartmann, P and Sleijpen, O (eds.) (2003) **The transformation of the European financial sector** (Second ECB Central Banking Conference).

Giannetti, M, Guiso, L, Jappelli, T, Padula, M and Pagano, M (2002) **Financial markets integration, corporate financing and economic growth.** Final report by the Centre for Economic Policy Research to the European Commission.

Gual, J (1999) **Deregulation, integration and market structure in European banking.** EIB Papers, Vol. 4, No. 2.

Gual, J (2004) **The integration of EU banking markets.** CEPR Discussion Paper No. 4212.

Hartmann, P, Maddaloni, A and Manganelli, S (2003) **The euro area financial system: Structure, integration, and policy initiatives.** Oxford Review of Economic policy, Vol. 19(1), 180–213.

Huizinga, H (2003) **Comments on the article by Dermine (2003).** In Gaspar et al (eds.) (2003) The transformation of the European financial sector (Second ECB Central Banking Conference).

Koskenkylä, H (2002) **Efficiency and competition in European Banking.** Irish Banking Review, Summer.

London Economics (2002) **Quantification of the macroeconomic impact of integration of EU financial markets.** Final report by London Economics in association with PriceWaterhouseCoopers and Oxford Economic Forecasting to the European Commission.

Manna, M (2004) **Developing statistical indicators of the integration of the euro area financial system.** ECB Working Paper No. 300.

OECD (2003) **Insurance Statistics Yearbook.**

Padoa-Schioppa, T (2004) **The evolving European financial landscape: integration and regulation.** Speech at the Colloquium organised by Groupe Caisse des Depots/KfW. Berlin 22 March 2004. http://www.ecb.int.

Rosengren, E (2003) **Comments on the article by Dermine (2003).** In Gaspar et al (eds.) (2003) The transformation of the European financial sector (Second ECB Central Banking Conference).

Salavirta, E (2002) **Money and capital markets.** In Heikki Koskenkylä (ed.) Finnish financial markets 2002. Bank of Finland Studies A:105. Helsinki.

Santos, J and Tsatsaronis, K (2003) **The cost of barriers to entry: evidence from the market for corporate euro underwriting.** BIS Working Papers No. 134.

Vander Vennet, R (2002) **Cost and profit efficiency of financial conglomerates and universal banks in Europe.** Journal of Money, Credit and Banking. 34, 254–282.

On-line references

http://europa.eu.int/comm/internal_market/en/finances/actionplan/docs/stocktaking/fasap-stocktaking-report-bank_en.pdf.

Chapter 5

Integration of exchange operations and clearing and settlement systems

Kirsi Ripatti

5 Integration of exchange operations and clearing and settlement systems 118
5.1 Introduction 118
5.2 Regulation, supervision and other authority- or market-driven measures 120
5.2.1 Measures of the European Commission and supporting activities 120
5.2.2 Other authority- and market-driven measures 126
5.3 Marketplaces and clearing and settlement centers – towards bigger entities 128
5.3.1 Integration of an area in the light of studies 128
5.3.2 Functional approach to consolidation 129
5.3.3 Consolidation in horizontal and vertical operating environments 131
5.4 Development prospects and challenges of integration 137
5.5 Conclusion 139

References 141

5 Integration of exchange operations and clearing and settlement systems

5.1 Introduction

Efficient and modern financial markets require well functioning marketplaces for securities. Once an agreement on a securities trade is made between two parties, either in an exchange or bilaterally eg in an unregulated market, a clearing process is initiated. The outcome of this process is that the trade is executed and the buyer receives all rights related to the object of the trade and the seller receives his money. The latter operation is known as settlement. Securities clearing and settlement arrangements are cornerstones of an entire modern financial system, and the efficiency and reliability of the financial markets depends on them.

This chapter looks at integration from the viewpoint of the production structure of securities markets' infrastructure services. Integration, ie removal of barriers between cross-border operations, takes place in two main ways: corporate restructuring, ie M&A activities among service providers, and increases in the compatibility of systems used by service providers. The integration of marketplaces has taken place to a large extent via market-driven restructuring (consolidation), and significant benefits have also been achieved without ownership changes through common use of trading systems or their technical harmonisation. Ownership arrangements usually lead to common systems. However, the operating environment remains highly fragmented – there are almost 20 stock exchanges with different rules and technical systems in the EU area. As regards clearing and settlement systems, progress has, until very recently, taken the form of systems harmonisation. This is important for the development of a common market since the benefits of efficient securities markets cannot be enjoyed without reliable clearing and settlement systems and agents responsible for these systems.

Cross-border trades can be cleared through three channels. The broker used by an investor may itself function as a remote member (direct access) in a foreign securities settlement system. Or the broker may make use of a specialised bank (custodian) or a central securities depositary (CSD) with access to the foreign securities settlement system. Especially in the past, it has been common to use the services offered by a local participant or foreign CSD. Hence the linkages have been mostly indirect.

Following adoption of the euro, interest in EU-wide financial activities has increased. The inefficiency and high cost of cross-border operations are particularly emphasised in the fragmented field of securities clearing and settlement, which is largely based on national practices. Improvement of the efficiency of cross-border operations is in fact considered one of the main challenges for the creation of an internal market for financial services.

The fragmentation of privately owned European marketplaces is not so much a result of barriers imposed by authorities as the high costs of cross-border trades, due to inefficiencies in post-trade clearing and settlement. Although these arrangements in Europe are relatively cost-effective and secure for national needs, cross-border arrangements are complex and fragmented, which significantly boosts costs, risks and inefficiency. In practice, there have been many intermediaries, and national arrangements with limited monopoly-like positions. Inefficient clearing and settlement arrangements undermine market participants' ability and desire to engage in securities trading in the EU, reduce the liquidity of financial markets, and unnecessarily increase the cost of capital.

According to the Giovannini reports[1] published in 2001 and 2003, the post-trade situation can be significantly improved through market-driven integration of national systems. However, the existence of profit-seeking local companies and monopolies poses a significant obstacle.

In contrast, gradual progress has been made on another front. As a result of the Lamfalussy report[2], the efficiency of the legislative process has improved and the Committee of European Securities Regulators (CESR) has been assigned an important role. In addition to its consultative role in drafting legislation, the committee has been empowered to issue guidelines and common standards supporting national regulation and to promote cooperation. This may be a step towards a level playing field in Europe.[3]

Since the introduction of the euro, market infrastructure solutions in the EU have been concentrated in a few companies serving as operators of marketplaces and clearing and settlement systems, and often also as information system providers. The major companies are

[1] Giovannini (2001) and (2003).
[2] Lamfalussy Report (2001) For more information, see chapter 7 of this book.
[3] See chapter 7 of this book.

the Euronext Group[4] and Deutsche Börse[5]. The OMHEX Group operating in the Nordic and Baltic countries (more detail in sec. 5.3.3) has also gained a prominent position due to its outstanding technological expertise. These companies' European competitors are mostly national players. The wholesale market for trade settlement and safekeeping functions is dominated by international central securities depositaries (ICSDs), while national CSDs indirectly cater to the needs of small investors.

The deepening of the internal market requires harmonisation of trading, clearing and settlement systems as well as their regulatory framework. The need for cost-effective solutions will lead to consolidation of both markets and clearing and settlement systems. This chapter looks at the regulatory framework, supervisory issues, and both market- and authority-driven initiatives, and delves deeper into consolidation in both horizontal and vertical operating environments, and from the viewpoint of the functional approach. Finally, an attempt is made to sketch future development prospects.

5.2 Regulation, supervision and other authority- or market-driven measures

5.2.1 European Commission measures and supporting activities

Recent studies show that integration of financial markets could boost economic growth by about 1.0 percentage point within the next ten years and the employment rate by 0.5 percentage point. Furthermore, significant cost savings could be achieved by improving the efficiency of cross-border clearing and settlement.[6]

The first steps in liberalisation of securities trade in line with internal market principles were taken on 1 January 1996, when two directives issued in 1993 entered into force. The Financial Services Directive (COM/93/22/EC) gives an authorised investment firm the right to operate in all member states once it is granted authorisation in its home member state. Such an EU-wide authorisation is referred to

[4] Euronext Group operates in Belgium, France, Netherlands, Portugal and United Kingdom.
[5] The Deutsche Börse Group operates in Austria, Luxemburg and Germany.
[6] LE (2002).

as a European passport. The Capital Adequacy Directive (COM 93/6/EC), which establishes minimum initial capital for establishment of an investment firm, lays down the conditions for issuing European passports.

A lack of legislation on securities clearing and settlement systems in EU and the fact that some institutions providing clearing and settlement services have the authorisation of a bank or investment firm cause problems concerning the right to provide services. There are also differences in capital adequacy requirements of providers of clearing and settlement services.

Significant structural changes in European financial markets, such as increased interest in cross-border provision of financial services particularly after the introduction of the euro, have brought a need to amend legislation on financial services. The European Commission, in its Financial Services Action Plan (FSAP)[7] of 1999, set out objectives for the achievement of the internal market. Of these objectives, the following, at least indirectly, concern clearing and settlement systems:

– common wholesale financial markets, with the aim of raising capital on an EU-wide basis
– establishment of a common legal framework for integrated securities and derivatives markets
– containment of systemic risk in securities clearing and settlement
– secure and transparent environment for cross-border restructuring
– a single market that works for investors.

Problems connected with legal matters can be considered significant barriers to integration. Such matters include differences in the application of national rules on conflict of laws, national differences in the legal treatment of bilateral netting, and the lack of an EU-wide framework for dealing with securities-related rights. All of these serve to increase the cost and uncertainty of cross-border clearing and settlement.

Current EU legislation already addresses some of these issues. Differences in the treatment of netting and conflict of laws have been provided for in the Settlement Finality Directive (COM 98/26/EC) and the Collateral Directive (COM 2002/47/EC). These directives include special provisions on the application of insolvency laws to securities clearing and settlement systems and financial collateral arrangements, the aim being to improve the security of the systems and financial

[7] COM (1999) 232.

collateral arrangements. Both directives have been implemented in Finnish legislation.

Other directives adopted in the final stages of the ongoing FSAP process include the Market Abuse Directive (COM 2003/6/EC), which entered into force in April 2003. It broadens the supervision and investigation rights of national supervision authorities and is expected to prevent market irregularities and to improve the effectiveness of recognising and investigating incidents of market abuse. The Prospectus Directive (COM 2003/71/EC) entered into force in December 2003. Its aim is to harmonise requirements concerning prospectuses on offering and listing securities and to facilitate the offering of securities across borders in the EU area. The directive makes it easier to raise capital from the entire EU area and reduces costs for issuers and providers of securities.

One of the main initiatives included in the FSAP was a revision of the Financial Service Directive in accordance with the Lamfalussy process, in the form of a new framework directive (Directive on Financial Instruments Markets, FIM), which was adopted by the Council of the European Union at the end of April 2004. The new directive (COM 2004/39/EC) enters into force in the member states two years after its publication. The renewal of the Financial Instruments Markets Directive aims to increase the openness of vertical cooperation arrangements (silos) by offering market participants the opportunity to choose which regulated market in the Community to use for clearing and settlement. The directive also addresses consumer protection issues by including investment advice in the scope of regulation and supervision, thus making it a service subject to authorisation. Another extension is the inclusion of commodity derivatives in the scope of application of the directive. The directive clarifies supervision responsibilities in cross-border service provision. If a service is offered directly across a border, the supervision responsibility of the home country is extended. As regards local branches, supervision in the host country is strengthened since the local authority is closer to the branch and can therefore better detect potential neglect of operating rules and take appropriate steps.

Table 1. **European Commission's main measures concerning exchange operations and clearing and settlement activities**

Title and number of the measure
Council Directive (89/298/EEC) of 17 June 1989 coordinating the requirements for the drawing-up, scrutiny and distribution of the prospectus to be published when transferable securities are offered to the public.
Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field.
Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investments firms and credit institutions.
Directive (98/26/EC) of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems.
Directive 2001/34/EC of the European Parliament and of the Council of 28 May 2001 on the admission of securities to official stock exchange listing and on information to be published on those securities. This Directive (so-called Prospectus Directive) combined the following Directives: (79/279/EEC), (80/390/EEC) and (82/121/EEC).
Directive of the European Parliament and of the Council on financial collateral arrangements (2002/47/EC) 6 June 2002.
Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse).
Directive 2003/71/EC of the European Parliament and of the Council of 1 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC.
Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments (so-called Investment Service Directive II).
Proposal for a Directive of the European Parliament and the Council on the harmonisation of transparency requirements with regard to information about issuers whose securities are admitted to trading on a regulated market (8765/04).
Communication from the Commission to the Council and the European Parliament: Clearing and settlement in the European Union – Main policy issues and future challenges COM (2002) 257, 28 May 2002.
Communication from the Commission to the Council and the European Parliament: Clearing and Settlement in the European Union – The way forward COM (2004) 312, 28 April 2004.

The aforementioned Giovannini Reports have been particularly important for the progress of integration since they have created a bridge between complex technical issues and political goals. They have clearly raised pressure to abolish unnecessary barriers and have alerted producers of infrastructure services and authorities to the fact that the prevailing inefficiency may carry severe consequences for the EU economy. The first report of the Giovannini group, which consists

of market participants and assists the Commission, lists 15 barriers to development and efficient functioning of cross-border securities clearing and settlement. The second report presents means for removing these barriers and improving the efficiency of European post-trade infrastructure.

The Commission will take the conclusions and recommendations of the Giovannini Reports into consideration in its communications on securities clearing. On 28 May 2002 the Commission published its first communication on clearing[8], according to which the achievement of an integrated EU clearing environment requires that the following two main objectives be met.

1. Such barriers to the finalisation of individual cross-border transactions should be removed that result from national differences in:

   – technical requirements
   – market practice
   – tax procedures and
   – laws applying to securities.

2. Distortions and limitations hindering post-trade operations in the EU should be removed in order to ensure a level playing field for entities performing similar clearing and settlement. In other words, the following must be guaranteed:

   – equal competitive environment for entities engaging in clearing and settlement,
   – access to clearing and settlement systems and freedom of choice and
   – the development of a common regulative view.

The purpose of these measures is to enable conditions where clearing and settlement systems can be renewed on the basis of market needs without endangering the stability of the financial system.

Although the first settlement communication already implied that the Commission may intervene in securities clearing and settlement by means of directive-level regulations, it was not until the end of April 2004 that the Commission published its second communication on

---

[8] Communication from the Commission to the Council and the European Parliament: Clearing and settlement in the European Union – Main policy issues and future challenges COM (2002) 257.

clearing[9], which furthers this objective. The second communication thoroughly analyses barriers as well as removal measures listed in the reports of the Giovannini group. The communication presents an action plan and initiatives considered necessary for ensuring integrated, safe and efficient clearing and settlement processes and for creating a level playing field for providers of different services. The second communication presents the following four practical initiatives:

1. Establishment of an advisory and monitoring group with the aim of tackling the barriers listed in the Giovannini report
2. Drafting a proposal for a framework directive on clearing and settlement
3. Highlighting legal problems and tax issues by setting up an expert group to consider the legal and tax-related barriers to integration
4. Ensuring effective implementation of competition law in national legislation, in cooperation with national competition authorities.

Removal of technical or market-practice barriers, driven primarily by the private sector, is a necessary, but not the only, prerequisite for achieving an integrated and competitive market for post-trade operations in the EU. The Commission feels that in order to achieve this aim a framework directive needs to be adopted, which provides for the granting of comprehensive rights of access for the providers of clearing and settlement services, the creation of a common clearing and settlement system and the establishment of appropriate and open governance arrangements. Once all required measures have been adopted, consolidation among Securities settlement systems and Central counterparties (CCP)[10] is expected to accelerate. The Commission agrees with the conclusions of both the Lamfalussy and Giovannini Reports that the process of consolidation needs to be primarily market-driven. As long as the appropriate regulatory, supervisory and competition policy safeguards are established, the Commission should be neutral as regards such structural issues as the degree and form of consolidation (either horizontal or vertical), and

---

[9] Communication from the Commission (COM/2004/312) to the Council and the European Parliament: Clearing and Settlement in the European Union – The way forward COM (2004) 312; public consultation ended 30 July 2004.

[10] The role of central counterparty in the settlement process is as intermediary for the parties of a trade, in order to guarantee trade execution. It acts as the seller to the original buyer and as the buyer to the seller (novation). Hence the original parties to the trade no longer have a contractual relationship with each other but only with the central counterparty.

the opportunity for Securities settlement systems and Central counterparties to offer Intermediary and/or Banking services.

5.2.2 Other authority- and market-driven measures

In addition to the reports by the Giovannini group and communications of the European Commission, there have been other projects, both authority- and market-driven, addressing the enhancement of credibility and efficiency of securities markets – particularly from the viewpoint of post-trade processing. The Committee on Payment and Settlement Systems (CPSS) of the G10 countries and the International Organisation of Securities Commissions (IOSCO) published their recommendations on securities settlement systems in 2001.[11] On this basis, the ESCB and the European Securities Market Supervisors are working on more stringent European standards for clearing and settlement systems.[12] In spring 2004, CPSS and IOSCO also published recommendations on risk management for central counterparties[13]. These recommendations are of a general nature, and an appropriate European version will probably be forthcoming. The G30 group acting as a cooperation organ of financial institutions published a report in 2003 on the global clearing and settlement of securities[14] with the aim of promoting particularly the emergence of global technical and functional standards. The primary point of departure in these initiatives has been the needs and objectives of large countries.

Other market-driven projects include initiatives by EACH (European Association of Central Counterparty Clearing Houses), ISSA (International Securities Services Association) and ECSDA (European Central Securities Depositories Association). These groups act as cooperation forums for their members and have published many standards and recommendations for their member groups.

Self-regulation is at least as important as traditional regulation by authorities in creating common operating and market practices, both internally and between communities. What often proves troublesome is the implementation of market-driven projects – the achievement of a common view among market participants. Although the ECB and

---

[11] CPSS-IOSCO (2001).
[12] The work of the ESCB-CESR has continued since 2001.
[13] Consultative Report on Recommendations for Central Counterparties; public consultation ended 9 June 2004.
[14] G30 (2003).

European Commission have commonly expressed the principle that development should be market-driven, with authorities acting only as catalyst and working to remove barriers to development, it has become clear that this has not been sufficient. Authorities have often had to intervene to a greater extent in markets developments via regulative measures. The broadening of the Lamfalussy process enables more integrated technical rules. It is hoped this will contribute to the emergence of a common set of rules between market participants which can be revised quickly when necessary.

Another supervisory issue is general oversight of securities clearing and settlement based on national legislation of euro area countries. As a user of securities settlement systems, the ECB has set minimum standards for these systems and the links between them,[15] which are applied in the execution of monetary policy as well as in delivery and custody of collateral for central banks.[16] These standards were drafted to reduce risks to the Eurosystem associated with its monetary policy operations. At the moment there are 66 approved links. Compliance with the standards is monitored regularly by the ESCB. For example, the systems used are assessed annually and the links when necessary by PSSC (Payment and Settlement Systems Committee) and its sub-working group SWG (Securities Working Group). The ESCB also engages in dialogue with market participants, eg within the scope of the COGESI group (Contact Group on Euro Securities Infrastructure). The Bank of Finland participates actively the work of the ESCB, in both the committees and working groups.

Domestically, the Bank of Finland oversees and monitors particularly the activities and systems of the central securities depositary, as part of its general oversight and user activities, eg by arranging regular oversight meetings and examining reports. Furthermore, it actively monitors structural developments in the sector as a whole and engages in close cooperation eg with the Financial Supervision Authority and Ministry of Finance, as well as meeting occasionally market participants and representatives of their interest groups.[17]

---

[15] Once securities have been transferred via these links from one securities settlement system to another, they can be used in the same way as domestic collateral.

[16] EMI (1998). The standards are currently being revised.

[17] For more information on general oversight, see Bank of Finland A:105, (2002).

5.3 Marketplaces and clearing and settlement centers – towards bigger entities

The trend in the market towards larger, more efficient entities in exchange activities and clearing and settlement systems has occurred mainly through horizontal or vertical integration or a combination. The second Giovannini Report approaches integration developments by considering the degree of consolidation of clearing and settlement from the viewpoint of cost-effectiveness, competition and systemic risk.

5.3.1 Integration of an area in the light of studies

Centralisation of marketplaces has roots in the consolidation of stock markets, which is hardly just an EU phenomenon but rather part of a global effort to integrate markets. It has been postulated that the consolidation movement would lead to a global common market for the more liquid instruments while the less liquid instruments would be left for domestic trade.[18] It is felt that consolidation of securities exchanges generates benefits in the form of economies of scale in trading and other activities.[19] By adopting common or shared trading platforms, cross-country costs can be reduced by attracting new investors to the market and boosting trading volumes. In turn, these benefits help improve liquidity, which decreases price fluctuations (volatility). In a recent study, Von Thadden and Ramos (2003) found that market integration results in lower transaction costs and leads to increased trading activity in the long run.[20] On the other hand, Hasan and Schmiedel, using a theory on the impact of networking, studied whether the networking of European exchanges generates more added value in the production of trading services. Based on their results, those exchanges that have adopted a networking strategy are significantly more liquid, efficient, and faster growing. In addition, networking helps reduces exchanges' trading and operating costs.[21]

National borders and special features are prominent in securities clearing and settlement. This clearly increases costs of cross-border operations. It has indeed been shown that the costs of cross-border

---

[18] Gaa et al (2001).
[19] Pagano (1989) and Steil (2001).
[20] Von Thadden and Ramos (2003).
[21] Hasan and Schmiedel (2003).

clearing in Europe are significantly higher than for domestic clearing. Cross-border clearing in Europe is still as expensive as eg clearing between Europe and the US.[22] Although there are uncertainties related to these studies, many other studies have arrived at similar conclusions. Schmiedel et al, in their study, found that there are significant economies of scale in securities register and clearing systems.[23] The extent of the scale economies, however, varies according to size and location of clearing centre. The largest untapped economies of scale are found in small clearing centres since the largest clearing centres have improved their cost-effectiveness the most.

5.3.2 Functional approach to consolidation

Recently it has become more and more common to assess structural issues of clearing and settlement using the 'functional approach'.[24] The functional approach aims to avoid problems resulting from different institutional settings in different countries by focusing the review on institutions participating in the production of a given activity in each country. The Giovannini group's report[25] approaches structural issues in terms of three functional models (fig. 1):

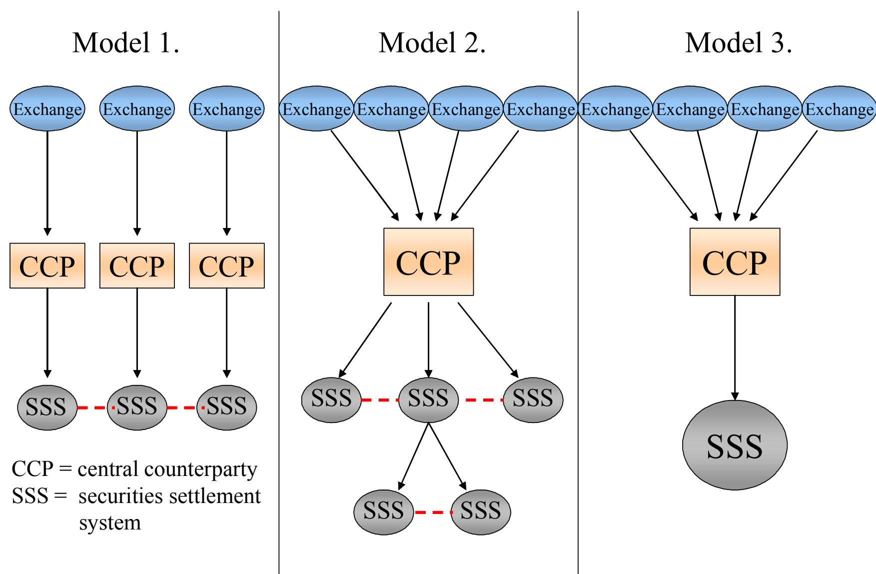
– limited consolidation – several central counterparties and securities settlement systems in the market; a kind of 'status quo' (model 1)
– full consolidation of clearing, but limited consolidation of settlement – one central counterparty and a limited number of securities settlement systems (model 2);
– full consolidation – one central counterparty and one securities settlement system (model 3).

Each model is assessed from the viewpoint of cost-effectiveness, competition and systemic risk. The report concludes that each model has its advantages and disadvantages. The models should be assessed only as examples of different infrastructure options since the interests

[22] Financial Integration Monitor (2004).
[23] Schmiedel, Malkamäki and Tarkka (2002).
[24] The functional approach was presented in the CPSS-IOSCO report (2001).
[25] The Giovannini Group (2003).

of market participants differ significantly from each other and do not as such fit directly into any single framework.[26]

Figure 1. **Models of consolidation**



Sources: Giovannini Group and Bank of Finland.

In the context of limited consolidation ('status quo') there are many central counterparties and securities settlement systems in the market. With the costs of clearing and settlement rising significantly due to increasing numbers of market participants, the model will clearly be less cost-effective than full consolidation. But in terms of competition, the model of limited consolidation is quite efficient. Decentralisation offers protection from systemic risk but on the other hand requires comprehensive cooperation between national authorities. Limited consolidation enables local market participants to obtain basic infrastructure services via services that best meet their needs. Links between marketplaces would be one such service. The achievement of sufficient efficiency and risk-management benefits would, however, require eg harmonisation of operative models and real-time delivery versus payment in central bank money.

[26] The models are based on the assumption the users and providers of clearing and settlement systems already function in an integrated (barrier-free) environment.

However, if the consolidation process results in full consolidation of clearing but only partial consolidation of settlement, there will be only one central counterparty but several settlement systems. With just one central counterparty in the market, significant cost savings could accrue particularly to large market participants, due to lower back office costs and increased netting opportunities, while the benefits for smaller agents might be fairly limited, particularly if they had to resort to services provided by direct members of the central counterparty system. Barriers to market entry and new innovations might also become significant. Moreover, potential systemic risk increases once the central counterparty becomes a focal point of risk, which then increases the importance of risk management.

In the case of full consolidation there is only one central counterparty and one securities settlement system in the market. From the viewpoint of cost-effectiveness, full consolidation is an efficient solution. However, efficient operations require technical and legal standardisation, which is hard to achieve. For example, the US derivatives markets have not even moved close to the one-CCP model, although the market is considered quite efficient by international standards. Furthermore, a lack of competition may bring about negative effects eg in pricing and further development of operations. A highly concentrated market structure may also become a significant source of systemic risk. Comprehensive consolidation of infrastructure could also increase pressure for participants to consolidate and for the market to become a playing field for large agents. A shortcoming of the Giovannini report is that it neglects requirements posed by full consolidation on oversight by authorities. The natural consequences of development also include pressure to centralise oversight and supervision.

5.3.3 Consolidation in horizontal and vertical operating environments

Unlike exchange trading, which occurs in a marketplace that handles the whole trading operation, clearing and settlement may be combined in a single central securities depositary or split so that clearing is handled by a clearing house and settlement by a CSD. Before 2000, each EU country had its own national infrastructure, which comprised a separate entity with its own operating policies, technical solutions and ownership arrangements. London, Frankfurt and Paris have traditionally been the major financial centres in Europe. Cross-border

cooperation has been mainly carried out through custodian banks, Cedel and Euroclear being two of the larger ones.

Integration took off through the linking of CDSs – later complemented by some significant ownership arrangements. Competition between marketplaces has been fierce from time to time and there have even been many attempts at hostile takeover. Market-driven integration can be considered to have truly commenced in autumn 2000, when the stock exchanges of Amsterdam, Brussels and Paris consolidated horizontally to form the Euronext stock exchange. At the same time, the CSDs operating in association with these exchanges merged to form the Euroclear Group while the CCPs formed the Clearnet Group. Another significant consolidation step was the merger between Euroclear and the UK CSD Crest in July 2002. Subsequently, also the Portuguese stock exchange joined the Euronext Group, which bought the London-based LIFFE derivatives exchange in February 2002. A significant consolidation step between CCPs was the merger of London Clearing House (LCH) and Clearnet announced in late 2003.

Another significant consolidation project in Europe was the formation of the Deustche Börse Group via vertical consolidation. The group handle the whole array of operations. After acquiring in 2002 the Clearstream Group, which operates the CSDs of Germany and Luxembourg, Deutsche Börse now also manages (with Eurex Clearing) clearing operations for Luxembourg, Germany and Austria.

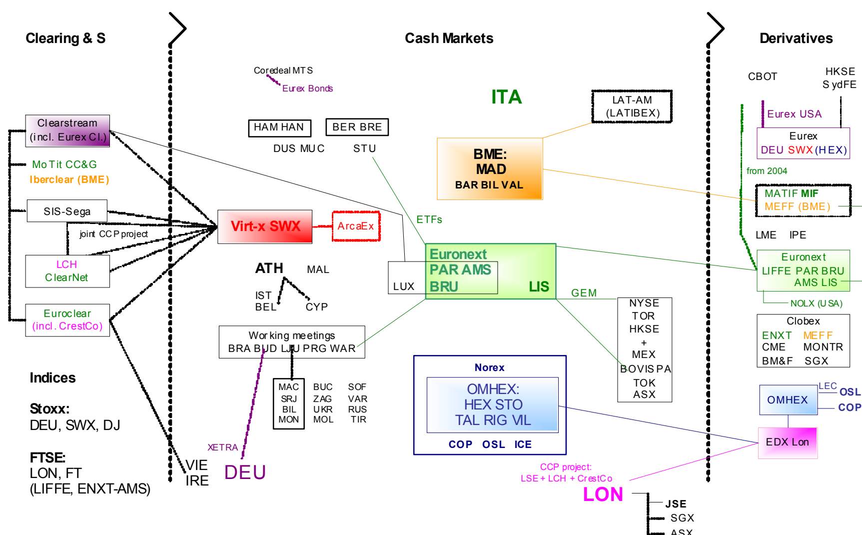
Deutsche Börse and Euronext are presently considered the major marketplaces in Europe. The third major marketplace in Europe (though outside of the euro area) is the London Stock Exchange (LSE). Clearing and settlement functions have been concentrated around LSE via horizontal consolidation, with clearing handled by LCH.Clearnet and settlement by Euroclear (after combining with Crest). These developments left the other, small and middle-sized, marketplaces in an uncertain position, with structural choices to make.[27] Under these circumstances, the interlinking of systems has not resulted in the benefits desired, for technical and operative reasons. Some of these countries have instead focused on increasing domestic cooperation – eg through the merger of Spanish CSDs into Iberclear – or by broadening service ranges, as indicated by increased use of CCP

[27] For a description of market capitalisation of the major European stock exchanges, see chapter 3 of this book: Integration of Securities Markets.

clearing in stock trades.[28] For this reason integration of infrastructures at EU level has not proceeded on all fronts.

The European scene is changing constantly and, the infrastructure integration that has occurred is not easy to describe (fig. 2). Consolidation is mainly market-driven and can be classified according to cash markets (equity shares, bonds), derivatives markets, and clearing and settlement. As examples of consolidation based on ownership arrangements and system integration, we can mention LCH.Clearnet and Euroclear, and for clearing and settlement Clearstream. Euronext Group is a corresponding example for the cash markets. Focusing on support services, the division could be made eg in accord with index calculations (Stoxx, FTSE), technology (Norex), and looser cooperation arrangements (development). In this operating environment, the merger of Swedish OM and Finnish HEX, which entered into force on 4 September 2003, was a significant step.

Figure 2. **European operating environment, 7 April 2004**



Source: Federation of European Securities Exchanges (FESE).

[28] Actual clearing functions are carried out increasingly by clearing houses acting as CCPs (central counterparty clearing). Previously CCP clearing was used primarily in the derivatives market, but more recently the major European marketplaces in France, Belgium, Netherlands, Portugal (Euronext), UK (LSE) and Italy (Borsa Italia) have shifted to CCP clearing for shares quoted on main lists.

Following the merger, the former HEX became part of the quoted Swedish OMHEX Group. The group's shares are traded publicly on both the Helsinki and Stockholm stock exchanges. Business operations are divided in the following two closely related business units (divisions):

– OM Technology, which provides support services for transaction technology and for the industry around the world in the financial and energy markets.
– HEX Integrated Markets (HEXIM), which originally included the stock exchanges of Stockholm, Helsinki, Estonia, Latvia and Lithuania and CSDs of Finland, Estonia, Latvia and Lithuania.[29] Execution of a letter of intent between OMHEX and VPC on sale of Finnish CSD to Swedish CSD (VPC) changed the structure significantly.

The domicile of HEXIM, which is important for market operations, is Helsinki.[30]

The vertically integrated model of Finland and the Baltic countries had not been used in Sweden, and vertical integration broke down also in Finland when OMHEX announced in its exchange report on 22 April 2004 it had issued a letter of intent with the VPC (owned by Swedish banks) on founding a CSD for the Nordic countries (Nordic Central Securities Depository, NCSD). Its operations will be based on the EXIGO register, clearing and settlement system, which will be adopted – although not concurrently – by the CSDs of Finland, Sweden and the Baltic countries. However, the latter will remain in HEXIM ownership. Also the Finnish CSD will continue as a separate Finnish legal entity, a subsidiary of VPC. According to OMHEX, the creation of a Nordic – initially Finnish-Swedish – central Securities Depositary will facilitate harmonisation of rules and clearing processes and promote the development of a common technological platform. After the merger, Föreningssparbanken, Nordea, SEB, Svenska Handelsbanken and OMHEX each own about 19.8% of NCSD, but access to the project has also been reserved to a small number of Finnish owners.

[29] In 2001 HEX acquired 62% ownership in the Tallinn stock exchange, the other owners being local market participants. In summer 2003 NEX acquired 93% ownership in the Riga stock exchange, which at the same time became owner of the local CSD. In May 2004 it finalised negotiations for acquiring over 80% of the Lithuanian stock exchange (NSEL) and about 32% of the national CSD (CSDL).
[30] OMHEX (2004).

The main objective of the OMHEX merger is to create fully integrated securities markets in the Nordic countries and the Baltic region. Combined, the group operates Europe's largest marketplace in the technology sector. Market capitalisation (in early 2004) amounted to about EUR 420 billion, and daily volume averaged EUR 3 billion. There are about 70,000 trades made on a daily basis. One significant structural change since the turn of the millennium is the significant growth in remote brokers' share in the Helsinki stock exchange – from 10% to 50–60% of total trading volume – and the number of remote brokers increased to over 50. In Stockholm, the number and importance of remote brokers in much smaller.

For the longer term, OMHEX aims to create a single securities exchange for the Nordic and Baltic countries. At present, trading is being promoted eg by the NOREX Alliance, which also includes the stock exchanges of Copenhagen, Oslo and Reykjavik. In autumn 2004, there will be a common trading system operating in all Nordic and Baltic securities exchanges except Lithuania's.

The derivatives trading system of the Helsinki Stock Exchange was replaced in June 2004 by the derivatives trading and settlement systems of OM Technology, which are already used in other Nordic exchanges. This marked the beginning of a transitional phase, in which derivatives trading and settlement will move from Helsinki to the Stockholm exchange by the end of 2004. Trading in the most actively traded derivatives will continue to be carried out in the Eurex trading system.[31]

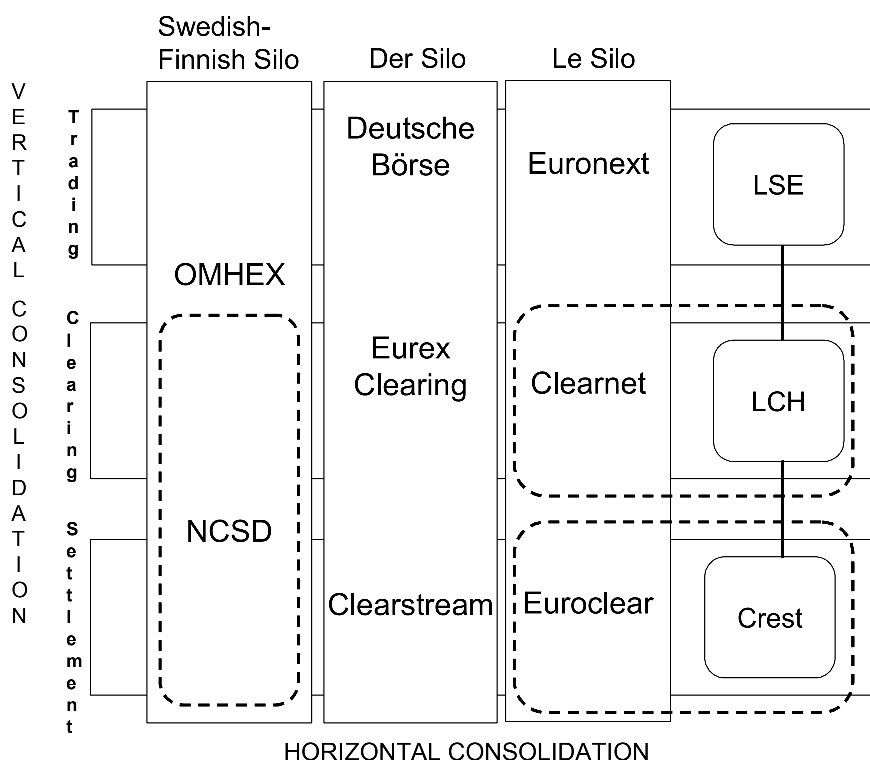
The cooperation in derivatives settlement between the Stockholm, Copenhagen and Oslo Stock Exchanges has contributed to an increase in the liquidity of derivatives trading. In the scope of this cooperation, all three exchanges now offer Swedish, Danish and Norwegian stock derivatives with local clearing. In spring 2003 trading began in a new derivatives exchange, EDX London, owned by OMHEX and the London Stock Exchange. By means of a joint clearing arrangement, London-based market participants are offered Nordic stock derivatives and local clearing. In early 2004 a clearing link was also opened between the Stockholm Stock Exchange and LCH.Clearnet. In order to improve the competitiveness of markets, plans have also been made to adopt a central counterparty service for equity instruments.

The emergence of such multi-faceted amalgamations (fig. 3) serves to muddy the waters between horizontal and vertical

[31] There are 13 Finnish derivatives products traded on Eurex. Nokia is one of the most actively traded stock options on Eurex.

consolidation in Europe. The possibility to automatise processes linking different functions is considered a benefit of vertical integration, while horizontal integration is considered to provide greater openness and to increase freedom of choice. Classification into horizontal and vertical consolidation is just another way to reflect on the organisational changes that have taken place. There are different organisational models which can be used as base for study, such as type of company, which indicates a shift towards limited company and exchange quoting.

Figure 3. **Horizontal/vertical consolidation**



Sources: HEX and Bank of Finland.

None of the models presented above could work alone as the culmination of structural development in the current constantly changing structural environment. At present, European markets are often geographically limited but cover all main types of instruments/sectors. For example, Eurex Clearing, LCH. Clearnet and Cassa di Compensazione e Garanzia (CCG) in Italy all provide CCP

clearing for derivatives, debt and equity instruments. On the other hand, it has been suggested that a consolidated system may also be decentralised, and that as markets progress towards intraday (T+0) clearing and settlement, a CCP will not be necessary.[32] Hence, the models presented really provide an evaluation framework for reviewing the potential impact of consolidation rather than an actual solution for the challenges posed by structural development.

5.4 Development prospects and challenges of integration

The Commission's goal has been to have a market-driven integration process, but its actions in the payment systems sector indicate that the Commission really expects that progress will be forthcoming; otherwise integration is apt to be promoted with the actions of authorities. The Commission has been particularly interested in improving the efficiency of cross-border clearing and settlement, and now it seems that the Commission is about to launch preparations for a framework directive on securities clearing and settlement.

Intervention by the Commission in securities clearing and settlement by means of directive-level regulation can be considered one of the first steps in the post-FSAP era. Increased use of framework directives following the Lamfalussy process is aimed at improving the efficiency of the legislative process at the Community level. However, since the adoption of common principles is difficult, there is a danger that framework directives will expand into detailed legislative packages and that their original role as light, harmonised legislation will be forgot. Framework directives and standards supporting them could be – if they work well – a step towards appropriate, practical regulation.

Reform of the Investment Services Directive in accordance with the Lamfalussy process enabling the selection of clearing location independent of any stock exchange serves to increase competition between clearing houses, CSDs and investment firms. The increase in competition and global nature of the operating environment are reflected also in the increase of international competition between derivatives markets seeking efficiency benefits. The operations and related clearing activities of the world's largest derivatives exchange,

[32] Leinonen (2003).

Eurex, operated by European marketplaces, expanded successfully into the US markets earlier this year. Interest in the Chinese markets has increased among European market participants and both the London Stock Exchange and OMHEX have entered into important agreements in China. On the other hand, national taxation and other legal practices hinder the emergence of a level field of competition.

The governance of systems poses a significant challenge for integration. Although eg the Giovannini group addressed consolidation, ie ownership of the infrastructure, it has not taken a strong stance on issues concerning governance of infrastructure. The governance of companies providing infrastructure services is subject to requirements and objectives that differ from obtaining for a typical company as regards the availability of information eg on development plans, risk management, and terms for customer relationships. As systems diversity increases and systems integration progresses, the governance of systems and definition of control issues may meet with completely new challenges, and there is a risk that when regulation increases, failures in governance will also lead to failures in regulation.

The reports, standards and recommendations issued by many authorities and market participants may be limited by their viewpoint, which can be characterised as Continental European or global and catering to the needs of large countries. There have not been many representatives from the Nordic countries in these working groups, which is why the special Nordic characteristics and viewpoints of smaller countries have not been clearly expressed. Similarly, questions resulting from the enlargement of the EU have often been left out of the review. The analysis of reports published so far has been too limited, and the impact of small countries should be strengthened.

The aspiration for pursuing the functional approach presented in the reports by the CPSS, IOSCO and Giovannini can indeed be seen as necessary in order to enable integration of securities clearing and settlement systems to move forward free of difficulties due to differences among national institutional structures. Simply put, the functional approach means that the same principles are applied to institutions carrying out the same activities (same activity – same risks). In practice, however, application has proven difficult.

When the Commission published its Financial Services Action Plan in 1999, its objectives were set for year 2005 and, as regards securities and venture capital markets, for 2003. Although many initiatives included in the Action Plan have been successfully completed, it is clear that this does not add up to completion of the integration of financial markets. This is clearly shown by the

infrastructural integration of marketplaces and securities clearing and settlement. Timetables for removal of existing barriers set out in the report of the Giovannini group assisting the Commission are also highly ambitious – all barriers are to be removed within three years of publication of the report – ie by 2006. This may prove difficult because the starting points are very different in the different countries and tax and legal issues are particularly problematic.

It may also be considered a problem that the level of technological development differs across countries. Achieving the objectives of integration may prove difficult if systems are still based on batch processing instead of real-time. It has also been suggested that it is not always necessary to focus on ownership arrangements, and that the same objectives can be achieved eg through common technology and standards and systems integration (eg the NOREX alliance with its common trading systems). However, changing the systems is slow and expensive, which can be seen as one explanation for the slow pace of integration. From the viewpoint of the authorities, it is also crucial that the systems be changed without risking stability.

The Giovannini Report is however based on the principle that market participants should be committed to the objectives presented in the report and should delegate the responsibility for implementation to many parties.

5.5 Conclusion

Although the integration of financial markets has increased, there is still a significant lack of efficiency, particularly in the EU post-trade service infrastructure. The integration of marketplaces has been market-driven. Progress has been made, although there have been both successes and failures, such as hostile takeover attempts. Studies have shown that a common market infrastructure and standardised financial instruments are significant contributors to fruitful integration.

Although the integration of marketplaces and clearing and settlement systems has taken many steps forward in recent years, the development has been neither easy nor rapid. Both market- and authority-led initiatives have had their problems. Therefore there is a risk that EU enlargement means – at least at first – a backward step in the integration of financial markets. Enlargement of the EU by ten new member states creates a group of very different infrastructure solutions to the field, which is already fragmented.

So far, the EU has focused on harmonising regulation and supervision in the EU area and on creating the single market. The next step is to promote global integration, which means global financial markets and supervision and regulation practices that are more harmonised on a global scale. Even in a global operating environment, one must not forget the self-regulative role of the markets as creator of rules nor the position of the investor. Investors must be able to make investments safely at reasonable cost in markets of their choice.

Initiatives taken by authorities or market participants help steer the development, regulation and supervision of securities markets in the near term in Finland as well as in the European and global environments. Also important are the views taken by those handling trades and post-trade processes regarding integration possibilities for markets and their own operating possibilities in this changing environment.

References

Bank of Finland (2002) **Finnish Financial Markets.** Bank of Finland Studies A:105, Heikki Koskenkylä (ed.). Helsinki.

CPSS – IOSCO (2001) **Recommendations for Securities Settlement Systems** (www.bis.org, www.iosco.org).

CPSS – IOSCO (2004) **Recommendations for Central counter-parties.**

EMI (1998) **Standards for the use of EU Securities Settlement Systems in ESCB Credit Operations.** Frankfurt am Main.

European Central Bank (2003) **The Euro Area Financial System: Structure, Integration and Policy Initiatives.** ECB Working Paper Series.

European Central Bank (2004) **Annual Report 2003.** Frankfurt am Main.

European Commission (1999) **Implementing the framework for financial markets: action plan, Communication from the Commission.** COM (1999) 232.

European Commission (2002) **Communication from the Commission to the Council and the European Parliament: Clearing and settlement in the European Union.** Main policy issues and future challenges. COM (2002) 257.

European Commission (2003) **Tracking EU financial integration.** Brussels.

European Commission (2004) **Communication from the Commission to the Council and the European Parliamanet: Clearing and settlement in the European Union – The way forward.** COM (2004) 312.

The Giovannini Group (2001) **Cross-Border Clearing and Settlement Arrangements in European Union.** Brussels.

The Giovannini Group (2003) **Second Report on EU Clearing and Settlement Arrangements.** Brussels.

Hasan, I and Schmiedel, H (2003) **Do networks in the stock exchange industry pay off? European evidence.** Bank of Finland Discussion Papers 2/2003.

Kauko, K, Paunonen, H, Pylkkönen, P and Ripatti, K (2002) **Rahoitusmarkkinoiden integration eteneminen.** Bank of Finland. Working Paper of the Financial Markets Department 2/2002.

Leinonen, H. (2003) **Restructuring securities systems processing – a blue brint proposal for real-time/t+0 processing.** Bank of Finland Discussion Papers 7/2003.

London Economics (2002) **Quantification of the macro-economic impact of integration of EU financial markets.**

OECD (2002) **European financial market integration – selected issues.**

DAFFE/CMF (2002)21, 31.10.2002.

OMHEX (2004) **Annual Report** 2003.

Pagano, M (1989) **Trading Volume and Asset Liquidity.** Quarterly Journal of Economics 104, No. 2.

Securities Expert Group (2004) **Financial Services Action Plan: Progress and Prospects.** Final Report.

Schmiedel, H, Malkamäki, M and Tarkka, J (2002) **Economies of scale and technological development in securities depository and settlement systems.** Bank of Finland Discussion Papers 26/2002.

Steil, B (2001) **Borderless Trading and Developing Securities Markets.**

Von Thadden, E and Ramos, S (2003) **Stock Exchange Competition in a Simple Model of Capital Market Equilibrium.** http://papers.ssrn.com/paper.taf?abstract_id=507702.

Chapter 6

Integration of payment systems

Heli Snellman

6 Integration of payment systems 144
6.1 Introduction 144
6.2 Regulation and supervision and other measures taken by the authorities 146
6.2.1 Measures taken by the European Commission 146
6.2.2 ESCB's tasks and role in payment systems 149
6.3 Large-value payment systems 152
6.3.1 Systems maintained by central banks 153
6.3.2 Private sector systems 154
6.4 Payment instruments and retail payment systems 156
6.4.1 Payment instruments 156
6.4.2 Retail payment systems 160
6.5 Future prospects and challenges of integration 163
6.6 Summary 166

References 167

6 Integration of payment systems

6.1 Introduction

Payment systems are very important for the functioning of the economy. They enable quick and secure transfer of money from payer to payee, and thus promote the smooth functioning of the real economy. The formation of a European single market also highlights the importance of reliable and efficient payment systems. Moreover, the integration of payment systems enables deepening of the single market by making the operation of businesses and citizens more efficient in the single economic area. This chapter first gives an overview of the integration of payment systems and its background, and of measures taken by authorities. After this, it analyses in more detail the integration of small- and large-value payments systems. Finally, it outlines future prospects and challenges for integration.

In talking about payment systems we come across many terms, which should first be defined. Here, payment instruments and payment methods refer to the various ways in which consumers and companies make payments. The instruments include eg cash, various kinds of payment cards, and cheques. Payment methods include eg cash payment, card payment, cheque payment, or making a credit transfer for example in an online bank or at a giro ATM. Payment system refers to the whole infrastructure, ie the technology, regulation and rules. A payment is transferred from payer to the payee via the payment system.

The integration of payment making and payment systems has several objectives: greater efficiency of systems, cost reductions, convergence and reduction of service prices, availability of services to all parties, and increased benefits to customers. Integration of payment systems within the EU has already commenced and continues to make progress. This integration process started with large-value payment systems because there was a need in the euro area for a central bank-maintained payment system to serve the needs of the single monetary policy. Therefore, the EU central banks developed the large-value payment system TARGET. In this system, interbank payments can be made in real time, and the prices of cross-border payments have been harmonised. The private sector also has a system for transferring large-value payments across borders, the EURO 1.

Retail payment systems, for interbank payments such as credit transfers, direct debits and card payments, are usually national

solutions and thus less integrated than the large-value payment systems. In many countries, retail payment systems operate automatically and efficiently within the country's borders, while cross-border payments still require slow and expensive manual handling. The objective is to develop more compatible and efficient systems. Of the payment instruments, cash is fully integrated within the euro area: the same physical money can be used for making payments in all the euro area countries. In addition, many international payment cards can be used to make payments, not only in the euro area but also worldwide.

In future, increasing cross-border trade, greater mobility of labour force, students and pensioners will increase the need for reliable and efficient integrated payment systems. In other words, each consumer should be able to effect payments eg from Finland to Portugal as quickly and reliably as a domestic interbank payment. Development of payment systems calls for cooperation between market participants and authorities, a working decision-making structure, commitment to decisions taken, common standards, and harmonised legislation and supervision. Reaching agreement on these issues can indeed be difficult. The role of various participants in the integration process is described in a simplified way in table 1.

Table 1. **Participants' roles in the integration of payment systems**

Participant	Role
European Commission	– Legislation and other regulation
ESCB	– Maintain and develop TARGET – Oversight – Catalyst – Right to issue regulations and guidelines
Market participants	– Develop payment systems and instruments

6.2 Regulation and supervision and other measures taken by the authorities

6.2.1 Measures taken by the European Commission

The European Commission develops the EU's common legislation to remove legal impediments and legal uncertainties from the single market. Although the development of financial markets is preferably market-driven, certain legislative measures are needed in order for integration to move ahead. Harmonised legislation in the EU countries should lead to a solution that is suitable for all countries and promote the efficiency, stability and reliability of the systems involved.

In the process of harmonising national legislation it is naturally difficult to enact appropriate laws on various matters, laws that are neither too stringent nor too lax. The task is made more challenging eg by differences in countries' regulation cultures. For example, in Finland payment making has been regulated via parts of several laws or alternatively by a separate statute such as the Credit Transfer Act. Legal relationships between payment systems are still mostly based on agreements between parties. Some of the measures taken by the EU on payment systems are listed in table 2.

Table 2. **Key measures of the EU regarding payment systems**

Name and number of measure
Directive 97/5/EEC of the European Parliament and of the Council of 27 January 1997 on cross-border credit transfers.
Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems.
Directive 1999/93/EC of the European Parliament and of the Council of 13 December 1999 on a Community framework for electronic signatures.
Directive 2000/31/EC of the European Parliament and of the Council of 8 June 2000 on certain legal aspects of information society services, in particular electronic commerce, in the Internal Market.
Directive 2000/46/EC of the European Parliament and of the Council of 18 September 2000 on the taking up, pursuit of and prudential supervision of the business of electronic money institutions.
Directive 2001/97/EC of the European Parliament and of the Council of 4 December 2001 on amending Council Directive 91/308/EEC on prevention of the use of the financial system for the purpose of money laundering – Commission Declaration.
Regulation (EC) No 2560/2001 of the European Parliament and of the Council of 19 December 2001 on cross-border payments in euro.
Communication COM(2003)718 from the Commission to the Council and the European Parliament concerning a new legal framework for payments in the internal market (consultative document).

In May 1999 the EU Commission published a communication entitled ‘Implementing the framework for financial markets: action plan’.[1] This Financial Services Action Plan (FSAP) includes 42 measures for the creation of an integrated financial system for the EU. Changes implemented in the area of payment systems include the Directive on the finality of settlement, a communication from the Commission on forming a single euro payments area, the Directive on electronic money, and the Directive on money laundering. In addition, the Commission has issued communications and recommendations. For instance, in February 2001 the Commission issued a communication on e-commerce in financial services and an action plan for preventing fraud and counterfeiting in payment systems. Directives have also been adopted on cross-border credit transfers, e-commerce, and electronic signature.

[1] The communication is available at: http://europa.eu.int/comm/internal_market/en/finances/general/actionen.pdf.

In addition to the above-mentioned legislative measures the highly-debated Regulation (EC) No 2560/2001 of the European Parliament and of the Council on cross-border payments in euro was adopted in December 2001. Under this regulation, as of 1 July 2002, the charges levied for cross-border euro-denominated ATM withdrawals and card payments must be the same as those levied for domestic ATM withdrawals and card payments, and as of 1 July 2003, the charges levied for cross-border credit transfers must be the same as those levied for corresponding domestic credit transfers. The regulation states that credit transfers must fulfil the criteria for an EU payment, ie the payment order must include the international bank account number (IBAN) and international bank identifier code (BIC). Moreover, the payment must now be less than EUR 12,500 and, as of 1 January 2006, less than EUR 50,000. The Price Regulation was adopted because the European Commission was unsatisfied with the slowness and high costs of cross-border retail payments. The Commission had made several studies[2] on the subject, and throughout the 1990s it encouraged banks to make the processing of cross-border payments faster and cheaper. The banks did not make sufficient improvements despite numerous efforts by the Commission. As a result, the Commission decided to speed up the development by adopting a price regulation. Even though the regulation was heavily criticised, especially by the banking sector, it has worked well in practice and has promoted integration. The regulation provided an effective incentive for the banking sector to modernise the European payment infrastructure (sec. 6.4.2).

The European Commission is also preparing a new legal framework for payments. Its objective is to harmonise the legislation of EU countries and to examine the legislative reforms necessary for establishing a single euro payments area (SEPA). The European Commission's objective is to create a common legal basis for retail payment services. The existing legal framework for payments is based mainly on national legislation and rules which differ considerably across the EU countries. The objective is to remove legal barriers and thus to ensure eg efficient and secure payment services, a high level of consumer protection, and a level playing field. The legislation is aimed at creating added value eg by promoting stability and security

---

[2] The 2001 study is available at: http://europa.eu.int/comm/internal_market/payments/docs/studies/prices-2001/credit-transfer_en.pdf.

and efficiency of payments. The Commission Communication[3] on the New Legal Framework for Payments in the Internal Market includes 21 annexes on various specific legal and technical issues concerning payments. These include the right to offer payment services to the public, revocability of a payment order, execution times for credit transfers, and data protection. The communication was open for comment by the general public in early 2004. On the basis of these, the Commission will probably soon formulate some directives and other legislation.

In addition to taking legislative measures the European Commission has several working groups through which it develops payment and payment systems. These working groups include the Payment Systems Government Expert Group (PSGEG), which focuses on legal issues, and the Payment Systems Market Group (PSMG), which handles payment system issues on a broader scale. Furthermore, the Commission publishes analyses and research studies on payment systems and arranges conferences and other meetings with the various participants. On these occasions, the Commission receives feedback on its incentives.

6.2.2 ESCB's tasks and role in payment systems

According to article 105 (2) of the Treaty, one of the basic tasks of the European System of Central Banks (ESCB) is to promote the smooth operation of payment systems. Article 22 of the ESCB statute states that the ECB and national central banks may provide facilities and the ECB may make regulations, to ensure efficient and sound clearing and payment systems. The ESCB's objective is to ensure that payment systems work smoothly, efficiently and reliably. In addition to operational reliability the ESCB seeks to improve the harmonisation and integration of payment systems.

The ESCB has many tools for promoting the smooth operation of payment systems. These instruments include its own operations, oversight, issuance of regulations and opinions, influence eg in promoting development of payment systems, and providing information.

The key means of influencing include the ESCB's own operations. The ESCB maintains TARGET, a real-time system for large-value

[3] The Communication is available at:
http://europa.eu.int/eurlex/en/com/cnc/2003/com2003_0718en01.pdf.

payments. The ESCB created TARGET for its own monetary policy purposes. In addition, TARGET promotes the reliability of payment systems in the EU (sec. 6.3.1).

Another channel of influence is ESCB oversight of payment systems. Through oversight the central banks aim to ensure that payment systems operate smoothly, efficiently and reliably.[4] Oversight is largely harmonised and coordinated, and the harmonisation process continues. Eurosystem oversight activities are divided into four main categories: 1) formulation of oversight policy, 2) implementation of oversight policy, 3) monitoring payment system development to assess the scale of risks and efficiency of systems, and preventing excessive risk-taking and 4) managing problem situations.[5] Regarding the division of oversight tasks[6] it has been decided that the Governing Council of the ECB will formulate the common oversight policy stance, and the enforcement will be entrusted to the national central banks in respect of their national systems. A lead overseer is selected when necessary. Uniform oversight within the ESCB is important since adherence to common basic principles guarantees equitable treatment for all parties in all countries. One of the key oversight tools is to assess payment systems based on core principles[7] drawn up by the G10 central banks. The Committee on Payment and Settlement Systems (CPSS), which works under the Bank for International Settlements (BIS), published the core principles for systematically important payment systems in 2001, and their precursors, the Lamfalussy standards[8], as early as in 1990. In addition to these core principles, the ESCB has established core principles for retail payment systems. Oversight standards are currently being developed.

In addition to oversight conducted by NCBs, the banking supervisors monitor participants of payment systems. Smooth cooperation between NCBs and banking supervisors is essential for

---

[4] For instance, the statutory oversight function of the Bank of Finland is laid down in the aforementioned Treaty establishing the European Community and Statute of the ESCB, and in the Act on the Bank of Finland. The oversight function of the Bank of Finland is described eg in the publication 'Finnish financial markets 2002', edited by Heikki Koskenkylä.

[5] These principles and the development of oversight are described in more detail in Iivarinen et al (2003).

[6] The oversight policy of the euro system is discussed eg in the ECB publication 'Role of the euro system in the field of payment systems oversight' (http://www.ecb.int/pub/pub/paym/html/index.en.html).

[7] BIS (2001).

[8] BIS (1990).

identifying possible risks and acting on them in a timely manner. NCBs and banking supervisors have signed a memorandum of understanding (MoU[9]), mainly as a basis for cooperation and information sharing regarding large-value payment systems within the EU. The division of responsibilities between overseers and supervisors must be clear not only as to standard operations but also regarding crisis management situations and abnormal circumstances. The functioning and compatibility of oversight and supervision shall also be ensured with the integration of systems. Integration and the changes it involves pose a challenge for cooperation between overseers and supervisors.

In addition to maintaining the TARGET system and overseeing payment systems, the ECB can issue regulations and statements. So far, the ECB has not issued regulations on payment systems. Another important instrument of the ECB for promoting smooth operation of the payment systems is to participate in discussions on payment systems on various fora. The ECB is represented on numerous international committees and working groups on payment systems. As part of its general influencing efforts, the ECB seeks to be a catalyst for the development of payment systems. Market participants may sometimes find it difficult to agree eg on standards that would be essential for development because they often have conflicting short-term interests. Participants may have conflicting views on future development, and thus a payment innovation may be quite fragmented in its early stages. A current example of this is the numerous mobile phone applications for payment. Even in Finland, there are many incompatible solutions. Common standards drawn up in the early stages of development might succeed in significantly speeding up the creation of markets. The ECB's role as a catalyst also involves monitoring closely the development of markets. One example of this is the e-Payment Systems Observatory (ePSO) site[10] maintained by the ECB, to which information is compiled on the e-payment methods and mobile payment solutions of various countries. In addition to influencing, the ECB has a task of informing the public, which it does eg through its numerous publications. Moreover, many NCBs are active in making research work, which provides a basis for various kinds of publications.

Cooperation, decision-making and decision preparation within the ESCB takes place mainly in committees and their working groups,

---

[9] ECB 2001 (The ECB's press release is available at http://www.ecb.int).
[10] http://www.e-pso.info.

where each member state has at least one representative. For payment systems there is the Payment and Settlement Systems Committee (PSSC). The ECB also cooperates with other authorities and market participants. An example of this is the Contact Group on Euro Payments Strategy (COGEPS), which is the body for the Eurosystem and market participant cooperation on payment systems.

The Bank of Finland participates actively in the work of the ESCB. Moreover, EU laws enacted by the European Parliament and Council are applied in Finland as in other member states. For instance, the Price Regulation was directly binding legislation, and did not require separate implementation. A directive, on the other hand, must be implemented in national legislation. In Finland, directives have been implemented generally on schedule.

The Bank of Finland also works closely with other Finnish authorities. In various seminars and workshops, current issues are discussed, and participants try to find common positions eg on various payment system issues, if necessary. In addition to working with authorities, the Bank of Finland cooperates with market participants. There are two cooperation bodies in the payment systems area, ie the Payment Systems Steering Group and its subgroup, the Payment Systems Cooperation Group. In these, current payment system issues are discussed regularly a couple of times a year with banks and the Finnish Bankers' Association. In addition to regular working groups, issues are discussed in seminars and other meetings, which are arranged as necessary. Cooperation with market participants is important for exchanging views and for taking several perspectives into consideration in the oversight and development of payment systems. The key objective of cooperation is to promote the adoption of single market principles and to exchange information on EU incentives.

6.3 Large-value payment systems

Large-value payments are very important in promoting integration. They can be divided into systems provided and maintained by central banks and systems provided and maintained by the private sector.

The large-value payments system maintained by central banks, TARGET, was established first and foremost to serve the needs of the single monetary policy of the euro area. It commenced operations at the start of 1999 when the euro was introduced as scriptural money. Euro cash was introduced three years later, at the start of 2002. In

addition to the needs of the single monetary policy, the TARGET system was created for transferring safely and quickly large-value payments, which are important for the stability of the financial system. The system has operated well and has met its objectives.

Another large-value payment system operates in Europe – the EURO 1 – which is maintained by the private sector. This system replaced the ECU Clearing System at the start of 1999 when the euro replaced the ECU as scriptural money.

6.3.1 Systems maintained by central banks

TARGET (Trans-European Automated Real-time Gross settlement Express Transfer system) is an EU-wide payment system that processes euro-denominated payments. It consists of 15 national Real-Time Gross Settlement Systems (RTGS) and the ECB payment mechanism. The first version of TARGET was introduced in early 1999, and it has effectively promoted integration within the EU. It enables banks operating in EU countries to settle interbank payments in real time with central bank money. Settlement is irrevocable and final once it is completed. There are over 1,500 direct participants in TARGET, and over 40,000 banks are accessible via the system.[11]

TARGET, which was established to serve the needs of the single monetary policy of the ESCB, has been instrumental in formation of euro area money and securities markets. Another aim was to provide a safe and reliable real-time system for euro-denominated payments – ie to promote the stability of payment systems – and to improve the efficiency of cross-border payments in the euro area. TARGET can be said to have fulfilled these objectives. New EU member states connect to TARGET at latest upon entry into Economic and Monetary Union.

TARGET's new version, TARGET 2[12], is currently being developed. The objective is to harmonise services, ie to provide the same core services for all the banks using the system. In principle, all central banks participating in TARGET will shift to a single, shared platform. Participating banks will continue to hold accounts in their NCBs, even if they are technically located on a single shared platform. The banks do business with their NCB in the services provided by TARGET 2. As part of the harmonisation, the prices for core services

[11] More information on TARGET is available on the ECB website (http://www.ecb.int) and in publications ECB 2003a and ECB 2004.

[12] More information on TARGET 2 is available on the ECB website (http://www.ecb.int), eg in the document ECB 2003b.

will be the same for domestic and cross-border payments in each country. Moreover, the new system will operate cost-efficiently. TARGET 2 will also provide flexible liquidity management and greater efficiency.

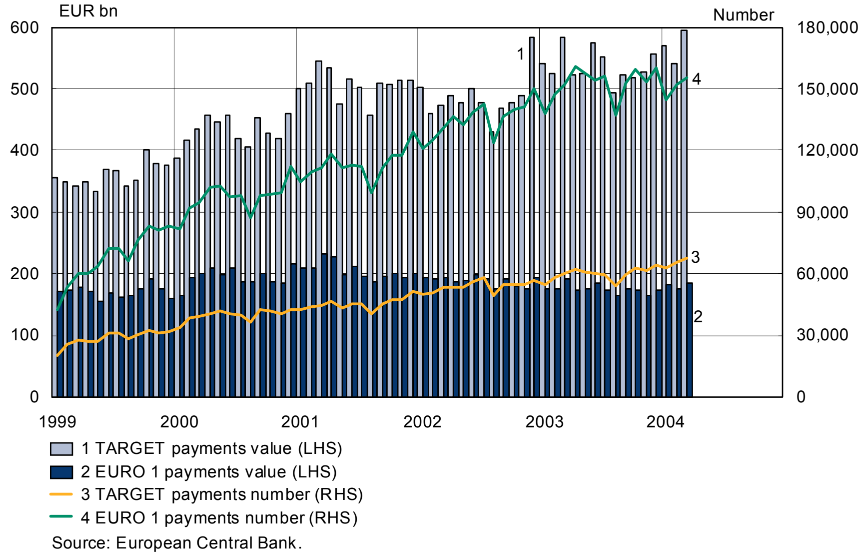
Fulfilling such objectives as creating harmonised services and achieving cost-effectiveness is a major challenge. Moreover, one of the key issues is the system's operating hours, since participants will increasingly need to make real-time money transfers 24 hours a day. Overall, the objective is to develop TARGET to better meet market needs concerning eg pricing and services, so that banks will use it for executing payments. Executing large-value payments that are important for the stability of financial markets through a real-time gross settlement system reduces risks to stability.

6.3.2 Private sector systems

In addition to the TARGET payment system maintained by central banks, another large-value payment system is operating in Europe. This EURO 1[13] is maintained by the Euro Banking Association (EBA). It is a netting system in which payments are settled in TARGET, via EBA's account at the ECB. Although EURO 1 is a large-value payment system, it is in practice used for effecting smaller payments and payments that may be less urgent than those executed in TARGET. However, more transactions are processed via EURO 1 than via TARGET (fig. 1 and 2). It should thus be noted that the markets are quite segmented: large-value payments are processed mainly in TARGET, medium-value payments in EURO 1, and retail payments in the STEP 2 system (sec. 6.4.2). This kind of segmentation is good in terms of risk management.

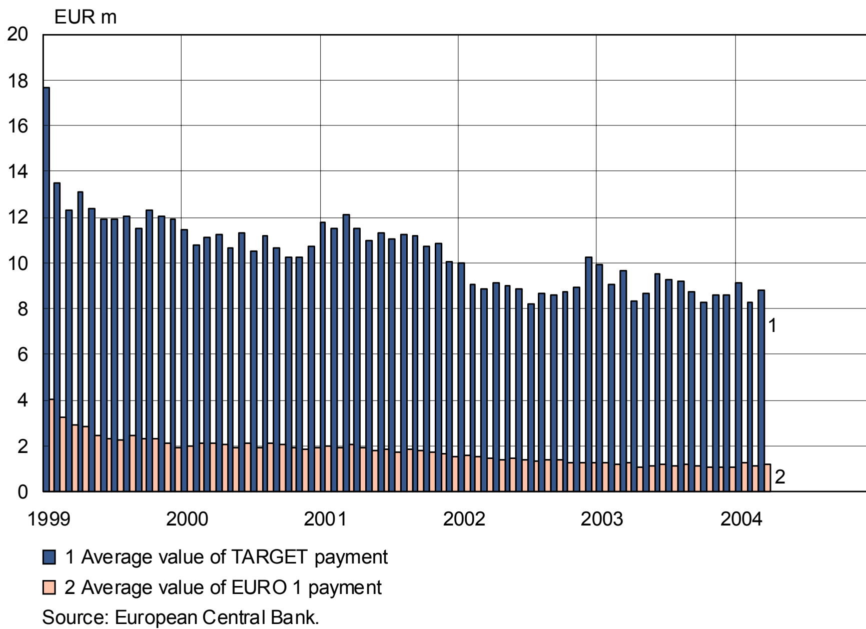
[13] More information on the EURO 1 system is available on the EBA website (http://www.abe.org).

Figure 1. **Average daily numbers and values of outgoing TARGET and EURO 1 payments in the EU, monthly**



Source: European Central Bank.

Figure 2. **Average value of payments in TARGET and EURO 1, monthly**



Source: European Central Bank.

Another system maintained by the private sector is the worldwide Continuous Linked Settlement[14] (CLS), which was designed to eliminate foreign exchange settlement risks. In the CLS, currency transaction payments are executed according to the payment-versus-payment (PVP) principle, ie ownership of the currencies involved switches simultaneously. CLS is a global system, and it has increased the interdependence of systems. Problems in one national RTGS system may hinder operation of the CLS and thus cause problems for other countries. In future, the CLS may expand its operations to new services, eg collateral management.

6.4 Payment instruments and retail payment systems

Before the introduction of the euro, each country had its own currency and national payment systems. Due to the currency exchange operations involved, cross-border payments involving different currencies were executed through correspondent banks[15]. After introduction of the euro, national systems could not be interlinked, and as a result the process of developing new methods for processing cross-border retail payments was started up.

6.4.1 Payment instruments

The euro countries changed over to a common cash system on 1 January 2002. To the ordinary consumer, this is the most concrete benefit of integration of payment systems. Consumers can pay with euro notes and coins in 12 countries which naturally facilitates eg travelling.

The euro cash changeover brought challenges also for the harmonisation of currency supply maintenance in the euro area. In April 2001 the Governing Council of the ECB decided that, over the next five years, production of euro banknotes would take place in accordance with a decentralised production scenario with pooling. In

[14] http://www.cls-group.com/about_cls/index.cfm.

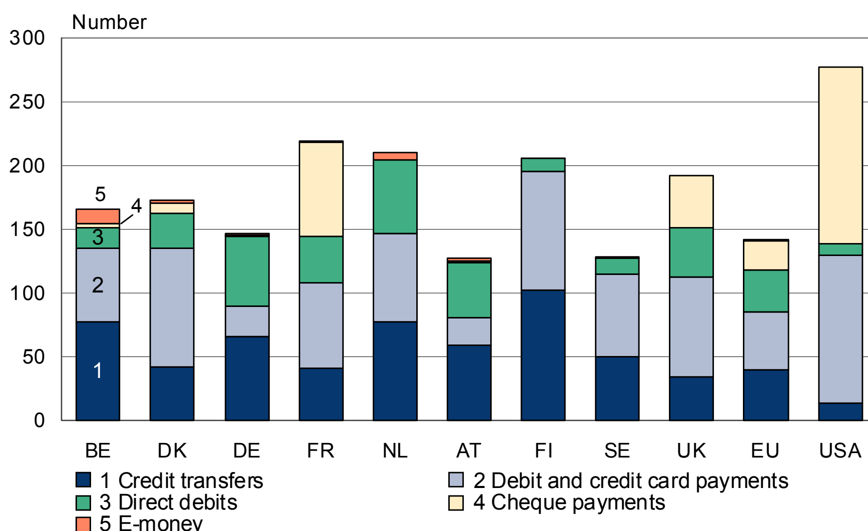
[15] In correspondent banking, a bank holds accounts on behalf of foreign banks in its own systems (loro accounts) and transfers payments to national payment systems. Similarly, eg a Finnish bank can hold an account in a foreign bank (nostro account), in which case the foreign bank operates as a link to local payment systems and payment transferring.

other words, each NCB is responsible for a certain portion of total euro banknote production and not more than a few denominations. This decentralised production scenario enables the Eurosystem to benefit from economies of scale and to ensure consistent-quality banknotes. The Governing Council of the ECB has also underlined the importance of a level playing field for cash services and several measures have been taken to promote it. In 2002 a common Eurosystem fee policy was implemented for cash transactions of professional clients at NCB counters. Moreover, a common approach to opening hours and debiting and crediting rules for cash services at NCB counters was defined. The Eurosystem also published terms of reference for the use of cash-recycling machines in the euro area.[16] Currency supply is a good example of harmonised operations which are still being harmonised.

Regarding other payment methods, euro area integration has not taken such a concrete form as with cash payments. Credit transfers, cheques and direct debits, for example, have been used mainly for executing domestic payments, and for them, national borders are still significant barriers to integration. Different payment methods are favoured in different countries.[17] Cheque payments are still common in some EU countries – eg France and United Kingdom – whereas credit transfers are very popular eg in Finland and the Netherlands (fig. 3).

[16] Levo and Takala (2004). Currency supply and its challenges are discussed also in eg the ECB Annual Report of 2002 and 2003 and in the ECB Monthly Bulletin, July 2003.
[17] Eg Jyrkönen and Paunonen (2003).

Figure 3. **Number of payment transactions per capita, 2002**



Sources: ECB and BIS.

Some international payment cards are accepted not only within the euro area but also worldwide. It is therefore interesting to consider how these have become so popular. One explanation seems to be that card payment is a practical payment method for the consumer, and card issuers have been able to market it widely to consumers as well as to sellers. An efficient, easy-to-use and widely-accepted payment method cannot be challenged easily. For instance, electronic money and mobile phone applications have at least not yet threatened the position of the traditional payment card.

The position of domestic payment cards is also interesting. It might well be asked whether we really need domestic debit cards or domestic credit card applications in an integrating Europe, or should we start using only international card systems. Integration of the euro area would, in principle, require that no card should be accepted in only one member state. On the other hand, this could cause problems. Operations could be fully in the hands of a few global operators, in which case it should be ensured that an adequate level of competition is maintained. Currently, only a small number of cross-border credit transfers are made from Finland.[18] In future, the number of cross-

[18] According to the Finnish Bankers Association (2004), international payments account for less than 1% of total payments.

border transactions may well increase because the increase of cross-border retail trade in the euro area will also increase the flow of money across borders. In addition, the increasing mobility of labour, students and pensioners may in future increase the number of cross-border payment transactions. Despite recent discussion of the need for Pan-European Direct Debit (PEDD), the issue remains somewhat unclear. The demand for PEDD may be greater elsewhere in Europe than in Finland because countries located closer to each other find it easier to make purchases from a neighbouring country.

The use of the Internet and mobile phones has increased rapidly during the past decade. Internet and mobile phone also serve as a new channel for many payment services. For instance, using bank services via the Internet is very popular. With the new channels, customers are no longer bound by time or location. They can handle their banking business while sitting on the pier of a summer cottage or from the other side of the world, in real-time, 24 hours a day. In addition to the new channel, new payment methods have been developed for the Internet and mobile phones. In Finland, the new Internet- and mobile-based payment methods have not yet become very popular. Almost every citizen has a bank account, and credit transfers from one bank account to another are very common. With the Internet, new and easy-to-use payment methods readily become global because the Internet enables people all over the world to log in as customers of service providers.

New payment methods can be considered a challenge to banks which have held strong positions in payment transfers in Finland. Security is naturally an integral factor in payment methods and payment instruments because consumers' confidence might falter considerably if serious operational disturbances, abuses or security shortcomings were encountered with one of the payment methods. Developing payment methods and payment transmission are a challenge also to regulation, oversight and supervision. All payment service providers should be on a level playing field in terms of legislation and other regulation. In addition, the same rules should be applied to all payment service providers in the EU. The harmonisation of the regulatory framework will aim at ensuring eg that an operator cannot operate without a license in one country if a license is required for operating in the same business in another country. In reforming the regulatory framework, it will be kept in mind that the regulatory burden should not become too heavy for the operators, as this would hinder implementation of innovations or lead to inefficiencies. Thus, harmonisation of the regulatory framework always entails risk.

6.4.2 Retail payment systems

The retail payment systems of different countries have developed in line with national needs. Numbers of cross-border retail payments have remained small and so banks have focused on making domestic payment systems as reliable and efficient as possible. As a result, the national systems may function well and efficiently, but they are not compatible. Instead, they function according to national standards. Due to system incompatibility, cross-border payments involve manual processing, which makes payment processing slow and expensive.

The European Commission has repeatedly drawn attention to the slowness and expensiveness of retail payments. In practice, this means that the channels used for handling cross-border payments – eg correspondent banking, STEP 1 and banking groups' own solutions (club solutions) – have not been able to offer consumers sufficiently efficient services. The European Parliament and Council in December 2001 adopted a Price Regulation, by which the banking sector immediately started developing the handling of cross-border payments (sec. 6.2). With the regulation, the banks had to reduce prices charged for cross-border payments in euro, although in practice the payments were still handled by the same inefficient methods. In answer to the price regulation, European banks in June 2002 set up the European Payments Council (EPC[19]), a cooperation body aimed at establishing a single euro payments area (SEPA[20]). SEPA enables individuals and companies to make cross-border euro-denominated payments anywhere in the euro area as quickly, cheaply and securely as domestic payments. An efficient infrastructure is needed for cross-border retail payments so that cross-border payments services will be on a par with domestic payment services. In other words, the aim of the SEPA project is to have payments processing that is as automated as possible and consistent with pan-European standards; to agree on common practices; to upgrade the processing of domestic and cross-border payments and ensure its cost-effectiveness. The SEPA project covers all the payment methods. One of the objectives of the project is to reduce the use of cheques as payment instruments since they are used mainly in domestic payments and are expensive to process. EPC is composed of European banking associations and dozens of banks, and its Finnish members are the Finnish Bankers' Association and

---

[19] http://www.europeanpaymentscouncil.org.

[20] EPC (2002) document Euroland: Our Single Payment Area! describes the SEPA plan (http://www.europeanpaymentscouncil.org/SEPA-%20WhitepaperSummary.pdf).

Nordea. EPC endeavours to work with the European Commission and ESCB. EPC is a joint decision-making body for the banking sector, although its decisions are not binding. It has several working groups and sub-working groups, which address the various issues in the payment field (table 3).

Table 3. **EPC working groups**

Working group	Task
Business and Customer Requirements Working Group	To monitor and manage the evolution of payment instruments along their lifecycles.
Infrastructure Working Group	To foster the development of and convergence towards the preferred infrastructure model. The favoured model is the Pan-European Automated Clearing House (PEACH).
End-to-end STP Working Group	To promote end-to-end STP for each SEPA instrument.
Cash Working Group	To improve the efficiency of cash handling in the euro area in the short term and to significantly reduce the use of cash in the long term.
Cards Working Group	To focus on issues concerning payment cards eg fraud prevention and pricing.

The objective is to achieve a true single euro payments area by 2010. The ECB has assessed the progress of the SEPA project in its annual progress report[21]. Monitoring progress is the key role of authorities in establishing a SEPA. It is important that the markets have also assumed the task of developing cross-border payment systems.

The SEPA project also included the introduction of STEP 2, the retail payment system of the Euro Banking Association (EBA), in summer 2003. The EBA also maintains the STEP 1 retail payment system. These systems differ eg in structure.[22] STEP 2 is a Pan-European automated clearing house (PEACH) in which at present only credit transfers are processed. In spring 2004 the Finnish direct STEP 2 members were Nordea and OKOBank. Other Finnish banks can receive incoming payments via STEP 2 through banks that are direct members of the system.

[21] ECB (2003c) (http://www.ecb.int).

[22] More information on the STEP 2 and STEP 1 systems is available on the EBA website (http://www.abe.org).

A key question concerning STEP 2 is whether it can entice European banks to transfer sufficient volumes of payments for processing. To achieve a critical mass, the EPC and ECB have proposed that all domestic credit transfers should be processed through STEP 2. For Finland, this could mean giving up its national retail payment system (PMJ) and switching to STEP 2. Before the current system is abandoned, the impact on customers and banks' operations of transferring to STEP 2 needs to be carefully assessed. The new system must be secure, reliable and efficient. Moreover, a European system may not be more costly to customers or banks than a domestic one. Because a sufficient level of competition is necessary[23], it is interesting to consider whether there is room in Europe for more than one PEACH. Competition could also be created by banks' club solutions, which include tailored cross-border payment systems for banking groups. In addition to these club solutions, large banks operating in several countries transfer a large number of payments in their own systems. The importance of these in-house systems may thus increase considerably if bank mergers continue until there are huge banks operating in nearly every country. Until now, not much attention has been paid on these kinds of in-house systems and their importance. Maintaining several systems or participating in several systems naturally raises costs for banks. Therefore, they need to assess carefully what kind of development will best serve the payment system as a whole.

It should be noted that all in all the SEPA project has been a remarkable step forward in promoting the integration of retail payment system, even though the systems will still require considerable development in the years ahead. The progress of integration can be assessed in terms of pricing, costs, speed of payment transfer, operational reliability, access to systems, and national security. Also technical innovations, such as Internet-based payment services, promote integration. The SEPA project and the New Legal Framework for Payments in the Internal Market, being prepared by the Commission, should promote integration significantly.

[23] Kemppainen (2003) analyses the connection between competition, cooperation and regulation in retail payment systems.

6.5 Future prospects and challenges of integration

The integration of payment systems will continue and payment systems are likely to continue to develop into ever larger entities consistent with the payments processed.[24] The main objective of integration is to achieve efficiency benefits. However, the stability, reliability and security of payments and payment systems must also be ensured. The integration process began in the large-value payment systems because a system maintained by central banks, TARGET, had to be developed to serve the needs of the single monetary policy of the euro area. The TARGET 2 system being developed will promote integration even more. Progress in the integration of retail payment systems has been considerably slower. Only recently have banks become serious about developing a single euro payments area (SEPA), and they have come to the conclusion that an efficient European solution for handling retail payments would be a Pan-European automated clearing house (PEACH). Europe cannot accommodate too many PEACHs if critical mass and operational efficiency are to be achieved. Thus development seems to be moving towards more centralised handling of retail payments – ie a large volume of payments handled in a few clearing houses. It remains to be seen whether national payment systems will disappear as integration progresses.

Technological advance is another factor that promotes integration. With the Internet, traditional and new payment methods can be used more flexibly than before. Increasing Internet-based trade and cross-border trade require efficient, fast, safe, and reliable payment methods and payment systems. Attention must be paid to the safety of payment methods being developed, to guarantee that the confidence of the general public in a given payment method does not falter. New channels also involve new kinds of threats, as is evident with eg from the problems that viruses have caused for information networks.

Another factor promoting integration is conglomeration, which means that different types of companies, not only by banks, offer payment services. Increasing competition is welcome, but at the same time, it must be ensured that payment services are reliable and that the same rules apply to the same type of operations.

---

[24] Iivarinen (2004).

Legal problems pose a major challenge to integration. The internal market should have common legislation, ie regulation should not create barriers in payment services. The same rules apply to domestic and cross-border payments in the euro area. The same kind of regulation should apply in different countries, to the same type of operation involving the same risk. The harmonisation of existing legislation is thus a notable challenge. But progress has already been achieved in this connection with the issuance of certain directives and regulations. In addition, the new legal framework for payment systems being developed will effectively promote the harmonisation of legislation in the various payment areas.

Another key challenge to integration is systems governance. To foster integration, it should be ensured that all parties have open and equal access to new payment systems. Moreover, each system must have an efficient decision-making body. In other words, the body taking decisions on operation and development of the system should be able to make all the participants of the system commit themselves to its decisions. On the other hand, the decision-making organisation should not be too inflexible to enable decision making in the first place. For example, it is integral for the development of SEPA that EPC can commit the entire banking sector to its decisions. There is not much point in agreed standards and procedures if they are not applied in practice. On the other hand, the decision-making body should be small enough to keep the decision-making process smooth, but it must have the weight to induce all banks in the area to implement its decisions. This is a major challenge because implementing decisions always requires investment on the part of banks, and the banks need to be ensured that they will benefit from the investment also in future. In general, an efficient decision-making organisation is integral to the development of the overall payment system, and this applies to both banks and central banks.

One factor slowing the integration of retail payment systems and methods is the lack of common standards. It can thus be asked what should be the role of the central bank in standardisation. The ESCB has clearly assumed the role of catalyst in seeking to move market development in the direction it considers the best. The ESCB's role also involves identifying problems and possible risks in cooperation. One way of fostering standardisation is to work with market participants to establish an effective procedure. The central bank could also issue regulations on payment systems. In fact, a regulation could be used to set up a specific, formal procedure, albeit this is not necessarily the best means of having an impact. Finland, for instance, has a highly developed retail payment system in which the banks have

agreed on standards among themselves, and acted in accordance with those standards. On the other hand, cooperation between banks has been easy in Finland because the number of banking groups is fairly small. If market participants are unable to agree on standards and thus slow down development, the national central banks should seek to influence market participants to ensure the progress of European integration. The central banks can compile information which is essential for development, and see to it that the information is transparent and available to all the interested parties, such as decision makers and researchers. At the same time, the central banks seek to maintain consumer confidence in payment systems. In other words, the stability, reliability, safety, and efficiency of systems also impact standardisation needs.

Until now, integration of payment systems has taken place mainly in EU countries, and global integration is perhaps not as evident as in some other sectors. However eg the CLS system, which provides foreign exchange transaction settlement services, is an international service provider, SWIFT messages[25] are used for data communications in payment systems, the Internet enables global provision of payment services, and some payment cards can be used nearly all over the world. In addition, system assessments performed as part of oversight activities are increasingly based on global standards. An example of integration is the transfer of international payments through the FedACH[26]. In this arrangement, retail payments can be transferred from the United States to Canada, Mexico, United Kingdom, Switzerland, Netherlands, Germany, and Austria.[27] The service has been operating since November 2003. Moreover, the banking sector has been planning to establish a Worldwide Automated Transaction Clearing House (WATCH[28]). However, this project has not yet gained popularity. Overall, it can be said that global and total integration of payment systems is not in view. In Europe, resources are needed for developing Pan-European payment and payment systems, which will be a challenge for years to come.

---

[25] http://www.swift.com.

[26] FedACH is the automated clearing house of the US Federal Reserve System.

[27] http://www.frbservices.org/Retail/intfedach.html.

[28] http://www.globalach.org.

6.6 Summary

The integration of large-value payments systems is quite advanced, whereas the integration of retail payment systems is in its early stages. Euro notes and coins are used in cash payments across the whole euro area, and some international payment cards are valid globally, whereas debit cards, cheques, credit transfers, and direct debits are mainly national solutions.

Large-value payment systems have an important role in crisis prevention since payments transferred through them involve potentially significant risks. In recent years, serious financial crises have not occurred in the EU. A key element of crisis prevention is to have well-functioning payment systems. In order to prevent crises in the future, the internal and external control of systems will need to be effective. Integration of systems also calls for a rethinking of how to organise central banks' oversight activities and the supervisory activities of banking supervisors. In a crisis situation, cooperation between central banks and banking supervisors is highlighted. The integration of payment systems will require common solutions also as regards supervision and oversight.

The fostering of integration poses challenges to both market participants and authorities. Legislation can be used to remove the biggest obstacles to integration, but the various parties must also be able and willing to take common decisions and adhere to them. In practice, promoting integration can be a very difficult and time-consuming process. The global integration of payment systems is also making progress, but probably quite slowly.

References

BIS (1990) **Report of the committee on interbank netting schemes of the central banks of the group of ten countries.**

BIS (2001) **Core Principles for Systemically Important Payment Systems.** CPSS Publications No. 43.

ECB (2000) **Role of the Eurosystem in the field of payment systems oversight.**

ECB (2001) **Memorandum of Understanding on Co-operation between Payment Systems Oversees and Banking Supervisors in Stage Three of Economic and Monetary Union.** Press release 2 April 2001.

ECB (2003a) **TARGET: the Trans-European Automated Real-Time Gross settlement Express Transfer system – update 2003.**

ECB (2003b) **TARGET2: the payment system of the €urosystem.**

ECB (2003c) **Towards a Single Euro Payments Area – Progress Report.**

ECB (2004) **TARGET Annual Report 2003.**

EPC (2002) **Euroland: Our Single Payment Area**. Summary http://www.europeanpaymentscouncil.org/SEPA-%20WhitepaperSummary.pdf.

Finnish Bankers' Association (2004) **Banking Technology in Finland.**

Iivarinen, T (2004) **Large value payment systems – principles and recent and future developments.** Bank of Finland Discussion Papers 13/2004. Helsinki.

Iivarinen, T, Leinonen, H, Lukka, M and Saarinen, V (2003) **Regulation and control of payment system risks – a Finnish perspective.** Bank of Finland Studies A:106. Helsinki.

Jyrkönen, H and Paunonen, H (2003) **Card, Internet and mobile payments in Finland.** Bank of Finland Discussion Papers 8/2003. Helsinki.

Kemppainen, K (2003) **Competition and regulation in European retail payment systems.** Bank of Finland Discussion Papers 16/2003. Helsinki.

Koskenkylä, H (ed.) (2002) **Finnish financial markets 2002.** Bank of Finland Studies A:105. Helsinki.

Levo, U and Takala, K (2004) **Finland's currency supply system.** Bank of Finland Bulletin 2/2004. Helsinki.

Chapter 7

Financial stability, regulation and supervision

Heikki Koskenkylä – Jenni Koskinen

7 Financial stability, regulation and supervision 170
7.1 Introduction 170
7.2 Integration and stability 172
7.3 Integration and regulation 174
7.3.1 Financial Services Action Plan (FSAP) and Lamfalussy process to enhance regulatory efficiency 176
7.3.2 Challenges and outlook for EU financial regulation 184
7.4 Integration and supervision 186
7.4.1 Supervisory arrangements in EU countries 188
7.4.2 Topical issues and challenges for supervision 190
7.5 Integration and the role of the central banks in promoting financial stability 193
7.5.1 Central banks' tasks vis-à-vis stability, macro-prudential analysis and oversight 193
7.5.2 Cooperation in the field of stability, supervision and oversight at EU and international level 195
7.5.3 Challenges ahead 197
7.6 Summary and outlook 198

References 201

Annex 1/7 206
Annex 2/7 209
Annex 3/7 212
Annex 4/7 213
Annex 5/7 215

7 Financial stability, regulation and supervision

7.1 Introduction

In the foregoing, the focus was on progress in financial integration and on issues related to regulation and supervision in the various sectors of the financial markets. Integration of the financial markets has proceeded at a highly varying pace across sectors, but, overall, cross-border trade in financial services has grown at an accelerating rate over the last few years. This has raised important questions concerning the institutional framework of financial regulation and supervision and related practical measures. Particularly in the euro area, the start of the single monetary policy and introduction of the euro in 1999 have underscored the importance of well-functioning regulatory and supervisory structures.

Towards the end of the last decade, a closer and more systematic approach was taken to assess the adequacy of the EU's institutional arrangements for safeguarding financial stability. Two questions were raised in this connection. The first is whether supervision based mainly on national responsibility is adequate to ensure the stability and reliability of financial markets and to manage crisis situations in the context of deepening integration. The second concerns the extent to which the EU's regulatory process – preparation of directives and regulations and their implementation at the national level – and the considerable differences in national supervisory practices have emerged as barriers to further integration and expansion of the financial markets.

Financial market legislation dates back to the Treaty of Rome, signed in 1957, after which banking legislation was first harmonised in the 1970s and 1980s, followed by subsequent extension of legislative measures to the securities markets. Legislation concerning financial infrastructure and particularly payment systems was put in place toward the end of the 1990s. Supervision has remained a national responsibility and, despite some discussion, there have been no initiatives to establish supranational bodies. However, since the 1970s we have seen the evolvement of a supranational committee and working group framework for discussions between countries on supervisory and regulatory issues. The committee structure has served mainly as a conduit for advice and information. In response to greater

integration and significant changes in financial market structures, national-level supervision has been reorganised in the last few years. A global perspective has also surfaced in discussions on supervisory and regulatory structures and the reform of related practices. Many of the EU's regulatory initiatives reflect a global orientation and a connection with the work of financial committees established by G10 countries or even larger groups of countries.

The discussions on the functioning and adequacy of the EU's regulatory and supervisory structures took shape in several important initiatives and measures in connection with the euro changeover at the end of the 1990s. In spring 1999, the European Council adopted a Financial Services Action Plan (FSAP), aimed at effecting a significant change in EU financial market legislation. The primary aim is to promote the internal market, but also to ensure financial stability. In autumn 1999, the ECOFIN Council asked the Economic and Financial Committee (EFC) to assess whether the EU's existing regulatory and supervisory framework was adequate to ensure the stability of the financial markets. The Committee set up the Brouwer working group, which, in slightly different compositions, issued two reports.[1] The recommendations contained in these reports for promoting financial stability and developing crisis management continue to be observed by the EFC and the ECOFIN Council. The next follow-up report on implementation of the recommendations will be finalised in September 2004 for submission to the ECOFIN Council.

In 2000, a working group known as the Lamfalussy Committee was set up to assess in particular the development of securities market regulation and supervision. Based on the Committee report, new committees for securities market regulators and supervisors were established to improve the efficiency of directives preparation and to foster cooperation between supervisors and harmonisation of supervisory methods.

The Economic and Financial Committee in autumn 2002 prepared an extensive analysis of the EU's financial regulation, supervision and stability. The assessment was based on the above-mentioned Lamfalussy report and the purpose was to extend the 'Lamfalussy process' to the banking and insurance sectors. New committees, corresponding to those in the securities sector, were established for the insurance sector at the end of 2003 and for the banking sector at the start of 2004.

---

[1] EFC (2000) and (2001).

7.2 Integration and stability

The Brouwer group's first report (Report on Financial Stability) analyses the impact of changes in the financial markets on EU regulation and supervision and on securing financial stability in Europe as a whole. The implications of integration and structural changes in the financial markets on financial stability are diverse, so it is difficult to assess the overall impact. Some factors for change increase stability by enhancing the financial system's risk-bearing capacity, while others expose the financial system to greater risks.

It is commonly held that the single monetary policy and the euro essentially improve the prospects for financial stability. Monetary policy conducted for a large region is less sensitive to shocks than is the monetary policy of a single country, and thus interest rate movements are less volatile. In other words, interest rate developments are more stable. Stable interest rate developments in turn underpin the stability of the financial markets. The elimination of exchange risk from operations within the euro area has a similar effect. Expanding and deepening single currency markets enable more effective risk diversification, which promotes the stability of the financial system.

The prime catalysts for change in the financial markets have been advances in information technology and abolition of regulation (liberalisation or deregulation). Indeed, free capital movements and cross-border services are among the central pillars of EU integration policy. These, together with the new technology, have accelerated the process of internationalisation of the financial markets. New information technology has lowered transaction costs in cross-border services trade and enabled the establishment of international networks. Financial companies have set up subsidiaries or branches in other countries, mergers and acquisitions have been done on a cross-border basis, and there has been substantial increase in cross assets and liabilities. These development trends were dealt with in the previous chapters of this book. Technological advances and deregulation have also provided scope for an ongoing development of new financial products. Their risk profiles differ essentially from those of ordinary products. Such new products are eg the various types of derivatives, securitisations and methods for credit risk transfer.

One new developmental feature is disintermediation. This means that companies increasingly raise funds directly in the capital markets

instead of borrowing from banks. In this respect, the European financial markets have become more like US markets, where recourse to direct capital market funding is still much more widespread than in Europe. Also banks and insurance companies are more dependent on capital markets as sources of funding.

Another key trend for change in the European banking markets has been consolidation, as reflected in mergers and acquisitions. Bank size growth and emergence of large multinational banking groups and financial conglomerates pose an increasing threat of systemic risk, as failures of large companies can involve others, provoking the transmission of risks to other companies. This could increase the 'moral hazard' problem because of the difficulty of allowing large (too big to fail) companies to fail. The ongoing consolidation of financial companies is also gradually becoming a problem for the competition authorities. So far, consolidation has not posed problems in the EU area, because there is competition from abroad and from other sectors, such as insurance. The operations and products of financial companies and sectors have also become more and more similar, as banks, insurance companies and investment firms produce and sell similar products, such as investment and savings products.

A common feature of the changes that have taken place in the financial markets is a substantial increase in the mutual interdependencies of financial companies and markets, between countries and between the different sectors of the financial markets. This facilitates the spreading of risks between companies, sectors and countries.

In the last few years, questions concerning the stability of the financial system have become an important item on the agenda of international and European institutions and fora. First, a forum for promoting the stability of the financial system – the Financial Stability Forum – composed mainly of authorities from large countries and international institutions, such as the International Monetary Fund (IMF), World Bank, Bank for International Settlements (BIS) and the Organisation for Economic Cooperation and Development (OECD), as well as other regulators and supervisors, has provided an important contribution to the analysis of potential sources of vulnerability in the global financial system. Second, following a decision taken by the ECOFIN Council in 2002, the Economic and Financial Committee (EFC) began to hold regular discussions on financial stability issues relevant for the EU. In addition, the Governing Council of the ECB initiated regular discussions on financial stability conditions in the euro area and EU countries, on the basis of work carried out by the ECB in cooperation with the ESCB's Banking Supervision Committee

(BSC). The aim of this work is to contribute to international and European discussions on financial stability issues.

7.3 Integration and regulation

Financial regulation is implemented in the EU by means of directives and regulations. Recommendations and communications are also used in the process, often prior to the actual preparation of legislation.

The EU is working to harmonise financial regulation and supervision and to develop more flexible EU legislation. The legislative aim is to promote the creation of an internal market for financial services, which should improve the functionality of the financial markets. This in turn will promote economic growth and employment. Such legislation will also help to safeguard financial stability and strengthen consumer and investor protection. Competitive aspects are also a key concern in the effort to improve efficiency. Excessive consolidation could reduce competition.

International cooperation and coordination have continued to assume increasing importance in financial regulation and supervision. This trend is especially visible in the need for a harmonised regulatory framework and supervisory standards. At the international level, harmonisation of the work of authorities confronts three types of challenges. First, the regulation of financial conglomerates established between countries and across the different segments of the financial sector requires uniform rules. Second, much effort is being expended to provide investors and consumers with increasingly better opportunities to access financial services offered anywhere in the EU home market area. Third, harmonised regulation and supervision are a precondition for credit institutions, investment firms and securities issuers to be able to operate in efficient and safe EU-wide markets with a level playing field. Harmonised regulation also aims to minimise 'regulatory arbitrage', ie the movement of companies to countries with less stringent regulatory and supervisory standards. Harmonised regulation fosters market integration and contributes to creating a level playing field for all parties, regardless of location within the EU.

The first directives on the financial markets were issued already in the late 1970s (the main directives and regulations are listed in annex 1 at the end of this book). The most important banking directives of the 1990s were the new directives on consolidated supervision and capital adequacy. Other new directives dealt with large exposures,

prevention of use of the financial system for money laundering and deposit-guarantee schemes. In addition, investment firms were brought under EU regulation, as the minimum capital adequacy requirements for credit institutions were extended to apply to investment firms. In the 1990s, an overall regulatory directive on investment services (ISD) was also adopted, as well as a directive on investor protection. The scope of application of the directives was subsequently extended to cover the financial infrastructure. A directive on cross-border credit transfers was adopted in 1997 and one on settlement finality in payment and securities settlement systems in 1998 (sec. 6.2.1).

The start of the new millennium witnessed the adoption of two 'codifying directives'. They combined several banking and securities markets directives that were harmonised and simplified at the same time. In 2001 an important directive on the reorganisation and winding-up of credit institutions (Winding-up Directive) was adopted, and at the same time a similar directive was adopted for the insurance sector. Developments in payment systems also continued: a directive on electronic money institutions was adopted in 2000, and a regulation on cross-border payments in euro was issued in the following year. A directive on financial conglomerates was adopted in 2002, and in 2003 directives of key importance to the securities markets entered into force in the areas of market abuse and prospectuses published upon listing.

A directive amending the accounting rules for financial instruments, applicable also to non-financial sectors, came into force in autumn 2001 (Fair Value Directive). The purpose of this amendment is to allow for EU-wide application of International Accounting Standards (IAS 39). In 2002, a regulation was adopted requiring listed EU companies, including the financial and insurance sector, to prepare their consolidated accounts in conformity with the International Accounting Standards (IAS) for each financial year starting on or after 1 January 2005. The EU Council regulation on the Statute for a European company (Societas Europapaea, SE) was adopted in October 2001. This regulation, due to become effective in October 2004, will create a new European supranational company form that largely resembles national limited liability companies. Adopting a European company status facilitates cross-border structural arrangements.

7.3.1 Financial Services Action Plan (FSAP) and Lamfalussy process to enhance regulatory efficiency

The current framework for a more integrated European financial system is based on the 1999 Financial Services Action Plan (FSAP) and on a regulatory process complying with a report published in 2001 by the Lamfalussy 'Committee of Wise Men'. The first high-level assessment of this framework will take place in 2004. In addition to the introduction of the single currency, the FSAP constitutes the most important measure to date on the means by which the EU is seeking to lower the costs of cross-border trade in financial services, in both the euro area and the EU as a whole. Preparation of a post-FSAP strategy has already been started, and a new FSAP is expected to be ready in 2005.

The most significant strategic objective of the Financial Services Action Plan is to promote financial sector integration and thereby enhance the efficiency of EU financial markets. Key priorities include completion of a single EU wholesale market and the creation of open and secure retail markets. The FSAP also seeks to strengthen the EU's regulatory and supervisory structure in order to ensure financial stability even in an environment of major structural changes. (Annex 2 at the end of this book provides a detailed overview of the FSAP.)

The Financial Services Action Plan originally comprised 42 proposals for measures, of which almost 40 have already been implemented. The majority of the measures are legislative initiatives in the form of either directives or regulations. The original plan has been supplemented by certain other measures that became topical during the implementation of the plan, which extended over several years. The initial aim was to have the plan finalised in its entirety by 2005 and, in respect of measures concerning the securities markets, as early as 2003. The FSAP was for the most part completed on schedule, but its implementation at the national level is clearly behind schedule and will still take several years. FSAP and related measures that were pending in spring 2004 include the following: minimum capital requirements for credit institutions and investment firms (annex 3/7), monitoring and implementation of action plans for company legislation and corporate governance practices, 14th Company Law Directive, modernisation of the 8th Company Law Directive (statutory audit), adoption of International Accounting Standards (IAS 32/39), consultation and potential legislative initiatives in respect of a Commission Communication on securities clearing and settlement, 3rd Money Laundering Directive, Directive on

Reinsurance Supervision, new legal framework for payments, revision of solvency margin requirements for insurance undertakings (solvency II) and reform of taxation of savings income in the form of interest payments.

The European Commission, assisted by committees, is responsible for preparing the EU's financial regulations (the most important old committees are listed in table 1 and the new committees in table 3). Legislation has been adopted through a co-decision procedure between the European Parliament and the EU Council, as revised in accordance with the Treaty of Amsterdam, providing the Parliament with a greater role in the legislative process. The European Parliament, prior to suspending work recently, accomplished a major task in enforcing the FSAP measures. The Parliament also played a role in adopting the Lamfalussy process in its entirety.

Table 1. **The most important committees assisting the Commission (prior to the new Lamfalussy committees)**

Committee	**Abbreviation**
Banking Advisory Committee	BAC
Insurance Committee	IC
High Level Securities Supervisors Committee	HLSSC
Forum of European Securities Commissions (securities markets supervisors of the EEA countries)	FESCO
Groupe de Contact (banking supervisors of the EEA countries, mainly via BAC)	GdC
Financial Services Policy Group	FSPG
Conference of Insurance Supervisory Authorities	CISA
UCITS Contact Committee	UCITS

Particularly the Banking Advisory Committee (under the European Commission) and the Insurance Committee each had a formally important status within the 'comitology procedure'. With the assistance of these committees, the Commission was able to amend, albeit only to a limited extent, the technical details of the directives. Thus the Commission had the power to adopt legislative implementing measures. When these committees acted as 'comitology committees', they were chaired by a Commission representative. A comitology committee adopts, on the basis of powers conferred in the relevant directives, the rules concerning the details and technical implementation of the directives. In connection with the adoption of FSAP measures, the ECOFIN Council took the initiative in

establishing a forum composed of representatives of ministries responsible for financial market regulation, the Financial Services Policy Group (FSPG), entrusted with the task of assisting the Commission in defining the focal areas for development of financial regulation. The Group acted as a link between policy-makers and committees responsible for the technical preparation of directives, ie the Banking Advisory Committee, the Insurance Committee and the High Level Securities Supervisors Committee.

Over the years, many aspects of EU financial legislation have been adapted to changes that have taken place in the financial markets (described in more detail in sec. 7.2). The international standards issued for different sectors by international committees and certain organisations have played an important role in the development of EU countries' regulation, supervision and oversight (table 2). One of the key tasks of the Basel Committee on Banking Supervision, acting in connection with the BIS, is to provide a regular forum for discussions on matters concerning the G10 countries' banking supervision, but the work of the Committee has in recent years increasingly focused on regulatory development. Another committee working in connection with the BIS, the Committee on the Global Financial System (CGFS), is charged with supporting central banks in fulfilling their stability-related responsibilities, which it has done eg by preparing an analysis of financial stability conditions. The Financial Stability Forum (FSF), composed of regulatory and supervisory authorities and representatives of central bank committees responsible for the stability of internationally important finance centres, is also working in connection with the BIS. This forum convenes twice a year to analyse potential vulnerabilities in the financial system. In addition, the International Organisation of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS) have issued international standards concerning their respective areas of responsibility. The Financial Action Task Force on Money Laundering (FATF) has been responsible for the issuance of standards for the prevention of money laundering and financing of terrorism (Key standards for sound financial systems are listed in annex 1/7.) The Commission has observer status in many of these committees.

Table 2. **Key international committees and working groups dealing with regulatory and supervisory issues**

Committee	Abbreviation
Basel Committee on Banking Supervision	BCBS
International Organisation of Securities Commissions	IOSCO
International Association of Insurance Supervisors	IAIS
Committee on Payment and Settlement Systems (works in connection with the BIS)	CPSS
Committee on the Global Financial System, CGFS (works in connection with the BIS)	CGFS
Financial Stability Forum (works in connection with the BIS)	FSF
Financial Action Task Force on Money Laundering	FATF
Joint Forum (constituted under the aegis of the BCBS, IOSCO and IAIS to develop regulation and supervision of financial conglomerates)	Joint Forum

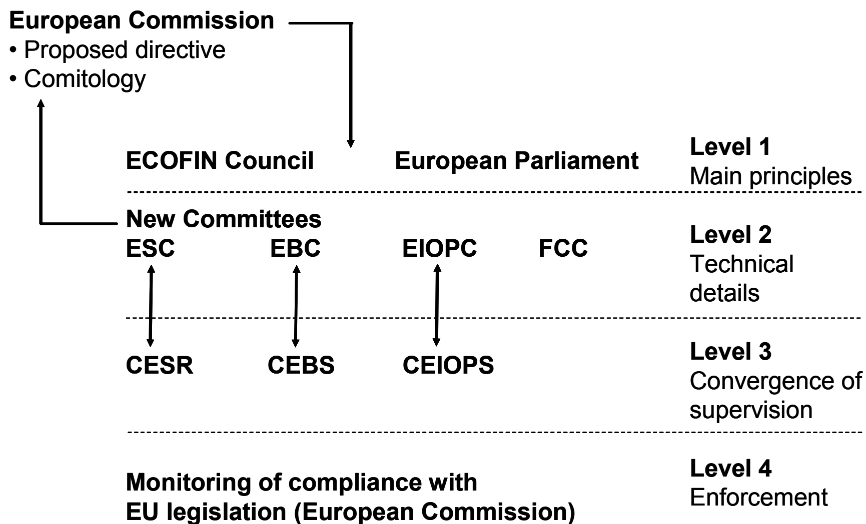
The work of the Joint Forum has been important in developing EU regulation for financial conglomerates. The IMF's Financial Sector Assessment Program, analysing the stability of countries' financial systems, incorporates additional documentation in the form of 'Reports on Observance of Standards and Codes' (ROSC), which evaluate compliance with international standards and codes (annex 1/7).

In autumn 1999 the EU Council meeting in the composition of the ministers of economy and finance (ECOFIN Council) requested the Economic and Financial Committee (EFC) to examine whether the existing framework for EU financial sector regulation and supervision is adequate to ensure the stability of the financial system. The two Brouwer working groups investigated the issue in 2000 and 2001 (further details in sec. 7.2). The working groups focused on measures fostering financial stability and crisis management. The outcome of the work was that no major institutional changes are required for regulation and supervision, whereas practical cooperation, notably between supervisors and committees of supervisors, needs to be upgraded. (The Brouwer working groups' recommendations are provided in annex 4/7.)

Another working group set up by the ECOFIN Council, the Committee of Wise Men (Lamfalussy Committee), surveyed the conditions and needs for development in the area of securities markets regulation and supervision. In February 2001 the Committee issued a

report on proposals for further development of EU legislation concerning the securities markets. The report highlighted the need to speed up the EU legislative process but noted the importance of attending to the balance in decision-making between EU institutions, viz the European Parliament, European Commission and EU Council. The Commission proposal for a directive, based on four levels, as outlined by the Committee, is shown in box 1. The proposal also includes the new banking and insurance sector committees established later (table 3).

Box 1. **Lamfalussy process**



Sources: European Commission's proposal for a directive of the European Parliament and of the Council amending Council Directives 73/239/EEC, 85/611/EEC, 91/675/EEC, 93/6/EEC and 94/19/EC and Directives 2000/12/EC, 2002/83/EC and 2002/87/EC of the European Parliament and of the Council, in order to establish a new financial services committee organisational structure. See also Kurek (2004).

As indicated, the Lamfalussy process involves four levels. The EU's primary legislation, ie directives and regulations, focuses only on key provisions (level 1). More detailed technical implementing measures are adopted through a lower-level procedure, ie the comitology procedure (level 2). The committees of regulators and supervisors assist the Commission in connection with implementation proposals. Level 3 of the Lamfalussy process requires supervisory authorities to upgrade cooperation and issue common guidelines, recommendations

for interpretation and standards to achieve greater harmonisation of supervisory measures. Level 4 concerns the monitoring of compliance with EU legislation, which is the responsibility especially of the European Commission.[2]

Based on the Lamfalussy proposals, the European Commission in 2001 set up two committees: the European Securities Committee (ESC) and the above-mentioned Committee of European Securities Regulators (CESR). The European Securities Committee is a comitology committee, as defined in EU legislation, which, on the basis of powers conferred in the respective directives, adopts rules concerning the details and technical implementation of the directives. The Committee of European Securities Regulators, assisting the European Securities Committee and the European Commission, is responsible for, besides its tasks within the Lamfalussy framework, the issuance and adoption of recommendations of its own, for which the harmonised compliance by the member states is considered important. The Committee of European Securities Regulators set up a panel of its own to review the implementation and degree of harmonisation of regulations across member states. The first tasks undertaken by the panel were reviews of the Standards for Alternative Trading Systems (ATS) that were adopted by the Committee, as well as of compliance with the standards for the European Regime of Investor Protection. The panel agreed on uniform review principles. The results, which are based on self-assessment undertaken by each Committee member, were published on the Committee's website in early 2004.

The first implementing measures for compliance with the comitology procedure were adopted within the new committee framework in autumn 2003. The Commission made its proposals for the Market Abuse Directive and Prospectus Directive only after having addressed provisional mandates to the Committee of European Securities Regulators for technical advice on possible implementing measures. Following approval of the proposals by the European Securities Committee and a decision by the European Parliament to agree to the proposals, the Commission was in a position to adopt the directives.

Upon request of the ECOFIN Council, the Economic and Financial Committee in 2002 issued a report entitled 'EU arrangements for financial regulation, supervision and stability', which recommended the extension of the Lamfalussy process to the banking and insurance

---

[2] Financial Supervision Authority (2003).

sectors. The report also included proposals for greater efficiency in financial regulation and supervision within the EU. The overall aim was to enhance the efficiency and flexibility of the EU legislative process in connection with financial market issues, to strengthen arrangements between authorities in the EU financial markets, and to promote the harmonisation of regulation and supervision across the EU area. The report proposed the establishment of several new committees. The ECOFIN Council adopted a major part of the proposals of the Economic and Financial Committee in the latter part of 2002.

Subsequently, in November 2003, the European Commission submitted a proposal for measures by which the Lamfalussy framework would be extended to cover the financial sector as a whole. (The new committees set up on the basis of this proposal are listed in table 3.) It was, however, necessary to conduct thorough negotiations with the European Parliament in 2003 and 2004 on the establishment of the new committees. The Parliament had not previously deemed it urgent to extend the Lamfalussy framework to the banking and insurance sectors. The problem arose because of a procedure under which the Commission would be given powers to adopt implementing measures (level 2). The Parliament considered it crucial that, if the Commission is given powers to adopt implementing measures for the financial sector within the Lamfalussy process, there would be simultaneous reform of the legislative regime of the European Union. The Parliament required amendment of article 202 of the Treaty establishing the European Community such that the European Parliament would be granted the right to demand call-back in connection with level 2 legislation. The Parliament somehow feared that the extended comitology procedure would concede genuine legislative powers to the Commission and the committees. Under an agreement reached between the European Parliament, EU Council and European Commission, the Parliament must be kept informed of preparation of level 2 measures. Moreover, if the Parliament deems that level 2 measures exceed the powers delegated in the relevant directive, it has the right to review the measures. The Parliament has one month to express its view and, if it is of the opinion that the powers have been exceeded, the Commission must reconsider its proposal, with the utmost concern for the Parliament's position.

Table 3. **New committees assisting the Commission**

Old committee	**New committee**
Financial Services Policy Group, FSPG	Financial Services Committee (FSC) mainly assisting EFC and ECOFIN Council
High Level Securities Supervisors Committee	European Securities Committee (ESC)
Forum of European Securities Commissions	Committee of European Securities Regulators (CESR)
UCITS Contact Committee	Tasks transferred to ESC and CESR
Banking Advisory Committee (BAC)	European Banking Committee (EBC)
BAC and GdC partly assumed tasks in the area of supervisory cooperation and coordination	Committee of European Banking Supervisors (CEBS)
Insurance Committee (IC)	European Insurance and Occupational Pensions Committee (EIOPC)
Conference of Insurance Supervisory Authorities (CISA)	Committee of European Insurance and Occupational Pension Supervisors (CEIOPS)
Mixed Technical Group (MTG)	Financial Conglomerates Committee (FCC)

The new European Banking Committee (EBC) will start work in 2004; the new Committee of European Banking Supervisors (CEBS) commenced operations already at the start of 2004. Participating in the work of the Committee of European Banking Supervisors are the heads of EU countries' banking supervisors or their deputies (voting members). Non-voting members are central banks with no banking supervision function, such as the Bank of Finland. Observer status is held by representatives of banking supervisors and central banks of EEA countries, as also by the ECB and the chairperson of the ESCB's Banking Supervision Committee. The Groupe de Contact (GdC), the cooperative body of EEA countries' banking supervisors over a longer period of time, will become a permanent working group of the Committee of European Banking Supervisors (CEBS). The CEBS has also set up a working group for accounting and auditing matters and for reforming the capital adequacy framework of banks and investment firms (Basel II, annex 3/7). A new committee was established in late 2003 for regulating financial conglomerates, but it was not yet considered necessary to set up a committee for their supervision. Responsibility for this area is shared by three other supervisory committees (CESR, CEBS and CEIOPS). Consequently,

the chairpersons of these three committees have already begun to hold regular meetings to discuss common supervisory issues concerning financial conglomerates.

The ECB participates as an observer in the regulatory and supervisory committees, with the exception of those in the insurance sector. Thus the ECB is able to contribute to the shaping of EU financial regulation and supervision in accordance with its institutional tasks (sec. 7.5).

The tasks of the new banking and insurance committees are very similar to those of the securities markets committees discussed above. The regulatory committees assist the Commission in preparing directives, and they constitute part of the comitology procedure. The supervisory committees provide advice to the Commission in respect of technical implementing measures (level 2). They engage in extensive consultation and dialogue with market participants when preparing their proposals. In addition, these committees are mandated to promote cooperation between supervisors and convergence of supervisory practices.

The most important task of the new committees of banking and insurance supervisors is now the preparation of the new capital adequacy framework. For banks, this concerns Basel II; for the insurance sector, a review of the solvency system (solvency II). The convergence of supervisory methods has come under great pressure from the Commission and from market participants.

The new Financial Services Committee (FSC) started work at the onset of 2004. Its mandate is similar to, but somewhat more extensive than, that of its predecessor. The Financial Services Committee oversees and monitors progress made in integration and the functioning of the regulatory and supervisory committees. The Committee has links with the ECOFIN Council, mainly through the Economic and Financial Committee, and provides a central forum for the preparation of the ECOFIN Council's stability discussions.

7.3.2 Challenges and outlook for EU financial regulation

The regulatory structures and processes of the European Union have undergone significant reforms over the last few years. It is not yet possible to evaluate the ramifications, except for the securities markets sector, in which the new committee framework has been functioning for about three years. The results obtained from this market segment are encouraging, but there are problems due to the slowness of the Lamfalussy process and the large amount of work involved.

Developments are expected to be similar in the banking and insurance sectors.

The Financial Services Action Plan (FSAP) should be completed on schedule in 2005, although there has been a suspension of legislative work as a result of changeover in the European Parliament in June 2004. Whereas legislation and other regulation considered in the FSAP may be adopted in autumn 2004, there will still be one large and crucially important project to carry out. National implementation of many of the FSAP measures will take several years, and there have previously been problems with such implementation. The new supervisory committees are responsible for ensuring consistent and effective implementation of an extensive legislative package. Only after some years will it be possible to assess the extent to which the FSAP has promoted financial integration and the creation of an internal market and contributed to the removal of barriers to integration.

Although the Financial Services Action Plan is still incomplete in respect of certain important areas, the European Commission has already initiated preparations for a post-FSAP strategy for further development and efficiency upgrading in the EU financial markets. For this purpose, the European Commission requested four groups of experts to assess the progress made in integration and the remaining barriers to integration, and to submit a proposal for measures to further deepen the integration of the financial markets. The experts' groups were composed mainly of representatives of market participants, in areas such as banking, insurance, securities markets and asset management. The groups' reports were published in May 2004. At the same time, the Commission published its own assessment of how integration had progressed in the different financial market segments.[3] The Commission intends to prepare similar assessments annually based on an 'indicator method'. In addition, the Financial Services Committee, operating since the start of this year, submitted an assessment of integration developments and required further action to the June ECOFIN Council.

The information package published by the European Commission in May 2004 is now available for consultation and comment until September 2004.[4] Making use of the feedback received, the Commission will continue the preparation of the new FSAP in autumn 2004. This matter continues to be one of the items on the agenda at

---

[3] European Commission (2004a).

[4] European Commission (2004b).

several meetings held in 2004 by the Economic and Financial Committee and the ECOFIN Council of ministers of economy and finance. It is hoped that all concerned parties, ie authorities such as ministries, supervisors and central banks, the relevant companies and interest groups, consumer organisations and citizens, will take part in discussions on the post-FSAP strategy. Consultation is now more widely based than in connection with preparation of the original FSAP. The European Commission has also noted that there is no intention to create a new extensive legislative package, because national implementation, even in respect of current legislation, is still lagging behind schedule. Moreover, it seems that the current legislative package may prove too large for effective and uniform application without problems.

7.4 Integraation and supervision

Many of the EU's initiatives for regulatory reform are either directly or at least indirectly related to supervisory questions within the EU. Overall, financial regulation and supervision are highly interdependent functions. The major reform initiatives and assessments of the regulation and supervision of EU financial markets were:

1. 1999 Financial Services Action Plan (FSAP)
2. Assessments and recommendations by the Brouwer working groups in 2000 and 2001
3. Report by the Lamfalussy Committee in 2001
4. Report by the Economic and Financial Committee in 2002.

No new large-scale initiatives are currently on the horizon.

The above-mentioned extensive FSAP package did not in any respect interfere with the original main principles of financial integration and supervision, ie single licence, home country rule of supervision and mutual recognition.

Financial market supervision and crisis management continue to be entirely the responsibility of national authorities. The fundamental question is whether a completely decentralised supervisory framework is able to ensure the stability of the financial system in the face of ongoing further integration and structural change. Another question is whether decentralised supervision will gradually become a barrier to integration. Decentralised supervision, in providing supervisors access to widely different procedural methods, increases considerably the

costs of supervision. Some consider that the situation has already reached that stage and that the convergence of supervisory methods is too slow relative to market needs.[5]

The new Financial Services Committee has the mandate to examine, first, how supervision of cross-border banking groups and financial conglomerates should be effected, irrespective of whether a company operates abroad on the basis of a subsidiary or a branch structure and, second, how crises are managed in a cross-border context. The work of international committees is also reflected in the way EU-level supervisory authorities act.

In addition to the committees, the mutual Memoranda of Understanding (MoU) form an integral part of cooperation between supervisors in the EU countries. A large number of, mainly bilateral, MoUs have been issued between supervisors, in connection with practical cooperation in supervision and crisis management[6]. The MoUs are not legally binding, nor harmonised within the EU. In general, the MoUs concern EEA countries, but there are also MoUs signed with supervisors outside the EEA. The Second Banking Co-ordination Directive presupposes cooperation between supervisors, which is considered to occur within committees of supervisors and via Memoranda of Understanding.

It has gradually become necessary to draft multilateral Memoranda of Understanding. Within the EU, two multilateral MoUs have been signed between central banks and banking supervisors (sec. 7.5). On the other hand, multilateral MoUs have been signed between supervisors of several countries in respect of banking groups and financial conglomerates that are major players in many countries. Such MoUs are more extensive and thorough than the above-mentioned ordinary bilateral MoUs. More comprehensive and far-reaching Memoranda of Understanding have been issued eg between the Nordic supervisors. These MoUs concern the supervision of the Nordea and Sampo groups. MoUs have also been issued between the Belgian and French banking supervisors concerning Dexia and between the Dutch and Belgian banking and insurance supervisors concerning Fortis. In addition, certain committees, such as the Committee of European Securities Regulators (CESR), have updated the Memoranda of Understanding signed between their members.

At roughly five-year intervals, in the context of the Financial Sector Assessment Program (FSAP), the International Monetary Fund

[5] Heikensten (2004); Padoa-Schioppa (2004).
[6] EFC (2000) and (2001).

and World Bank evaluate the entire financial system of a single country, including the operability, stability and reliability of system regulation and supervision, and examine country compliance with international standards (sec. 7.2–7.3 and 7.5, and annex 1/7). The assessment is updated in connection with IMF Article IV consultations. Supervisory cooperation and coordination between EU and Swiss authorities and between EU and US authorities have come to play a central role because of the increased significance of international financial groups in these regions.

7.4.1 Supervisory arrangements in EU countries

Institutional arrangements for supervision of financial markets differ greatly across the EU countries. In the last few years, a large number of divergent changes have taken place in the supervisory structures. These changes have been made in order to increase efficiency and effectiveness in supervision. The government, or generally the ministry responsible for financial markets, bears ultimate responsibility for organising supervision in a country. The main issues concerning structural changes in supervision over the last few years have been the combination of supervisory tasks of authorities responsible for supervision of different sectors and particularly the central bank's role in banking supervision. The ECB does not have duties directly related to banking or other micro-level supervision (sec. 7.5). (Table 4 provides an analysis of supervisory structures in EU countries.)

Table 4. **Structure of financial supervision in EU countries**

Country	Number of supervisory authorities	Central bank is involved in banking supervision[1)]	Form of central bank involvement			
			Central bank is the banking supervisor (B), securities markets supervisor (S) or insurance supervisor (I)	Central bank is involved in the management of banking supervision	Central bank is allocated specific tasks in banking supervision	Central bank and banking supervisor share resources
Belgium	1	Yes	No	Yes	No	Yes
Spain	3	Yes	Yes/B			
Netherlands[2)]	2	Yes	Yes/S,B,I			
Ireland	1	Yes	No	No	No	Yes
United Kingdom	1	Yes	No	Yes	No	No
Italy[3)]	3	Yes	Yes/B			
Austria	1	Yes	No	Yes	Yes	No
Greece	3	Yes	Yes/B			
Cyprus	4	Yes	Yes/B			
Latvia	1	Yes	No	Yes	No	Yes
Lithuania	3	Yes	Yes/B			
Luxembourg	2	No	No	No	No	No
Malta	1	No	No	No	No	No
Portugal	3	Yes	Yes/B			
Poland	3	Yes	No	Yes	No	Yes
France	6	Yes	No	Yes	No	Yes
Sweden	1	Yes	No	Yes	No	No
Germany	1	Yes	No	No	Yes	Yes
Slovakia	2	Yes	Yes/B			
Slovenia	3	Yes	Yes/B			
Finland	2	Yes	No	Yes	No	Yes
Denmark	1	No	No	No	No	No
Czech Republic	4	Yes	Yes/B			
Hungary	1	Yes	No	No	No	Yes
Estonia	1	Yes	No	Yes	No	Yes

[1)] The central bank is involved in banking supervision if it is itself a banking supervisor or it has been allocated tasks or responsibilities in the management of banking supervision or oversight, or it performs supervisory tasks or shares resources with the supervisor (ECB, 2003f). Only recently have there been changes in the information contained in the table presented by the ECB.
[2)] In the Netherlands, owing to an organisational change in 2004, the central bank bears responsibility for prudential supervision of all sectors (footnote 2), while a separate market supervisor is responsible for the securities markets.
[3)] In Italy, supervision is undergoing structural change, making the central bank responsible for prudential supervision of all sectors and providing for a separate market supervisor for the securities markets. The proposed new organisational model would largely correspond to the Dutch model.

While the supervisory organisations of the EU countries differ greatly from each other, the changes in these structures reveal certain common tendencies.[7] First, consolidated supervision has led to a decrease in the number of supervisors in several countries. At present, 11 EU countries each have a single supervisory agency, whereas the other countries have several (2–6) supervisors. Second, structural changes have led to the formulation of three types of supervisory models. Supervision may be differentiated by sector (banking, insurance and securities markets), as is the case in ten countries and to

[7] ECB (2003f).

an extent in Finland and Luxembourg. On the other hand, it is possible to combine the supervision of all sectors under a single supervisory agency, which is the framework in place in 11 countries. In the Netherlands, in turn, supervision is organised according to objectives set for supervision. In this case, the central bank ensures achievement of the stability objective on a centralised basis via prudential supervision of individual institutions, while a separate authority ensures the functioning and soundness of the markets on the basis of procedures and codes of conduct. A corresponding model has also been recommended for Italy.

Central banks continue to play a pivotal role in banking supervision in 20 countries, albeit this role may differ sharply across countries. In ten countries banking supervision is entirely the central bank's responsibility, and in ten other countries the central bank has more or less tasks, or some other role, in banking supervision.

In certain countries, a formal cooperation committee between the various authorities has been established for ensuring the stability of the financial system. These types of committees exist at least in Belgium, United Kingdom, Ireland, Austria, France, Germany and Estonia. The corresponding Finnish organ (swot working group) has been informally active since 1999. The working group includes representatives from the Ministry of Finance, Ministry of Social Affairs and Health, Bank of Finland, Financial Supervision Authority and the Insurance Supervisory Authority.

Companies operating in the financial markets and other economic agents, such as consumers, have become increasingly interested in issues of regulation and supervision. In several countries, this has led to increased consultation by the authorities with other economic agents. Advisory groups or committees have been set up and are convening on a regular basis.

The supervision of banking and insurance conglomerates in Finland and the supervision of Nordea among the Nordic countries (annex 5/7) provide one example of supervisory arrangements.

7.4.2 Topical issues and challenges for supervision

Within the EU, there is an ongoing discussion on the organisation and operability of supervision. The framework as a whole is difficult to envision, and its incoherent nature is subject to criticism even outside the EU. Apart from the authorities and financial market participants, other entities have also started to monitor the effectiveness of supervision in the EU countries.

The recommendations of the Brouwer reports, issued years ago, became perhaps surprisingly the subject of long-term monitoring. The recommendations of both reports (annex 4/7) continue to be monitored by the ECOFIN Council and the EU's Economic and Financial Committee. According to the first Brouwer report[8], no institutional changes are required in supervision within the EU, whereas the practical functioning of the institutional arrangements needs enhancement.

Many of the recommendations contained in the Brouwer reports have been implemented fairly well in practice, but in certain respects the implementation is still incomplete. The Memoranda of Understanding (MoU) do not yet thoroughly cover crisis management, and the monitoring of information on multinational financial institutions is not well organised.[9] In addition, much effort needs to be put into the further development of stress tests, which will also take place in the context of the second pillar of Basel II. The term 'co-ordinating supervisor' was defined in the new directive on financial conglomerates, but the concept requires further specification.

The new supervisory committees will be subject to great expectations and confronted with significant work pressure (sec. 7.3.1, table 3). The 'bottom-up' method should facilitate the convergence of supervisory practices and models among 25 countries. This is a demanding and time-consuming venture which has not progressed with sufficient dispatch.[10] Centralised decision-making would possibly be required to make the process advance more quickly and efficiently.[11] So far, harmonisation has focused mainly on high level principles of various facets of supervision, but practical supervisory measures continue to differ greatly.[12] The 2001 Lamfalussy report states that establishment of a single centralised regulatory authority may need to be considered in a few years' time in the case of failure to implement properly the report's recommendations.[13]

Revision of the capital adequacy requirements, and especially pillar II of the new capital adequacy framework enabling exercise of discretion by the supervisors, emphasise the need for more convergence of national supervisory practices. (The elements of the

---

[8] EFC (2000).
[9] Padoa-Schioppa (2004).
[10] Padoa-Schioppa (2004).
[11] Aglietta and Scialom (2003).
[12] Heikensten (2004).
[13] Mogg (2003).

new capital adequacy framework are presented in full in annex 3/7.) Country differences in reporting are also far too great.

Certain basic pillars in EU regulation have been identified as new areas for development in supervision. Shared home and host country responsibility in supervision is being put to trial because of rapid, important changes in financial market structures. The role of the host country in monitoring liquidity is diminishing, as large institutions tend to centralise their liquidity management on a cross-border basis. In large groups, subsidiaries may have a dominating role in key operations, which may make host country supervision the most important element in the whole group's supervision. There will also be structural arrangements in which branches may be systemically important in the host country but in which, according to the home country rule of supervision, the supervisory role of the host country will be limited. Overall, it has already been acknowledged that there is reason to reconsider the responsibilities of home and host country supervisors. Currently, discussions of supervisory responsibilities within the EU make use of several concepts. These include supervision by home and host country, coordinating supervisor, lead supervisor and consolidated supervision.

In the euro area, effective structures for regulation and supervision become even more important, because the geographic areas of responsibility for monetary policy and prudential supervision no longer coincide. If a major disruption, eg in the availability of liquidity, occurs in the financial markets, the Eurosystem may make use of monetary policy, if necessary, to ensure financial stability or the functioning of the payment system. On the other hand, the national authorities bear full responsibility for problem situations affecting individual institutions. Supervision of financial stability and prudential supervision are largely exercised at the national level.

Financial companies and the European Commission exert pressure to strengthen the role of one supervisor to ensure, in particular, a uniform implementation of Basel II monitoring across countries. The problem here is that Basel II leaves room for a wide variety of national options and discretion. Differences in the national application of supervisory measures could essentially obstruct the efficient implementation of Basel II. In addition, there is considerable need for harmonised measures as between supervisors in the area of crisis management. In the next few years it will become clear whether the quite considerable differences in supervision across various countries and their various supervisors can be harmonised by means of the newly created committee structure. If convergence proves impossible

within a reasonable time, the need to review the supervisory structures within the EU will increase.

7.5 Integration and the role of central banks in promoting financial stability

Central banks around the world have the general task of promoting financial stability, irrespective of whether supervisory responsibility lies with the central bank or a separate authority. In order to meet the objectives associated with this task, central banks continuously oversee payment and settlement systems and analyse the operation, stability and development of the overall financial system from a macro-prudential perspective.

7.5.1 Central banks' tasks vis-à-vis stability, macro-prudential analysis and oversight

Central banks' macro-prudential and oversight duties generally feature the monitoring of overall financial stability. Thus, the aim is to chart factors that may jeopardise stability, especially in terms of systemic risk and efficiency. A systemic crisis can occur if the solvency of several market participants is threatened as a result of the insolvency of one participant. Overall financial stability refers to the ability of the whole financial system to function in exceptional circumstances. It is therefore natural that central banks place a strong emphasis on banks and payment and settlement systems in their stability analysis.

In practice, the primary tasks can be divided into two parts: macro-prudential analysis of financial markets and oversight. The legal basis for ECB and ESCB tasks are discussed thoroughly in, eg 'Finnish financial markets 2002'.[14] Oversight, which aims at ensuring the smooth, reliable and effective functioning of payment and settlement systems, is directly linked to other key functions of central banks, such as the stability role. Moreover, central banks maintain and develop central systems and participate in the development of regulation and supervision. Central banks contribute to regulation especially by participating in preparatory legislative work and by issuing opinions. Furthermore, central banks play an important role in

[14] Koskenkylä (2002, section 5.1).

crisis management and in providing emergency liquidity assistance (ELA).[15]

Generally central banks are also active in financial economics research, on a wide range of subjects. As a result of rapid structural change and integration of financial markets, research has become increasingly important for central banks. Results of the analyses are published and discussed and opinions are rendered in numerous national and international fora. The stability of the financial system is treated in numerous articles[16] and publications[17]. At present the Governing Council of the ECB discusses financial stability at regular intervals. Central banks should follow the principle of accountability and the closely-related principle of transparency (first international standard, annex 1). According to these principles, central banks should be transparent in their actions. In addition to making information publicly available, it is important that information on both financial structures and developments be presented in a manner that is understandable to the public.

The institutional framework for financial stability in the EU and euro area is based on national competence and international cooperation. The ECB has competence in those 12 countries that have adopted the single currency and thus belong to the euro area. However, all 25 central banks of the enlarged EU are included in the European System of Central Banks (ESCB), which plays a crucial role in promoting stability in Europe. A variety of national structures and practices contribute to the pursuance of financial stability objectives.[18]

The ECB must be consulted[19] on matters that fall within its fields of competence, such as currency matters, means of payment, national central banks, statistical issues, payment and settlement systems, as well as rules applicable to financial institutions insofar as they materially influence the stability of financial institutions and markets. The ECB has been consulted in a number of issues, since, in addition to stability, the ESCB is also committed to fostering efficiency and integration of European financial markets and market infrastructures.

---

[15] Emergency liquidity assistance (ELA) is also called the lender of last resort (LLR). Central banks can grant such credit to financially sound but temporarily illiquid banks, beyond normal monetary policy amounts.

[16] For instance, ECB (2002b) and (2003c).

[17] ECB (2003a) and (2003e).

[18] This is based on the harmonised regulation determined on the basis of the Treaty establishing the European Community and other related regulation as mentioned in the Statute of the ESCB and the ECB.

[19] This requirement is based on the Article 105(4) of the Treaty establishing the European Community.

Central banks have ongoing cooperation on several stability-related issues with other national authorities, especially banking supervisors. Cooperation is particularly close in crisis situations. One of the aims of this cooperation is to foster national authorities' commitment to legislative and regulatory framework that strives for both the freedom of the single market and financial stability. Despite integration, responsibility for crisis management remains solely with national authorities. It is therefore essential that crisis management be planned in cooperation with national authorities of different countries. In some countries, eg Belgium, Germany and the United Kingdom, authorities have established official committees to discuss issues related to the shock resilience and stability of the overall financial system. Management of the consequences of potential shocks and, inter alia, the sufficiency of contractual arrangements between authorities, are also among the important issues.[20] In Finland, authorities analyse the strengths and weaknesses of the Finnish financial system as a whole and assess the vulnerability of the system using stress tests within the regularly-convening SWOT Working Group. The Working Group has also agreed on principles on the management of a possible financial system crisis (see also sec. 7.4).

7.5.2 Cooperation in the field of stability, supervision and oversight at EU and international level

Central banks of the EU take part in ESCB cooperative work mainly via two ESCB committees and their working groups. The analytical tools used and the statistical data collection principles are largely determined by the ESCB.

The Banking Supervision Committee (BSC) is one of the committees of the ESCB. All central banks and banking supervisory authorities of EU countries are represented in the BSC. It is the main body for assisting the Eurosystem and ESCB in accomplishing its above-mentioned tasks. The Committee is responsible for carrying out a significant part of the macro-prudential analysis of the euro area and EU countries. At the same time, it may also act as a forum for consultations among EU banking supervisors on issues not related to the supervisory tasks of the Eurosystem. The BSC has developed a framework for macro-prudential analysis of problems and risks encountered by the EU banking systems.

[20] For details, see eg Bank of England (2003) and (1997).

The ESCB Payment and Settlement Systems Committee (PSSC) coordinates euro area oversight and frames oversight policy. The Committee has adopted principles for evaluating payment systems as well as standards for securities settlement systems. Most of the oversight methods used in the EU are based on global principles. However, increased cross-border business activity and changes in competitive positions and in participants' risk profiles also suggest that national central banks' evaluation criteria should be more harmonious. For this reason, standards are revised in a more detailed manner than before. One example of this is the cooperation between the ESCB and the Committee of European Securities Regulators (CESR), to create standards for securities settlement systems. These standards are based on the global recommendations of the Committee on Payment and Settlement Systems (CPSS) of the central banks of the Group of Ten countries and the International Organization of Securities Commissions (IOSCO), which are aimed at minimising systemic risk and ensuring the reliability of securities clearing and settlement.

In addition to cooperation committees and working groups, another important coordination mechanism used by the authorities is the multilateral Memorandum of Understanding (MoU). These have usually been prepared within the PSSC and the BSC (for further details, see sec. 7.4). In 2001, payment systems overseers and banking supervisors signed an MoU on specific arrangements for cooperation in relation to large-value payment systems.[21] The MoU was updated in summer 2004. An MoU on cooperation between the banking supervisors and central banks of the EU in crisis management situations[22] was signed in 2003. In addition to these, a crisis exercise was conducted in order to evaluate operational readiness in exceptional circumstances.

The Statute of the ESCB stipulates how the Eurosystem is to be represented at the international level.[23] Responsibility for the management of international relations and formulation of Eurosystem, ESCB and ECB positions lies with the International Relations Committee (IRC). The emphasis and changes therein of discussions on financial stability among authorities, including eg US market supervision authorities, that take place in international fora for cooperation are highly visible in the work of the ESCB.

[21] ECB (2001b).
[22] ECB (2003b).
[23] Eg ECB (2001a).

Nordic authorities' mutual regional cooperation in stability and crisis management has been very close due to the advanced integration of Nordic banking groups, financial conglomerates, stock exchanges, and clearing organisations. In summer 2003, Nordic countries' central banks signed a multilateral MoU on the management of a financial crisis in banks with cross-border establishments.[24] Nordic supervisors have also signed similar extensive mutual supervisory agreements and established supervisory groups in this connection.

Central banks play an important role in cooperation on stability and crisis management within the G10 and at the global level. In particular, the ECB has close relations with and participates in committees and working groups of the European Commission, CESR, IOSCO (see sec. 7.4), IMF, BIS, FSF (Financial Stability Forum) and several other organisations. Central bank committees working within the BIS are the CPSS and the CGFS (see table 2).

Central banks participate in the work of the IMF and World Bank, particularly through the Financial Sector Assessment Program (FSAP), which was launched by the two organisations in 1999 (see sec. 7.3.1). The assessments are conducted in changing and independent international compositions, representing also the central banks (for further details see sec. 7.4). It is also relevant that the European Commission Observer take part in the agenda issues related to stability, regulation and supervision in the meetings of the ESCB committees and working groups, and that the ECB has been granted similar status in the European Commission working group meetings with respect to the same agenda issues. In addition, the ECB has increased its cooperation with market participants, and its role as a catalyst has become more important. This way the ECB can expound its views on issues that are important in terms of stability and efficiency.

7.5.3 Challenges ahead

In recent years, several banks and central securities depositories, also those operating in Nordic countries, have relocated outside their home countries. Internalisation and the development of large payment and settlement systems have affected dependencies between banks and between banks and other financial institutions. There are frequently large open intraday positions between market participants.

[24] Eg Bank of Finland (2003).

Internationalisation poses challenges for authorities. It must be certain that, even in the face of change, crisis management methods are sufficient and that the robustness of the national financial system as a whole is not threatened in any circumstances. This means, above all, that EU central banks must cooperate in assessing potential vulnerabilities of financial systems and in stability analysis. Regional and global cooperation and coordination between central banks is also becoming increasingly important.

The central challenges that arise are related to the coordination and convergence of banking and securities market supervisors' and central banks' regulatory, supervisory and oversight arrangements at the European level. Even in the Nordic markets, central banks have for several reasons differing views on both macro-prudential analysis and oversight of infrastructure. Cooperation between authorities should be upgraded so that crisis management can be conducted effectively and without hindrance in potential financial crisis situations.

7.6 Summary and outlook

Financial market integration has progressed rapidly in recent years, but at different speeds in different sectors. Integration, technological development and the introduction of the euro have accelerated structural change in the financial sector. Companies have become bigger in size, the cross-border trade on financial services has expanded, and large multinational financial and insurance conglomerates have been established.

Against this background, more weight has been given to issues related to financial market regulation and supervision within EU policies. Their significance has been emphasised by the fact that the deepening and widening of financial market integration play a central role in the Lisbon Strategy adopted by the EU. According to the European Commission, improvements in financial markets have considerable effects on growth and employment.

The regulation of financial markets began in the form of directives at the end of the 1970s in the banking sector. All financial market segments have gradually been regulated through directives or regulations. The introduction of the euro, the start of the single monetary policy in the euro area, and continuing structural changes have forced the EU to renew and enhance its regulation. Increasing attention has also been placed on consumer protection, prevention of

the financing of money laundering and terrorism, and – with the growth of business size – issues connected to competition.

One question that has been presented more often is whether the structures for regulation and supervision in the EU are adequate for securing the stability and reliability of the financial markets as integration progresses and structural changes continue. Another question that has been raised deals with the problem of whether the wide differences between national supervisory practices are hampering progress towards integration. The third question is whether the slow preparation of legislation and its inadequate implementation are preventing the extension of integration.

The European commission has sought answers to these questions and taken action to address the problems and shortcomings. The European Parliament and EU Council have actively supported the Commission in this task.

The Financial Services Action Plan (FSAP) launched in 1999 is an extensive package of measures aimed at developing legislation. The Action Plan has now reached its final stages of complementation. The FSAP focuses on developing unified financial market regulation in the EU in order to support integration and efficiency and to maintain stability of and confidence in financial markets. Preparations for a new but a more restricted Action Plan (post-FSAP) have already been started. It is currently considered important that the original FSAP be implemented thoroughly and harmoniously at the national level.

The Lamfalussy process launched in the securities market a few years ago is aimed at enhancing and speeding up the preparation of legislation. The new European Securities Committee (ESC), established at the same time, has a key role in this work. Consulting with market participants is also essential for improving the quality of legislation.

The organisation of supervision varies considerably across EU countries, and the differences have remained in place despite the fast tempo of organisational reforms in recent years. The central bank has a key role in banking supervision in about half of the EU countries. Irrespective of the supervisory role, all EU central banks share the common task of oversight of payment and settlement systems and so-called overall stability. In addition to oversight, this responsibility also includes analysis and preparedness for threats to stability and the development of crisis management. The ECB and the central banking system as a whole have a similar role. The need for cooperation between central banks and supervisors has increased with integration and structural changes, and it has been enhanced by committee work and MoUs in connection with crisis management.

The geographic areas of monetary policy and supervision are totally different. Monetary policy is fully common from the euro area perspective, but each individual country is solely responsible for its own supervision and crisis management. Many consider this arrangement problematic. Progress towards integration and ongoing structural changes have posed more challenges to supervision. These challenges have been addressed by increasing the cooperation between supervisory authorities of different countries. New supervisory committees have been established as part of the Lamfalussy process. Their task is to assist with preparation of directives and technical implementation instructions, and to develop supervisory cooperation and crisis management and, above all, the convergence of supervisory methods and practices. If the progress on convergence is not sufficient, the need to centralise supervisory structures in the EU will grow.

In developing EU regulation and supervision, more attention should be paid to the global perspective. The internationalisation of financial markets is progressing rapidly, and as a result the importance of global fora for cooperation is accentuated. The EU, ECB and large EU countries in particular are already well represented in international committees and working groups. Small countries' activities on the international front are largely restricted to the IMF and the BIS, but they also participate to an extent in work of global committees.

References

Aglietta, M (2000) **A Lender of Last Resort for Europe.** In Goodhart, C A E. (ed.) Which lender of last resort for Europe? Central Banking Publications. London.

Aglietta, M and Scialom, L (2003) **The Challenge of European Integration for Prudential Policy.** IADB seminar on Financial safety nets. Washington DC. 13 June 2003.

Bank of England (1997) **Memorandum of Understanding between HM Treasury, the Bank of England and the Financial Services Authority.**

Bank of England (2003) **Do we need new statutory powers?** Bank of England for the Task Force on Major Operational Disruption in the Financial System 2003.

Bank of Finland (2003) **Management of a financial crisis in banks with cross-border establishments; Memorandum of Understanding between the central banks of Denmark, Finland, Iceland, Norway and Sweden.** Bank of Finland Press Release. 12 June 2003.

Basel Committee on Banking Supervision (1999) **A New Capital Adequacy Framework.** BIS. Basel Committee Publications No. 50.

Berger, A N and Smith, D C (2003) **Global Integration in the Banking Industry.** Federal Reserve Bulletin November.

Committee of Wise Men (2001) **Final Report of the Committee of Wise Men on the Regulation of European Securities Markets.** Brussels. (Lamfalyssy Report).

Council of the European Union (2003) **Ninth interim report on the implementation of the Financial Services Action Plan – the FSAP enters the Home Straight.** EF65, ECOFIN 389. Brussels.

Duisenberg, W (2004) **The Role of the Eurosystem in prudential supervision.** In Kuppens, T, Prast, H and Wessling, S (eds.) Banking Supervision at the Crossroads. Edward Elgar Publishing.

ECB (1999) **The institutional framework for financial stability.** ECB Annual Report 1999.

ECB (2001a) **The ECB's relations with international institutions and fora.** ECB Monthly Bulletin. January.

ECB (2001b) **Memorandum of Understanding on cooperation between payment systems overseers and banking supervisors in Stage Three of Economic and Monetary Union.** ECB Press Release. 2 April 2001.

ECB (2001c) **The Role of Central Banks in Prudential Supervision.**

ECB (2002a) **International supervisory cooperation.** ECB Monthly Bulletin. May.

ECB (2002b) **Recent developments and risks in the euro area banking sector.** ECB Monthly Bulletin. August.

ECB (2002c) **Structural developments in the EU banking sector.** November.

ECB (2003a) **EU banking sector stability.** February.

ECB (2003b) **Memorandum of Understanding on high-level principles of co-operation between the banking supervisors and central banks of the European Union in crisis management situations.** ECB press release 10 March 2003.

ECB (2003c) **Recent developments in the euro area banking sector.** ECB Monthly Bulletin. August.

ECB (2003d) **The integration of Europe's financial markets.** ECB Monthly Bulletin. October.

ECB (2003e) **EU banking sector stability.** November.

ECB (2001–2004) **Annual Report 2001, 2002 and 2003.**

ECB (2003f) **Developments in National Supervisory Structures.**

Economic and Financial Committee EFC (2000) **Report on Financial Stability.** Economic Papers No. 143, May 2000, EFC/ECFIN/240/00 (Brouwer Report 1).

EFC (2001) **Report of Financial Crisis Management.** Economic Papers No. 156, July 2001, EFC/ECFIN/251/01 (Brouwer Report 2).

EFC (2002) **EU Arrangements for Financial Regulation, Supervision and Stability.** Report by the EFC. November.

European Commission (2004a) **Financial Integration Monitor 2004.** Working Paper, SEC(2004)559.

European Commission (2004b) **Review of Financial Services Action Plan: Publication of reports of four independent expert groups on banking, insurance and pensions, securities and asset management.** Working document of DG internal market.

European Parliamentary Financial Services, Forum (2004) **Achievements of this Parliament in Financial Services.**

Financial Stability Forum (2004) **12 Key Standards for Sound Financial Systems.**

Financial Supervision Authority (2004) **Annual Report 2003.**

Freixas, X (2003) **Crisis Management in Europe.** In Kremers, J J M, Schoenmaker, D and Wierts, P J (eds.) Financial Supervision in Europe. Edvard Elgar Publishing.

Galati, G and Tsatsaronis, K (2001) **The Impact of the Euro on Europe's Financial Markets.** BIS Working Papers No. 100.

Goodhart, C A E (ed.) (2000) **Which Lender of Last Resort for Europe.** London. Central Banking Publications.

Group of Ten (2001) **Consolidation in the Financial Sector.**

Hartmann, P, Maddaloni, A and Manganelli, S (2003) **The euro area financial system: structure, integration and policy initiatives.** ECB Working Paper Series, Working Paper No. 230.

Heikensten, L (2004) **The Integration of European Banking: Some Regulatory Challenges.** Seminar on the integration of Financial markets in Europe. Stockholm.

Hertig, G and Lee, R (2002) **Four Predictions about the Future of EU Securities Regulation.** Anton Philips Conference on Regulatory Competition in Europe Tilburg.

Huizinga, H and Nicodème, G (2002) **Deposit Insurance and International Bank Deposits.** European Commission Economic Paper No. 164.

Koskenkylä, H (2002) **Efficiency and Competition in European Banking.** Irish Banking Review. Summer 2002.

Koskenkylä, H (ed.) (2002) **Finnish Financial Market 2002.** Bank of Finland Publications A:105.

Kremers, J J M, Schoenmaker, D and Wierts, P J (eds.) (2003) **Financial Supervision in Europe.** Edward Elgar Publishing.

Kuppens, T, Prast, H and Wesseling, S (eds.) (2004) **Banking Supervision at the Crossroads.** De Nederlandsche Bank. Edward Elgar Publishing.

Kurek, D (2004) **The EU's Financial Services Action Plan.** Danmarks Nationalbank. Monetary Review, 1st Quarter 2004.

Lastra, R M (2003) **The Governance Structure for Financial Regulation and Supervision in Europe.** Columbia Journal of European Law, Vol. 10.

Levitt, M (2001) **Does Europe want a single Market.** The Financial Regulator, 5.

Lilja, P (1999) **Strukturella förändringar i banksektorn – drivkrafter och konsekvenser.** Penning- och valutapolitik 4. Riksbanken.

Mogg, J F (2003) **Financial Markets' legislation – consequences for the structure of supervision.** Kremers, J J M, Schoenmaker, D and Wierts, P J (eds.) Financial Supervision in Europe. Edward Elgar Publishing.

Padoa-Schioppa, T (2000) **EMU and Banking Supervision.** In Goodhart, C A E (ed.) Which Lender of Last Resort for Europe? Central Banking Publications.

Padoa-Schioppa, T (2003) **Financial Supervision: inside or outside central banks?** In Kremer, J J M, Schoenmaker, D and Wierts, P J (eds.) Financial Supervision in Europe. Edward Elgar Publishing.

Padoa-Schioppa, T (2004) **The Evolving European Financial Landscape: integration and regulation, colloquium.** Groupe Caisse des Dépôts/KfW. Berlin.

Prati, A and Schinasi, G J (2000) **Financial Stability in European Economic and Monetary Union.** In Goodhart, C A E (ed.) Which Lender of Last Resort for Europe. Central Banking Publications.

Schoenmaker, D and Wierts, P (2002) **Financial Supervision: Which model for Europe?** London School of Economics, Financial Markets Group, Special Paper 143.

de Swaan, T (2004) **Convergence in Supervision: a commercial banker's perspective.** In Kuppens, T, Prast, H, Wesseling, S (eds.) Banking Supervision at the Crossroads. Edward Elgar Publishing.

Vives, X (2001) **Restructuring Financial Regulation in the European Monetary Union.** Journal of Financial Services Research, Vol. 19.

Annex 1/7

Key standards for sound financial systems

The Financial Stability Forum (FSF) established by the G7 countries and international organisations and committees has adopted 12 international standards which will help to safeguard the soundness of the international financial system (see FSF, 12 Key Standards, 2004). The standards represent the minimum requirements in each area, and all countries are expected to implement them. The Financial Sector Assessment Plan (FSAP) of the International Monetary Fund (IMF) and World Bank gives rise to stability assessments of each country's implementation and application of standards (see sec. 7.3).

The following lists the standards by areas (there are in all three areas). The issuing body is also mentioned:

I. Macroeconomic Policy and Data Transparency

1. Monetary and financial policy transparency
   Standard: Code of Good Practices on Transparency in Monetary and Financial Policies
   Issuing Body: IMF

2. Fiscal Policy Transparency
   Standard: Code of Good Practices in Fiscal Transparency
   Issuing Body: IMF

3. Data Dissemination
   Standard: Special Data Dissemination Standard/General Data Dissemination System
   Issuing Body: IMF

The SDDS is a more stringent standard and refers to countries with access to international capital markets. The GDDS refers to other countries.

II. Institutional and Market Infrastructure

Standard: Insolvency (under preparation)
Issuing Body: World Bank

The World Bank is co-ordinating a broad-based effort to develop a set of principles and guidelines on insolvency regimes. The United Nations Commission on International Trade Law (UNCITRAL), which adopted the Model Law on Cross-Border Insolvency in 1997, will help facilitate the implementation of the Insolvency Standard.

5. Corporate Governance
   Standard: Principles of Corporate Governance
   Issuing Body: OECD

6. Accounting
   Standard: International Accounting Standards (IAS)
   Issuing Body: IASB (International Accounting Standards Board)

The IASB is a private sector standard-setting body. The International Federation of Accountants (IFAC) (see item 7) is also a private sector body. All other standard-setting bodies are administrative organisations.

7. Auditing
   Standard: International Standards on Auditing (ISA)
   Issuing Body: IFAC (International Federation of Accountants) (see item 6)

8. Payment and Settlement
   Standard: Core Principles for Systematically Important Payment Systems, and Recommendations for Securities Settlement Systems
   Issuing Body: CPSS (Committee of Payment and Settlement Systems) and CPSS/IOSCO (see section 7.3)

9. Market Integrity
   Standard: The Forty Recommendations of the Financial Action Task Force (FATF)/8 Special Recommendations Against Terrorist Financing
   Issuing Body: FATF

III. Financial Regulation and Supervision

10. Banking Supervision
    Standard: Core Principles for Effective Banking Supervision
    Issuing Body: Basel Committee on Banking Supervision (BCBS)

11. Securities Regulation
    Standard: Objectives and Principles of Securities Regulation
    Issuing Body: International Organization of Securities Commissions (IOSCO)

12. Insurance Supervision
    Standard: Insurance Core Principles
    Issuing Body: International Association of Insurance Supervisors (IAIS)

Source: Financial Stability Forum (2004) 12 Key Standards for Sound Financial Systems.

Annex 2/7

Financial Services Action Plan; actual and additional measures completed by May 2004[25]

(legislative proposals in bold)

Actual measures (39):

(1) **Directive (2003/71/EC) of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading.**
(2) Commission Communication on the Application of Conduct of Business Rules under Article 11 of the Investment Services Directive (ISD) (distinction between professional and retail investors). Issued on 14 November 2000, COM(2000)722.
(3) **Directive (2003/6/EC) of 28 January 2003 on insider dealing and market manipulation (market abuse). To be transposed by 12 October 2004.**
(4) **Directive (2004/39/EC) on Financial Instruments Markets (update Investment Services Directive) adopted on 21 April 2004. The directive was based on a Commission Communication issued on 15 November 2000, (COM(2000)729), on upgrading the Investment Services Directive.**
(5) **Amendments to the 4th and 7th Company Law Directives to allow fair value accounting. Directive 2001/65/EC adopted on 27 September 2001. Transposition deadline has passed on 1 January 2004.**
(6) Commission Communication updating the EU accounting strategy. Issued on 13 June 2000, COM(2000)359.
(7) **Regulation (EC) 1606/2002 of the European Parliament and of the Council on the application of international accounting standards adopted on 19 July 2002. Publicly traded companies governed by the law of a member state are to apply international accounting standards as from 2005.**
(8) **Modernisation of the accounting provisions of the 4th and 7th Company Law Directives adopted on 16 June 2003. Directive 2003/51/EC amending Directives 78/660/EEC, 83/349/EEC, 86/635/EEC, and 91/647/EEC on the annual and consolidated accounts of companies, banks and other financial institutions and insurance undertakings. To be transposed by 1 January 2005.**
(9) Commission Communication COM(2003)286 of 21 May 2003 reinforcing the statutory audit in the EU, following Commission Recommendation 2001/256 of 15 November 2000 on quality assurance of the statutory audit (C(2000) 3304).
(10) Commission Recommendation 2001/6942 of 16 May 2002 on statutory auditor's independence in the EU: A set of fundamental principles (C(2002) 1873).
(11) Implementation of the Settlement Finality Directive 98/26/EC of 19 May 1998. In the coming months, the Commission will publish a modification of this Directive to integrate the Hague Convention into EU Law.
(12) **Directive 2002/47/EC on financial collateral arrangements adopted pm 6 June 2002. Transposition deadline has passed on 27 December 2003.**
(13) **Directive (2004/xx[26]/EC) on Take Over Bids.**

---

[25] See also http://europa.eu.int/comm/internal_market/en/finances/actionplan/index.htm.
[26] Has not yet been published in the Official Journal of the European Union.

(14) Political agreement on the European company Statute. Directive 2001/86/EC and Regulation (EC) 2157/2001 adopted on 8 October 2001. To be transposed by 8 October 2004.

(15) Commission Communication (COM(2003)284) of 21 May 2003 on modernising Company Law and enhancing Corporate Governance in the EU. The final Comparative Study report was published on 27 March 2002 (available on DG Internal Market website: http://europa.eu.int/comm/internal_market/en/company/company/news/index.htm).

(16) Commission Communication on funded Pension Schemes. Issued on 11 May 1999, COM(1999)134.

(17) Adoption of the two Directives on UCITS. Directives 2001/107/EC and 2001/108/EC of 21 January 2002.

(18) Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision adopted on 3 June 2003. To be transposed by 23 September 2005.

(19) Directive 2002/64/EC on the distance marketing of consumer financial services adopted on 23 September 2002. To be transposed by 9 October 2004.

(20) Commission Communication on clear and comprehensible information for purchasers. The work on the communication has been integrated in the context of the Commission Communication on an e-commerce policy for financial services. Issued on 7 February 2001, (COM(2001)66).

(21) Commission Recommendation 2001/193 of 1 March 2001 to support best practice in respect of information provision (mortgage credit) C(2001)477.

(22) Commission report on substantive differences between national arrangements relating to consumer-business transactions. Discussions with industry (Forum Group) and consumers are concluded. Information gathered is used for further Commission initiatives in the field of retail financial services.

(23) Interpretative communication on the freedom to provide services and the general good in insurance. Issued on 2 February 2000, C(1999)5046.

(24) Directive 2002/92/EC on insurance mediation of 9 December 2002. To be transposed by 15 January 2005.

(25) Commission Communication on a single market for payments. Issued on 31 January 2000, COM(2000)36.

(26) Commission Action Plan to prevent fraud and counterfeiting in payment systems. Issued on 9. February 2001, COM (2001)11.

(27) Commission Communication on an e-commerce policy for financial services. Issued on 7 February 2001, COM(2001)66.

(28) Adoption of the proposed Directive on the reorganisation and winding-up of credit institutions. Directive 2001/17/EC adopted on 19 March 2001.

(29) Adoption of the proposed Directive on the reorganisation and winding-up of credit institutions. Directive 2001/24/EC of 4 April 2001. To be transposed by 5 May 2005.

(30) Directive 2000/46/EC on the taking up, pursuit and prudential supervision of the businesses of electronic money institutions. Adopted on 18 September 2000.

(31) Amendment to the Money Laundering Directive. Directive 2001/97/EC adopted on 4 December 2001.

(32) Commission Recommendation 2000/408 of 23 June 2000 on disclosure of financial instruments, C(2000)1372.

(33) Amendments to the solvency margin requirements in the Insurance Directives. Directives 2002/12/EC and 2002/13/EC adopted on 5 March 2002.

(34) Amendments of the Insurance Directives and the Investment Services Directive to permit information exchange with third countries. Directive 2000/64/EC adopted on 7 November 2000.

(35) Directive on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate. Directive 2002/87/E of 16 December 2002.To be transposed by 11 August 2004.

(36) Creation of two Securities Committees. Decision of 6 June 2001 setting up the European Securities Committee – ESC (C(2001)1493) and Decision of 6 June 2001 setting up the Committee of European Securities Regulators – CESR (C(2001)1501).

(37) Directive 2003/48/EC on the taxation of savings income in the form of interest payments. Adopted on 3 June 2003. Transposition deadline has passed on 1 January 2004 with application deadline on 1 January 2005.

(38) Directive 2004/xx[27]/EC on the harmonisation of transparency requirements with regard to information about issuers whose securities are admitted to trading on a regulated market (Transparency Directive).

(39) Commission Recommendation (2001)447 of 1 March 2001 on pre-contractual information to be given to consumers by lenders offering home loans.

Further (5) measures not included in the original FSAP plan, *the first measure is completed:*

(1) Second Commission Communication on securities clearing and settlement (COM(2004)312). Issued on 28 April 2004. The Communication is based on the Commission Communication (COM(2002)257) of 28 May 2002 and the information obtained in the following consultation.

(2) Work on Insurance Guarantee Schemes. Ongoing measure. Technical level work started in February 2002 on the basis of the work existing for banking sector and securities.

(3) Reinsurance supervision. The Commission presented its proposal for a Directive on a fast-track reinsurance supervision (COM(2004)273) on 21 April 2004.

(4) Fundamental review of the solvency system in insurance (Insurance Solvency II). Ongoing process aimed at representing a proposal for a framework Directive in early 2005.

(5) Third Money Laundering Directive of the EU. Commission Communication was presented on 22 April 2004. The project is connected with the progress of the work undertaken by the Financial Task Force on Money Laundering FATF.

[27] The directive has not yet been published in the Official Journal of the European Union.

Annex 3/7

New capital adequacy framework pillars (Basel II)

Pillar I Minimum capital requirements	Pillar II Supervisory review process	Pillar III Market discipline
• Sets minimum capital requirements. • Introduces an explicit treatment of operational risk. • Increases the risk sensitivity of minimum capital requirements for credit risk, market risk and operational risk. • Provides distinct alternative methodologies for calculating minimum capital requirements. • Allows banks to make use of their own internal credit risk rating information and apply internal advanced models in market and operational risk.	• Requires supervisors and supervised entities to conduct a sound capital adequacy assessment in relation to bank's overall risk profile. • Allows consideration of risks not covered or partially covered under pillar I rules, as well as evaluation of internal control and risk management. • Includes assessment of necessary capital buffers. • Also covers assessment of compliance with minimum standards and requirements for pillar I methodologies and pillar III disclosure requirements.	• Aims at fostering market discipline. • Sets minimum disclosure requirements and describes principles for having a formal disclosure policy approved by the board of directors. • Widens the range of disclosure requirements.

Supervised entity is required to have
- a well thought-out strategic capital plan based on the underlying business strategy
- a systematic process for setting capital targets and assessing overall capital adequacy and risk bearing capacity

Source: Financial Supervision Authority (2003) Annual Report 2002.

Annex 4/7

Recommendations of the Brouwer Reports prepared under the aegis of the EFC

The first Brouwer Report[28] included the following recommendations for safeguarding financial stability:

– Strengthening cross-sector cooperation of supervisors at the international level, ie cooperation on supervising international financial conglomerates.
– Strengthening the monitoring of large international groups and the exchange of information on them among supervisory authorities of different countries, and between supervisory authorities and central banks.
– Strengthening cooperation between supervisory authorities and ministries in the preparation of legislation.
– Strengthening cooperation between supervisors and central banks, especially with respect to crisis management.
– Working on convergence of supervisory practices in the EU, especially to enhance supervision of cross-border financial institutions.

The second Brouwer report[29] examined crisis management in the EU. The report made the following recommendations:

– Supervisory authorities should ensure that financial institutions are able to generate accurate information on financial position at short notice in all circumstances. Major institutions should perform stress tests and have contingency procedures for crisis situations.
– In a crisis situation, all authorities should be informed in a timely manner. Any remaining legal impediments to information exchange should be removed. Each authority should develop its own checklist of the main issues to be addressed in a crisis.
– For the major financial institutions and conglomerates, agreement should be reached on the coordinating supervisor and its responsibilities in crisis situations.

[28] EFC 2000.
[29] EFC 2001.

– Supervisory authorities should further develop MoUs to deal more concretely with issues related to crisis management.
– Competition authorities should develop timely and robust procedures for considering the competitive implications of crisis management measures.

Sources: EFC (2000) Report on Financial Stability. Economic Papers no 143. EFC/ECFIN/240/00 and EFC (2001) Report of Financial Crisis Management. Economic Papers no 156. EFC/ECFIN/251/01.

Annex 5/7

Supervision of banking and insurance conglomerates in Finland

The ever-closer cooperation between the financial and insurance sectors increasingly emphasises the need for joint banking and insurance monitoring in the supervision of all banking groups.

The Sampo Group is jointly supervised by the Financial Supervision Authority and the Insurance Supervision Authority, with the FSA acting as the coordinating authority. Identification of risks at conglomerate level and assessment of their significance to the whole conglomerate are the most important tasks in the supervision of financial and insurance conglomerates.

The Nordea Group is supervised jointly by the supervisory authorities of the Nordic countries. The objective is to supervise the Group's risk areas, taking the risks of the Group's various companies operating in several countries into consideration and thus allowing comprehensive supervision of group-level risks. The supervisory responsibilities are divided between the authorities of the different countries largely according to the structure of the Group. Responsibilities and segregation of duties may change due to reorganisations of this structure.

In addition to the FSA, the amalgamation of cooperative banks is also supervised by the OKO Bank Group Central Cooperative. The FSA's supervision focuses on the amalgamation as a whole. Here it is important to identify the significant risks of the amalgamation. These FSA emphasises the responsibility of the amalgamation's central institution in the supervision of the individual member cooperative banks. Considering the management of overall risks in the amalgamation, the central institution must have adequate supervisory rights in relation to the individual member banks of the amalgamation.

The Savings Bank Inspectorate supervises the savings banks, and the FSA guidelines and supervises the inspectorate. Structural plans of the group of savings banks influence the allocation of supervision so that proper account is taken already at the planning stage to identifying and managing risks related to the arrangements.

Source: Financial Supervision Authority (2003) Annual Report 2002.

Annexes

Annex 1. Financial directives and decisions 218
Annex 2. Financial services action plan 1999 224
Annex 3. Abbreviations 228

Annex 1.

Financial directives and decisions

1. Stock exchanges and securities markets

- Council Recommendation of 25 July 1977 concerning a European code of conduct relating to transactions in transferable securities (77/534/EEC)
- Council Directive 79/279/EEC of 5 March 1979 coordinating the conditions for the admission of securities to official stock exchange listing
- Council Directive 80/390/EEC of 17 March 1980 coordinating the requirements for the drawing up, scrutiny and distribution of the listing particulars to be published for the admission of securities to official stock exchange listing
- Council Directive 82/121/EEC of 15 February 1982 on information to be published on a regular basis by companies the shares of which have been admitted to official stock-exchange listing
- Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS). Amended on 21 January 2002 (2001/107/EC) and (2001/108/EC).
- Council Directive 88/627/EEC of 12 December 1988 on the information to be published when a major holding in a listed company is acquired or disposed of
- Council Directive 89/298/EEC of 17 April 1989 coordinating the requirements for the drawing-up, scrutiny and distribution of the prospectus to be published when transferable securities are offered to the public
- Council Directive 89/592/EEC of 13 November 1989 coordinating regulations on insider dealing
- Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field
- Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor-compensation schemes

- Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems
- Directive 2001/34/EC of the European Parliament and of the Council of 28 May 2001 on the admission of securities to official stock exchange listing and on information to be published on those securities. This directive ('Prospectus Directive') combines aforementioned directives 79/279/EEC, 80/390/EEC, 82/121/EEC and 88/627/EEC.
- Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements
- Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse)
- Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC
- Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments ('Investment Services Directive II')
- Directive 2004/??/EC of the European Parliament and of the Council coordinating reporting requirements for issuers of securities in regulated markets

2. Banks

- Council Directive 73/183/EEC of 28 June 1973 on the abolition of restrictions on freedom of establishment and freedom to provide services in respect of self-employed activities of banks and other financial institutions
- First Council Directive 77/780/EEC of 12 December 1977 on the coordination of the laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions
- Council Directive 86/635/EEC of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions
- Council Directive 89/117/EEC of 13 February 1989 on the obligations of branches established in a Member State of credit institutions and financial institutions having their head offices

outside that Member State regarding the publication of annual accounting documents

- Council Directive 89/299/EEC of 17 April 1989 on the own funds of credit institutions
- Second Council Directive 89/646/EEC of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC
- Council Directive 89/647/EEC of 18 December 1989 on a solvency ratio for credit institutions
- Commission Recommendation 90/109/EEC of 14 February 1990 on the transparency of banking conditions relating to cross-border financial transactions
- Council Directive 91/308/EEC of 10 June 1991 on prevention of the use of the financial system for the purpose of money laundering
- Council Directive 92/30/EEC of 6 April 1992 on the supervision of credit institutions on a consolidated basis
- Council Directive 92/121/EEC of 21 December 1992 on the monitoring and control of large exposures of credit institutions
- Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investments firms and credit institutions
- Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes
- Directive 97/5/EEC of the European Parliament and of the Council of 27 January 1997 on cross-border credit transfers
- Directive 1999/93/EC of the European Parliament and of the Council of 13 December 1999 on a Community framework for electronic signatures
- Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions. This directive combines aforementioned Directives 73/183/EEC, 77/780/EEC, 89/299/EEC, 89/646/EEC, 89/647/EEC, 92/30/EEC and 92/121/EEC.
- Directive 2000/31/EC of the European Parliament and of the Council of 8 June 2000 on certain legal aspects of information society services, in particular electronic commerce, in the Internal Market ('Directive on electronic commerce')
- Directive 2000/46/EC of the European Parliament and of the Council of 18 September 2000 on the taking up, pursuit of and prudential supervision of the business of electronic money institutions

- Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions
- Directive 2001/65/EC of the European Parliament and of the Council of 27 September 2001 amending Directives 78/660/EEC, 83/349/EEC and 86/635/EEC as regards the valuation rules for the annual and consolidated accounts of certain types of companies as well as of banks and other financial institutions
- Directive 2001/97/EC of the European Parliament and of the Council of 4 December 2001 amending Council Directive 91/308/EEC on prevention of the use of the financial system for the purpose of money laundering – Commission Declaration
- Regulation (EC) No 2560/2001 of 19 December 2001 of the European Parliament and of the Council on cross-border payments in euro
- Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate and amending Council Directives 73/239/EEC, 79/267/EEC, 92/49/EEC, 92/96/EEC, 93/6/EEC and 93/22/EEC, and Directives 98/78/EC and 2000/12/EC of the European Parliament and of the Council

3. Insurance

- Council Directive 64/225/EEC of 25 February 1964 on the abolition of restrictions on freedom of establishment and freedom to provide services in respect of reinsurance and retrocession
- First Council Directive 73/239/EEC of 24 July 1973 on the coordination of laws, regulations and administrative provisions relating to the taking-up and pursuit of the business of direct insurance other than life assurance (‘First Non-Life Insurance Directive’)
- Council Directive 73/240/EEC of 24 July 1973 abolishing restrictions on freedom of establishment in the business of direct insurance other than life assurance
- First Council Directive 79/267/EEC of 5 March 1979 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of direct life assurance (‘First Life Assurance Directive’)
- Second Council Directive 88/357/EEC of 22 July 1988 on the coordination of laws, regulations and administrative provisions

relating to direct insurance other than life assurance and laying down provisions to facilitate the effective exercise of freedom to provide services and amending Directive 73/239/EEC ('Second Non-Life Insurance Directive')

- Council Directive 90/619/EEC of 8 November 1990 on the coordination of laws, regulations and administrative provisions relating to direct life assurance, laying down provisions to facilitate the effective exercise of freedom to provide services and amending Directive 79/267/EEC ('Second Life Assurance Directive')
- Council Directive 91/674/EEC of 19 December 1991 on the annual accounts and consolidated accounts of insurance undertakings
- Council Directive 91/675/EEC of 19 December 1991 setting up an insurance committee
- Council Directive 92/49/EEC of 18 June 1992 on the coordination of laws, regulations and administrative provisions relating to direct insurance other than life assurance and amending Directives 73/239/EEC and 88/357/EEC ('Third Non-Life Insurance Directive')
- Council Directive 92/96/EEC of 10 November 1992 on the coordination of laws, regulations and administrative provisions relating to direct life assurance and amending Directives 79/267/EEC and 90/619/EEC ('Third Life Assurance Directive')
- Directive 98/78/EC of the European Parliament and of the Council of 27 October 1998 on the supplementary supervision of insurance undertakings in an insurance group
- Directive 2000/31/EC of the European Parliament and of the Council of 8 June 2000 on certain legal aspects of information society services, in particular electronic commerce, in the Internal Market ('Directive on electronic commerce')
- Directive 2001/17/EC of the European Parliament and of the Council of 19 March 2001 on the reorganisation and winding up of insurance undertakings
- Directive 2002/65/EC of the European Parliament and of the Council of 23 September 2002 concerning the distance marketing of consumer financial services and amending Council Directive 90/619/EEC and Directives 97/7/EC and 98/27/EC
- Directive 2002/83/EC of the European Parliament and of the Council of 5 November 2002 concerning life assurance
- Directive 2002/92/EC of the European Parliament and of the Council of 9 December 2002 on insurance mediation
- Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of

credit institutions, insurance undertakings and investment firms in a financial conglomerate and amending Council Directives 73/239/EEC, 79/267/EEC, 92/49/EEC, 92/96/EEC, 93/6/EEC and 93/22/EEC, and Directives 98/78/EC and 2000/12/EC of the European Parliament and of the Council
- Commission Decision 2004/6/EC of 5 November 2003 establishing the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS)
- Commission Decision 2004/9/EC of 5 November 2003 establishing the European Insurance and Occupational Pensions Committee (EIOPC). Not yet in force (1 June 2004).

4. Other

- The European Parliament and the Council issued a regulation in June 2002 on the application of international accounting standards (IAS). In accordance with the Regulation, publicly-traded companies, such as banks and insurance corporations, governed by the law of a Member State shall prepare their consolidated accounts in conformity with the international accounting standards for each financial year starting on or after 1 January 2005.
- Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments

Annex 2.

Financial services action plan 1999

Strategic objective 1

A single EU wholesale market:

Action	Objective
Upgrade the Directives on Prospectuses through a possible legislative amendment.	Overcoming obstacles to the effective mutual recognition of prospectuses, so that a prospectus or offer document approved in one Member state will be accepted in all. In addition, incorporating "shelf registration" will provide for easier access to capital markets on the basis of streamlined prospectuses, derived from annual accounts.
Update the Directive on Regular Reporting (82/121/EEC).	More frequent and better quality information will enhance market confidence and attract capital.

Establishing a common legal framework for integrated securities and derivatives markets:

Action	Objective
Issue a Commission Communication on distinction between "sophisticated" investors and retail investors.	Summary of common interpretation of use of investor protection rules, including conduct of business rules to determine conditions under which host country business rules apply to cross-border securities transactions.
Directive to address market manipulation.	Enhance market integrity by reducing the possibility for institutional investors and intermediaries to rig markets. Set common disciplines for trading floors to enhance investor confidence in an embryonic single securities market.
Green Paper on upgrading the ISD.	Wide-ranging review of ISD as basis for integrated and efficient market for investment services. Tackle remaining obstacles to market access for brokers/dealers, obstacles to remote membership, and restrictions on trading in Tbonds. Address new regulatory challenges such as Alternative Trading systems.

Towards a single set of financial statements for listed companies:

Action	Objective
Amend the 4th and 7th Company Law Directives to allow fair value accounting.	Enabling European companies to account for certain financial assets at fair value, in accordance with International Accounting Standards.
Commission Communication updating the EU accounting strategy.	Map out strategy for enhancing comparability of financial reports issued by listed EU companies, based on combination of EU accounting Directives and financial statements issued in accordance with agreed international accounting standards. Strategy should prefigure mechanism for vetting international benchmark standards so that these can be used (with no national variations) by EU listed companies.
Modernisation of the accounting provisions of the 4th and 7th Company Law Directives.	Bringing the 4th and 7th Directives in line with the needs of the Single market and to take into account developments in international accounting standard-setting.
Commission Recommendation on EU auditing practices.	Upgrading the quality of statutory audits in the EU by recommending specific measures in the areas of quality assurance and auditing standards.

Containing systemic risk in securities settlement:

Action	Objective
Implementation of the Settlement Finality Directive.	Common and coherent application of the Directive throughout the EU is important for a smooth functioning of systems.
Directive on crossborder use of collateral.	Legal certainty as regards validity and enforceability of collateral provided to back cross-border securities transactions.

Towards a secure and transparent environment for cross-border restructuring:

Action	Objective
Political agreement of the proposed directive on Take Over Bids.	Create EU-wide clarity and transparency in respect of legal issues to be settled in event of take-over bid. Prevent pattern of EU corporate restructuring from being distorted by arbitrary differences in governance and management cultures.
Political agreement on the European Company Statute.	Create optional legal structure to facilitate companies to place pan-European operations on a rationalised single legal umbrella. Within this context clarify scope for participation by employees – thereby create further common ground in respect of corporate governance practices.
Review of EU corporate governance practices.	Identification of legal or administrative barriers and resulting differences in corporate governance regimes.
Amend the 10th Company Law Directive.	Create the possibility for companies to conduct cross-border mergers
14th Company Law Directive.	Allow companies to transfer their corporate seat to another Member State.

A Single Market which works for investors:

Action	Objective
Commission Communication on Funded pension Schemes.	Consultation on prudential framework for second-pillar pension fund schemes to protect beneficiary rights through stringent prudential safeguards and rigorous supervision.
Political agreement on the proposed directives on UCITS.	Proposal 1 will remove barriers to cross-border marketing of units of collective investment by widening assets in which funds can invest. Proposal 2 would provide a European passport for management companies, and widen the activities which they are allowed to undertake (also be authorised to provide individual portfolio management services).
Directive on the prudential supervision of pension funds.	Following the policy outlined in its Communication, the Commission will propose a Directive on the prudential supervision of pension funds. It will take into account the diversity of pension funds currently operating in the EU and will cover authorisation, reporting, fit & proper criteria and rules on liabilities and investments.

Strategic objective 2

Action	Objective
Political agreement on proposal for a Directive on the Distance Selling of Financial Services.	Proposal aims to bring about convergence of rules on business-to-consumer marketing and sales techniques. This will limit exposure of consumers to undesirable marketing techniques (inertia and pressure-selling) through inclusion of appropriate provisions (generous right of withdrawal rights, prohibitions). Once in place, distance selling via remote technologies should be free from this category of impediment.
Commission communication codifying clear and comprehensible information for purchasers.	Establish over-arching view of basic information requirements consumers need in order to assess credential of (cross-border) service suppliers, security/performance of services offered by latter (plus redress). Examine extent to which these requirements are complied for range of retail financial services.
Recommendation to support best practice in respect of information provision (mortgage credit).	Building on discussions in Consumer Dialogue, the Commission will publish a communication to endorse understanding in respect of information to be provided in event of cross-border provision of mortgage credit services. Commission involvement in monitoring of compliance.
Commission report on substantive differences between national arrangements relating to consumer-business transactions.	The report will catalogue obstacles to cross-border business-to-consumer transactions for relevant financial services. This will provide analysis of whether, how and why host-country consumer rules apply and determine conditions under which equivalence of national rules does/does not exist. Provide objective and empirical basis for discussion with MS and EP on how to facilitate cross-border provision of retail financial services without jeopardising consumer safeguards.
Interpretative Communication on the freedom to provide services and the general good in insurance.	Greater legal certainty and clarity for Member States, insurance undertakings and citizens, contributing to the creation of the single market.
Proposal for amendment of Insurance Intermediaries Directive.	Facilitation of the free provision of services by insurance intermediaries and enhanced consumer protection by updating and introducing safeguards on professionalism and competence. By creating stringent common ground-rules for intermediaries can facilitate placing on market of insurance premia by partner country underwriters.
Commission Communication on a single market for payments.	Will provide a road-map for public and private agencies with a role to play in ensuring that secure and cost-effective retail payments can be effected on a cross-border basis. At present, such transactions incur charges which are much higher in average than those within domestic payments systems – a situation which is untenable within a single currency zone. The Communication will focus heavily on credit transfers but will also address card payments, cheques and cash.
Commission Action Plan to prevent fraud and counterfeiting in payment systems.	Agree on ways to prevent fraud, e.g. in organising the exchange of data or increasing the security of technical systems.
Commission green paper on an ecommerce policy for financial services.	A clear and coherent policy for the whole financial sector, which takes account of existing rules, wider international developments, and technological progress.

Strategic objective 3

Action	Objective
Adopt the proposed directive on the winding-up and liquidation of insurance undertakings.	Provide a coherent legal framework for the winding-up and liquidation of insurance companies in the single market through the mutual recognition of proceedings and the principles of unity, universality, publicity and nondiscrimination.
Adopt the proposed directive on the winding-up and liquidation of banks.	Common rules on winding-up and liquidation will establish common principles for procedures to be followed in event of bank insolvency, identify responsible authority. As such will safeguard against continued activities by insolvent institutions which could represent source of counterpart risk.
Adopt the proposal for an Electronic Money directive.	Ensure market access and adequate regulation of e-money providers: clarify the prudential rules under which institutions other than traditional credit institutions can provide e-money services. Enable provision of this activity on crossborder basis.
Amendment of the money laundering directive.	Combat fraud and money laundering in the financial system to widen definition of predicate offences and to extend reporting ('suspicious transactions') requirements to relevant nonfinancial professions.
Commission Recommendation on disclosure of financial instruments.	Enhanced disclosure of the activities of banks and other financial institutions to allow investors to take informed decisions, and to foster market transparency and discipline as a complement to prudential supervision.
Amend the directives governing the capital framework for banks and investment firms.	Work on a review of the bank capital framework to reflect market developments is running in parallel with that of the G-10 Basel Committee on Banking Supervision. This work is expected to result in an overhaul of the EU's bank and investment capital framework.
Amend the solvency margin requirements in the insurance directives.	Protection of consumers in the single market by ensuring that insurance undertakings have adequate capital requirements in relation to the nature of their risks.
Proposal to amend the insurance directives and the ISD to permit information exchange with third countries.	Basis for international exchange of information to underpin financial stability.
Development of prudential rules for financial conglomerates following the recommendations of the 'Joint Forum'.	Addressing loopholes in the present sectoral legislation and additional prudential risks to ensure sound supervisory arrangements.
Creation of a Securities Committee.	A formal regulatory committee in this field will contribute to the elaboration of EU regulation in the securities area. Requires willingness on part of EU institutions to agree an appropriate comitology procedure.

General objective

Action	Objective
Adopt a Directive on Savings Tax.	The objective of the proposal is to remove disparities in tax treatment of private savings to complement the removal of obstacles to the free movement of capital and financial services will benefit the financial sector.
Implementation of the December 1997 Code of Conduct on business taxation.	Counter harmful tax competition which may significantly affect the location of business activity in the Union.
Review of taxation of financial service products.	Lower costs and remove disincentives for cross-border business.
Commission proposals for coordination of the tax arrangements governing supplementary pensions.	Building on discussions in Tax Policy Group, proposal for legislative action will be prepared to address tax treatment of crossborder contributions of migrant workers to supplementary pension funds. Will serve as a contribution to labour mobility.
Review of EU corporate governance practices.	Identification of legal or administrative barriers and resulting differences in corporate governance regimes.

Annex 3.

Abbreviations

Abbreviation	English term/explanations	Finnish term/explanation
APK	Finnish Central Securities Depository	Suomen Arvopaperikeskus
ATS	Alternative Trading System	vaihtoehtoiset kaupankäyntijärjestelmät
BAC	Banking Advisory Committee	pankkialan neuvoa-antava komitea
BCBS	Basel Committee on Banking Supervision	Baselin pankkivalvontakomitea
BIC	Bank Identifier Code	kansainvälinen pankkikoodi, BIC-koodi
BIS	Bank for International Settlements	Kansainvälinen järjestelypankki; keskuspankkien omistama ja niiden kansainvälisenä yhteistyöfoorumina toimiva pankki
BoF-RTGS	Bank of Finland Real-Time Gross Settlement System	Suomen Pankin sekkitilijärjestelmä
BSC	Banking Supervision Committee	EKPJ:n pankkivalvontakomitea
CCG	Cassa di Compensazione e Garanzia	italialainen keskusvastapuoliselvitys-yhteisö
CCP	Central counterparty	keskusvastapuoli
CEBS	Committee of European Banking Supervisors	Euroopan pankkivalvontaviranomaisten komitea
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors	Euroopan vakuutus- ja työeläkevalvontaviranomaisten komitea
CEPR	Centre for Economic Policy Research	Lontoossa sijaitseva talouspolitiikan tutkimuskeskus
CEPS	Centre for European Policy Studies	Brysselissä sijaitseva politiikan tutkimuskeskus
CESR	Committee of European Securities Regulators	Euroopan arvopaperimarkkinavalvojien komitea
CGFS	Committee on the Global Financial System	Kansainvälisen järjestelypankin (BIS) yhteydessä toimiva kansainvälisen rahoitusjärjestelmän komitea
CISA	Conference of Insurance Supervisory Authorities	Euroopan vakuutusvalvontaviranomaisten yhteistyöelin
CLICK		OM Technologyn johdannaisten kaupankäyntijärjestelmä
CLS	Continuous Linked Settlement	jatkuva linkitetty katteensiirto; CLS-järjestelmä poistaa maksuihin liittyvän toimitusriskin
COGEPS	Contact Group on Euro Payments Strategy	eurojärjestelmän ja markkinaosapuolten maksujärjestelmäalueen yhteistyöryhmä
COGESI	Contact Group on Euro Securities Infrastructure	eurojärjestelmän ja markkinaosapuolten arvopaperialueen yhteistyöryhmä
CPSS	Committee on Payment and Settlement System	Kansainvälisen järjestelypankin (BIS) yhteydessä toimiva maksu- ja selvitys-järjestelmäkomitea
EACH	European Association of Central Counterparty Clearing Houses	Euroopan keskusvastapuoliclearing-yhteisöjen (selvitystalojen) liitto
EBA	Euro Banking Association	euromaksuja välittävien pankkien yhteen-liittymä
EBC	European Banking Committee	Euroopan pankkikomitea
EBF	European Banking Federation	Euroopan pankkiyhdistysten liitto
EC	European Community	Euroopan yhteisö (EY)
Ecofin	ECOFIN	talous- ja valtiovarainministerien kokoonpanossa kokoontuva EU:n neuvosto

Abbreviation	English term/explanations	Finnish term/explanation
ECSDA	European Central Securities Depositories Association	Euroopan arvopaperikeskusten liitto
Ecu	European Currency Unit	valuuttakori, joka lasketaan tiettyjen EU:n valuuttojen painotettuna keskiarvona
EDX London		OMHEXin ja LSE:n omistama johdannaispörssi
EEA	European Economic Area	Euroopan talousalue
EEC	European Economic Community	Euroopan talousyhteisö (ETY)
EFC	Economic and Financial Committee	talous- ja rahoituskomitea (EU)
EIOPC	European Insurance and Occupational Pensions Committee	Euroopan vakuutus- ja työeläkekomitea
EKP		Euroopan keskuspankki
EKPJ		Euroopan keskuspankkijärjestelmä
EMI	European Monetary Institute	Euroopan rahapoliittinen instituutti, EKP:n edeltäjä
EMS	European Monetary System	Euroopan valuuttajärjestelmä
EMU	Economic and Monetary Union	talous- ja rahaliitto
Eonia	euro overnight index average	eoniakorko; pankkien välisiin, trans-aktioihin perustuvien euromääräisten yön yli -markkinoiden korko
EPC	European Payments Council	eurooppalaisten pankkien ja pankkijärjestöjen yhteistyöelin
ePSO	e-Payment Systems Observatory	EKP:n ylläpitämä Internet-sivusto, johon kootaan tietoja elektronisista maksu-tavoista ja mobiilimaksuratkaisuista
ESC	European Securities Committee	Euroopan arvopaperikomitea
ETA	EEA	Euroopan talousalue
ETY		Euroopan talousyhteisö (ETY)
EU	European Union	Euroopan unioni
EU-12		Euroopan talous- ja rahaliittoon kuuluvat maat (Alankomaat, Belgia, Espanja, Irlanti, Italia, Itävalta, Kreikka, Luxemburg, Portugali, Ranska, Saksa, Suomi)
EU-15		Euroopan unioniin ennen vuoden 2004 laajenemista kuuluneet maat (Alankomaat, Belgia, Espanja, Irlanti, Iso-Britannia, Italia, Itävalta, Kreikka, Luxemburg, Portugali, Ranska, Ruotsi, Saksa, Suomi, Tanska)
Euribor	euro interbank offered rate	parhaiksi luokiteltujen suurten pankkien toisilleen antamien euromääräisten luottojen korko
EURO 1		EBAn ylläpitämä suurten maksujen järjestelmä
EY		Euroopan yhteisö
FATF	Financial Action Task Force on Money Laundering	kansainvälinen rahanpesun ja terrorismin rahoituksen vastainen työryhmä
FCC	Financial Conglomerates Committee	finanssiryhmittymien sääntelykomitea (EU)
FED	Federal Reserve Bank	Yhdysvaltain keskuspankki
FESCO	Forum of European Securities Commissions	ETA-maiden arvopaperimarkkinavalvojien yhteistyöfoorumi
FESE	Federation of European Stock Exchanges	Euroopan pörssien yhdistys
FSAP	Financial Services Action Plan	rahoituspalvelujen toimintasuunnitelma (Euroopan komissio)
FSAP (IMF)	Financial Sector Assessment Program	Kansainvälisen valuuttarahaston ja Maailmanpankin rahoitusjärjestelmän arviointiohjelma
FSC	Financial Services Committee	rahoituspalvelujen komitea
FSF	Financial Stability Forum	rahoitusjärjestelmän vakautta edistävä foorumi
FSPG	Financial Services Policy Group	rahoituspalvelujen työryhmä

Abbreviation	English term/explanations	Finnish term/explanation
G7	Group of 7	Iso-Britannia, Italia, Japani, Kanada, Ranska, Saksa, Yhdysvallat
G10	Group of 10	Alankomaat, Belgia, Iso-Britannia, Italia, Japani, Kanada, Ranska, Ruotsi, Saksa, Yhdysvallat
G20	Group of 20	kahdenkymmenen pankin yhteistyöryhmä, johon kuuluu useita pankkeja samasta maasta. (Alankomaat, Iso-Britannia, Japani, Kanada, Ranska, Saksa, Sveitsi, Yhdysvallat)
G30	Group of 30	yli 30 maasta (ml. Suomi) raportoiva ryhmittymä
GdC	Croupe de Contact	ETA-maiden pankkivalvojien yhteistyöelin, joka edistää pankkivalvojien välistä yhteistyötä ja tietovaihtoa
HEXIM	HEX Integrated Markets	OMHEXin liiketoimintayksikkö (1.9.2004 alkaen liiketoimintayksikön nimi on OMX Exchanges)
HLSSC	High Level Securities Supervisors Committee	arvopaperivalvojien korkean tason komitea
IAIS	International Association of Insurance Supervisors	kansainvälinen vakuutusvalvojien järjestö
IAS	International Accounting Standards	kansainväliset tilinpäätösstandardit
IBAN	International Bank Account Number	kansainvälinen tilinumero
IC	Insurance Committee	vakuutuskomitea (EU)
ICBS	International Conference of Banking Supervisors	kansainvälinen pankkivalvojien konfe-renssi
IFRS	International Financial Reporting Standards	kansainväliset tilinpäätösstandardit
ILO	International Labour Organization	Kansainvälinen työjärjestö
IMF	International Monetary Fund	Kansainvälinen valuuttarahasto
IOSCO	International Organization of Securities Commissions	kansainvälinen arvopaperimarkkinoita valvovien viranomaisten yhteistyöjärjestö
IRC	International Relations Committee	Kansainvälisten suhteiden komitea (EKP)
ISD	Investment Services Directive	sijoituspalveludirektiivi
ISO	International Organization for Standardization	kansainvälinen standardisoimisjärjestö
ISSA	International Securities Services Association	arvopaperisäilyttäjien kansainvälinen yhteistyöjärjestö
LCH	London Clearing House	Lontoon selvityskeskus
LEC	Linked Exchange Clearing	johdannaiskaupan selvitysyhteistyö Tukholman, Kööpenhaminan ja Oslon pörssien välillä
LSE	London Stock Exchange	Lontoon pörssi
MTG	Mixed Technical Group	asiantuntijaryhmä finanssiryhmittymien sääntelyssä
NCSD	Nordic CSD	pohjoismainen arvopaperikeskus
NOREX		pohjoismainen yhteiseen kaupankäyntijärjestelmään perustuva pörssiyhteistyö
OECD	Organization for Economic Co-operation and Development	taloudellisen yhteistyön ja kehityksen järjestö
OMHEX		ruotsalais-suomalainen pörssikonserni (1.9.2004 alkaen konsernin nimi on OMX)
PEACH	Pan-European Automated Clearing House	Euroopan laajuinen selvityskeskus
PEDD	Pan-European Direct Debit	Euroopan laajuinen suoraveloitus
PMJ		pankkien välinen maksuliikennejärjestelmä Suomessa
PSGEG	Payment Systems Government Expert Group	Euroopan komission maksujärjestelmä-alueen yhteistyöryhmä (keskittyy lähinnä lakiasioihin)
PSMG	Payment Systems Market Group	Euroopan komission maksujärjestelmä-asioita käsittelevä yhteistyöryhmä

Abbreviation	English term/explanations	Finnish term/explanation
PSSC	Payment and Settlement Systems Committee	EKPJ:n maksu- ja selvitysjärjestelmä-komitea
PVP	Payment versus Payment	maksu maksua vastaan; esim. valuutta-kauppojen katteensiirtojärjestelmä, joka varmistaa varojen lopullisen siirron vain ja ainoastaan, mikäli vastapuolen lopullinen siirto tapahtuu samanaikaisesti
RATA		Rahoitustarkastus
RCAP	Risk Capital Action Plan	riskipääomaa koskeva toiminta-suunnitelma (EU)
ROSC	Report on Observance of Standards and Codes	rahoitussektorin kansainvälisten standardien ja sääntöjen noudattamista koskeva ns. ROSC-raportti
RTGS	Real-Time Gross Settlement System	reaaliaikainen bruttomaksujärjestelmä
SAXESS		OM Technologyn kehittämä pörssien osakekaupankäyntijärjestelmä
SE	Societas Europaea	eurooppayhtiö
SECUR		OM Technologyn johdannaisten selvitys-järjestelmä
SEPA	Single Euro Payments Area	yhtenäinen euromaksualue
SPY	The Finnish Bankers' Association	Suomen Pankkiyhdistys
SSS	Securities Settlement Systems	arvopaperikaupan selvitysjärjestelmä
STEP	Short Term European Paper	suunnitelma harmonisoiduista EU-alueen rahamarkkinapapereista
STEP 1		EBAn ylläpitämä pienten maksujen järjestelmä
STEP 2		EBAn ylläpitämä pienten maksujen järjestelmä
SWG	Securities Working Group	EKPJ:n maksu- ja selvitysjärjestelmä-komitean arvopaperiasioita käsittelevä alatyöryhmä
SWIFT	Society for Worldwide Interbank Financial Telecommunication	pankkien perustama tiedonsiirtojärjestö, joka ylläpitää pankkien välistä maailman-laajuista tiedonsiirtoverkkoa
TARGET	Trans-European Automated Real-time Gross settlement Express Transfer system	EU-maiden keskuspankkien yhteinen euromaksujen välitysjärjestelmä, joka toimii bruttoperiaatteella; TARGET yhdistää kansalliset RTGS-järjestelmät, joiden välillä maksut kulkevat ns. Interlinking-komponentin kautta
TARGET 2		TARGETin uusi, tekeillä oleva versio
UCITS	Undertakings for Collective Intrument in Transferable Securities	sijoitusrahastoja koskeva direktiivi
VM	Ministry of Finance	valtiovarainministeriö
VPC	Värdepapperscentralen	Ruotsin arvopaperikeskus
WATCH	Worldwide Automated Transaction Clearing House	maailmanlaajuinen automaattinen selvityskeskus
WFE	World Federation of Exchanges	arvopaperipörssien kansainvälinen yhdistys
WTO	World Trade Organization	Maailman kauppajärjestö
VVV	Insurance Supervisory Authority	Vakuutusvalvontavirasto

Publications of the Bank of Finland

Series A (ISSN 1238-1683, print) (ISSN 1456-5943, online)

(Nos. 1–35. Publications of the Bank of Finland Institute for Economic Research, 'Economic Analyses', a collections of articles from the period 1942–1972, in Finnish and Swedish, ISSN 0081-9476); nos. 36–92: Publications of the Bank of Finland in several languages, ISSN 0355-6034); nos. 93– in several languages.

A:93 Jarmo Kariluoto **Suomen maksutase. Laadintamenetelmät, tiedonhankinta ja vuosien 1975–92 aikasarjat** (Finland's Balance of Payments: Methods of Compilation, Acquisition of Data and Time Series for the Years 1975–92). 1995. 221 p. ISBN 951-686-456-2.

A:94 Juhani Laurila **Finnish-Soviet Clearing Trade and Payment System: History and Lessons**. 1995. 44 p. ISBN 951-686-469-4.

A:95 Jouko Rautava (ed.) **Russia's Financial Markets and the Banking Sector in Transition**. 1996. 201 p. ISBN 951-686-489-9.

A:96 Paavo Peisa (ed.) **Euro – yhteinen raha** (Euro – the Single Currency). 1996. 162 p. ISBN 951-686-499-6.

A:97 Juhani Hirvonen – Matti Virén **Käteisrahan käyttö suomalaisissa yrityksissä** (The Use of Cash in Finnish Business Firms). 1996. 78 p. ISBN 951-686-510-0.

A:98 Jarmo Kariluoto **Finland's Balance of Payments. Compilation methods, sources of information and the time series for 1975 to 1992**. (Finnish version – A:93). 1996. 182 p. ISBN 951-686-522-4.

A:99 Markku Malkamäki (ed.) **Suomen rahoitusmarkkinat 1996.** (Financial markets in Finland 1996). 1996. 196 p. ISBN 951-686-524-0.
(published in English as a special issue of the Bank of Finland Bulletin, 1996, see p. 5)

A:100 Harry Leinonen – Veikko Saarinen **Suomalaiset maksujärjestelmäriskit ja niiden sääntely- ja valvontatarpeet.** (English version – A:101). 1998. 89 p. ISBN 951-686-565-8.

A:101 Harry Leinonen – Veikko Saarinen **Payment system risks in Finland and the need for regulation and supervision**. (Finnish version – A:100). 1998. 89 p. ISBN 951-686-577-1.

A:102 Heikki Koskenkylä (toim.) **Suomen rahoitusmarkkinat 2002** (Finnish financial markets 2002). Compilation. (English version – A:105). 2002. 357 p. ISBN 952-462-023-5, print; ISBN 952-462-024-3, online.

A:103 Timo Iivarinen – Harry Leinonen – Matti Lukka – Veikko Saarinen **Maksujärjestelmäriskien sääntely ja hallinta – suomalainen näkökulma** (Regulation and control of payment system risks – a Finnish perspective). (English version – A:106). 2003. 136 p. ISBN 952-462-053-7, print; ISBN 952-462-054-5, online.

A:104 Katja Taipalus – Kari Korhonen – Pertti Pylkkönen **Arvopaperistaminen** (Securitisation). 2003. 180 p. ISBN 952-462-067-7, print; ISBN 952-462-068-5, online.

A:105 Heikki Koskenkylä (ed.) **Finnish financial markets 2002** (Suomen rahoitusmarkkinat 2002). Compilation. (Finnish version – A:102). 2003. 360 p. ISBN 952-462-090-1, print; ISBN 952-462-091-X, online.

A:106 Timo Iivarinen – Harry Leinonen – Matti Lukka – Veikko Sarinen **Regulation and control of payment system risks – a Finnish perspective** (Maksujärjestelmä-riskien sääntely ja hallinta – suomalainen näkökulma). (Finnish version – A:103). 2003. 135 p. ISBN 952-462-104-5, print; ISBN 952-462-105-3, online.

A:107 Heikki Koskenkylä (toim.) **Rahoitusmarkkinoiden integraatio** (Financial integration). Compilation. (English version – A:108) 2004. 233 p. ISBN 952-462-142-8, print; ISBN 952-462-143-6, online.

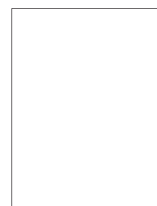
A:107 Heikki Koskenkylä (toim.) **Rahoitusmarkkinoiden integraatio** (Financial integration). Compilation. (English version – A:108) 2004. 233 p. ISBN 952-462-162-2, print; ISBN 952-462-163-0, online. Revised second edition.

A:108 Heikki Koskenkylä (ed.) **Financial integration** (Rahoitusmarkkinoiden integraatio). Compilation. 2004. (Finnish version – A:107) 231 p. ISBN 952-462-164-9, print; ISBN 952-462-165-7, online.

Suomen Pankki
Bank of Finland
PO BOX 160, FI – 00101 HELSINKI, FINLAND
Tel +358 10 8311, fax +358 9 174 872, email publications@bof.fi

Subscriptions to the A series of of the Bank of Finland's research publications and changes in address details

Old address details
Company
Name
Address
New address details/subscriptions
Company
Name
Address
New subscription ◯ Cancellation ◯ Number of copies



SUOMEN PANKKI
BANK OF FINLAND

PO BOX 160
FI – 00101 HELSINKI
FINLAND

Cut along dotted line.

ISBN 952-462-164-9
ISSN 1238-1683

Vammalan Kirjapaino Oy
Vammala 2004