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UCI-HVB: A STEP FORWARD IN EUROPEAN FINANCIAL INTEGRATION

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A view from the Central Bank*

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I) Financial integration in Europe

According to the recent financial integration report of the ECB[1] "the degree of integration varies greatly depending on the market segment. The unsecured money market has been fully integrated since shortly after the introduction of the euro. The repo market is highly integrated albeit to a lower extent. Government bond markets were significantly integrated even before the start of the EMU, although some yield differentials remain. The indicators of the corporate bond market, which has grown considerably since the advent of the single currency, point to a high degree of integration. Progress has also been made in the integration of euro area equity markets, where equity returns are increasingly determined by common factors. Banking markets are generally much less integrated".

The financial sector is lagging behind, suggesting obstacles to investment. This prompted the Commission to "remind Member States of the relevant basic Treaty freedoms in the area of cross-border investment in financial institutions and the requirement for strict proportionality in any restrictions to

[1] European Central Bank: Indicators of financial integration in the euro area – September 2005

*I wish to thank Ms Onenne Partsch from the legal services of our Bank for her contribution.

these freedoms which might be necessary to protect imperative requirements in the general interest”.[2]

Being a small open economy with a long established internationally oriented financial sector, Luxembourg has always considered cross-border investment to be a fact of life.

The merger of Unicredito with HVB is a major event in the European landscape in terms of size and countries affected. Total assets of this pan European bank with 730bn € are roughly equivalent to the combined GDP of the 3 Benelux countries and the 28 million customers also equal the population of Benelux.

II) The Eurosystem’s interest

“A well integrated financial system is of particular importance for the Eurosystem for three main reasons.

First, the financial system is used for the conduct of the monetary policy in the euro area, which is the basic task assigned to the Eurosystem under the Treaty establishing the European Community (the “Treaty”). The smooth and effective transmission of monetary policy impulses throughout the euro area is enhanced through integrated and efficient financial markets.

Second, it is important for the smooth functioning of payment and clearing systems, which is another basic task of the Eurosystem under the Treaty. Integration of capital markets is a key condition for the efficient liquidity and collateral management, which is, in turn, a basic condition for the settlement of securities and payment transactions.

Third, it is important for the interaction between the integration of financial systems and financial stability. The Eurosystem also has the task of contributing to financial stability in the euro area and the EU. The pursuit of

[2] European Central Bank: Eurosystem contribution to the public consultation on the European

financial integration can have very beneficial effects on financial stability as more integrated financial markets could provide the necessary conditions for the smoother absorption of financial shocks. It may also help financial institutions to better manage and diversify their risks and realize economies of scale, which may, in turn, lead to greater efficiency. At the same time, it is necessary to monitor more closely the challenges of financial integration for financial stability which may stem from contagion through intensified cross-border links (for instance, via market infrastructure, interbank exposures, shareholdings and participating interests). Moral hazard may also increase if larger institutions pose a higher risk to the system in the event of a failure.

The interaction between financial integration and financial stability therefore deserves continuous attention."[2]

The Eurosystem's involvement in financial integration on the basis of Article 105 of the Treaty takes three distinct channels:

a. direct action under its competence through improvement of existing infrastructure. Target2 is the outstanding example in this context;
b. contribution to the legislative process. This channel can be subdivided into 3 subchannels:
    i. Opinions concerning legislation of a more general nature in the field of competence of the ESCB
        - not only at European level such as the Capital Adequacy Directive or The Hague Convention,
        - but also opinions concerning legislation that remains at the national competence level such as securitization laws.
    ii. The second subchannel is based on Article 25 of the ESCB Statute and allows specifically for consultation on

Commission's Green Paper on financial services policy (2005-2010) – 1 August 2005
[2]European Central Bank: Eurosystem contribution to the public consultation on the European Commission's Green Paper on financial services policy (2005-2010) – 1 August 2005

prudential supervision, on payment systems oversight and stability of the financial system.

iii. The third subchannel is participation at the level of assessment of the legislative framework, for the purpose of
    - the need to regulate
    - the priorities of intervention or
    - predrafting. This is done in Level 2 or 3 committees of the Lamfalussy process, the Economic and Financial Committee, the Financial Services Committee or any appropriate level of the European architecture.

c. A third important channel is the contact of the Eurosystem this time not with the official authorities, but with subjects of official intervention or actors in the market.
    i. This can translate either into direct participation in private activities of pan-European interest such as
        1. the establishment of EONIA,
        2. STEP/ACI initiative for the standardization and harmonization of the short-term markets,
    ii. or it can take the form of consultation like the biannual informal dialogue with the financial industry at the highest level.

    At a more specialized level I could also mention the European Financial Markets Lawyers Group (EFMLG) which recommends specific legislative changes.

    It is obvious that certain important processes like the Single European Payments Area (SEPA) permeate the three institutional channels of direct intervention, interaction with the official authorities and interaction with the private actors.

III) Luxembourg and Europe

So far I have focused on where to strengthen the European integration process. But integration does not hinge on a one way road to centralization and harmonization. Subsidiarity, decentralization and proximity, as well as competition are key words in the constitutional framework of our European house.

Where do we draw the line?
What is left to public, what is left to private initiative?
We have pushed the conceptual barriers but implementation is sometimes tentative or piece-meal.

Let me only add some mosaics from this geographical speck on the map dotted with the presence of the legal and financial institutions of Europe, except for the ECB of course.

Let me start with what I know best:
Monetary policy will remain decentralized. Banks will deal with national central banks. After 7 years of operation, BCL has a balance sheet comparable to the central banks in Belgium or The Netherlands, higher than Austria, Ireland, Finland. Its off balance sheet is three times higher.

BCL is second to the Bundesbank in the provision of liquidity to the banking system.

HVB Luxembourg is one of our major counterparts in monetary policy operations.

In order to discharge our obligations in the Eurosystem we appreciate the existence of large professional counterparts. The heterogeneity of legal and cultural systems in Europe is at the basis of the subsidiarity and decentralization principles.

In the area of securities only the “ex post” life of securities has been harmonized. The “ex ante” life, i.e. rules governing the vehicle of issuance, the forms and types of securities and corporate and tax aspects remain governed by national law.

For illustration

1) ABS, CDO and risk transfer mechanisms are strongly influenced by national peculiarities.

   Let me mention in this respect that the largest ABS in the European market in 2005 was engineered by HVB Luxembourg with a 5,5 bn € transaction.

   In this country efforts to develop the legal infrastructure in this respect enjoy a high priority. Public-private cooperation has an established tradition in order to keep the financial centre’s legal surroundings at the edge of technological requirements.

   The recently established Luxembourg School of Finance, strongly influenced by the financial community, and the financial law orientation of the Legal Department of the University underlines this approach.

2) Bank loans which will play an increasing role in a broader pool of collateral are still exclusively governed by national law.

3) There is no common legal regime in sight for credit rating agencies.

4) Mortgage credit is still mainly determined by domestic law. The same goes to some extent for consumer credit. Therefore local and state of the art expertise remain an important asset in European-wide synergies exploiting economies of scale. Access to decision-making or transparency and transmission of information remain a locational asset of broad financial centres.

There is however a growing awareness on the part of the EU institutions of the limited efficiency of the measures adopted so far, in view of the national specifities as well as of the insufficient cooperation between supervisors at cross-border level and with the local authorities including national central banks.

During our last meeting at the ECB, Mr Profumo regretted that take-overs are not regulated at EU level and that in many countries the EU company statute is not in effect. I could not agree more.

But we do not need more legislation, we need better legislation.

The Commission wants to move from a hard-law model to more extensive soft-law one measuring cooperation with national supervisors/overseers and market players for the establishment of a general legal framework conducive to fostering financial integration through 1) self regulation 2) convergence of market practices and 3) setting of EU standards.

Today we see different interpretations of prudential and accounting rules, different reporting requirements and different use of the margin of discretion.

Will

- consolidation of existing legislation
- more efficient monitoring of implementation measures
- acceleration of supervisory convergence
- impact assessment of measures adopted or to be adopted

be able to create a truly level playing field?

A cooperative approach in supervision might be more successful in this respect than the recourse to a lead supervisor which does not avoid the risk of different attitudes among lead supervisors.

Better regulation and reporting are drivers for change. But equally important are

- the economic cycle and the development of capital markets
- demographic and cultural change
- technology
- politics.

Let me conclude.

In this country we know about the growth potential of the financial service sector, its share of GDP, government revenue and employment as well as its correlation with the competitiveness of the economy.

At a recent conference in Paris[3], Bart van Ark related that most of the difference in market services productivity growth between the US and Europe during 1995 and 2003 can be traced to six industries concentrated in trade and finance. Wholesale trade, retail trade and securities trade are larger sectors in the US than in Europe. ICT deepening is an important element. But according to a study by McKinsey Global Institute, the introduction of pro competitive regulations also played a significant role in this remarkable performance.

Thank you for your attention.

[3] Europe's Productivity Gap : Catching Up or Getting Stuck? - Bart van Ark, Groningen Growth and Development Centre, University of Groningen and The Conference Board Europe – November 2005