EUROPEAN CENTRAL BANK

EUROSYSTEM

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ECB

Financial Integration in Europe

2016 Report

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Joint conference of the European Central Bank and the European Commission on "Completing European Financial Integration: What Next?"

2016 contents

- **Key messages and overview (each chapter additional summary)**
- **Chapter 1. Recent developments in financial integration in the euro area**
- **Chapter 2. European institutional reform: establishing a European Deposit Insurance Scheme (EDIS)**
- **Chapter 3. Eurosystem activities for financial integration (Boxes on Capital Markets Union and financial market data standards)**
- **Special Features**
    A. Financial integration and risk sharing in a monetary union
    B. National options and discretions in the prudential legal framework for banks
    C. The future of the European retail payments market
    D. New financial integration indicators built from securities holdings statistics
- **Statistical annex (incl. full set of financial integration indicators and explanation of country groupings)**

Overall financial integration continued to recover, although moderating significantly as of late (spring/summer 2015)

- Re-integration trend since 2012 (Banking Union and OMTs)
- Fostered by monetary policy, since 2014 by SSM and since 2015 by SRM

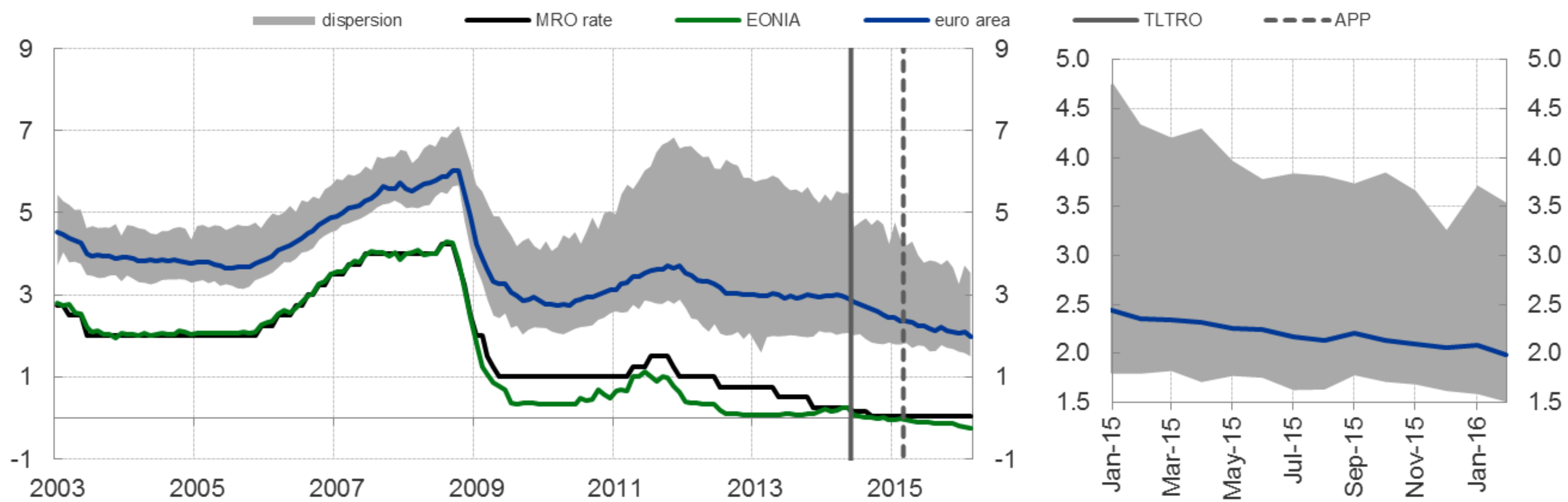
Euro area Financial INTEgration Composites (FINTECs)

Sources: ECB and ECB calculations (based on Hoffmann, Kremer and Zaharia (2015), FINTEC – A composite indicator of financial integration in Europe, see charts 1, S5 and S6 in report)

Deceleration explained by differential developments in prices and quantities of various segments: converging loan rates

- Rates to firms and households continued to converge
- Cross-border loans to firms continued to increase mildly (chart 27 in report)
- Supported by unconventional monetary policy (incl. TLTROs), gradual recovery and substantial progress with Banking Union

Composite bank lending rates for non-financial corporations (%)

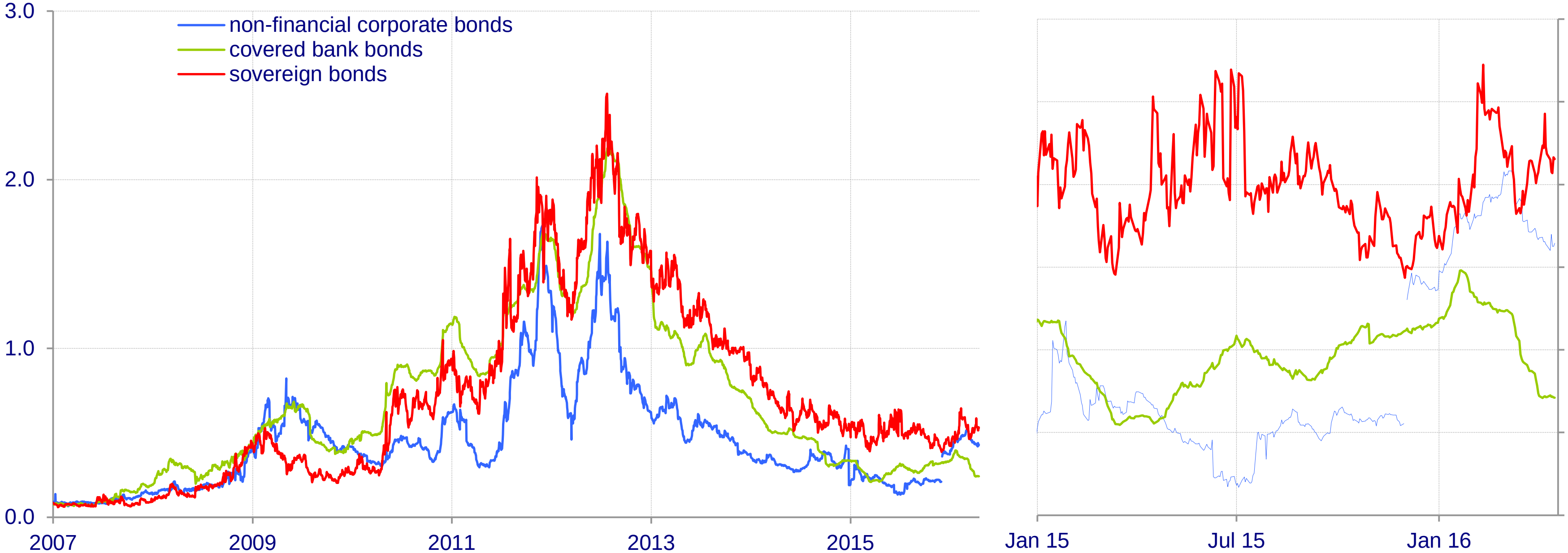


Sources: ECB and ECB calculations (see charts 24 and S32 in report)
Notes: The indicator is computed by aggregating short and long-term rates, using a 24-month moving average of new business volumes. The cross-country dispersion displays the min-max range after trimming off extreme values.

Deceleration explained by differential developments in prices and quantities of various segments: diverging bond yields

- Increasing risk aversion in global financial markets amidst EME slowdown
- Diverging economic outlooks across euro area countries
- Very recent correction though

Cross-country dispersion of bond yields (p.p.)



Sources: Thomson Reuters, Markit and ECB calculations (see chart 12 in report)
Notes: The chart shows daily standard deviations for Barclay's country indices for corporate bonds (issued by non-financial corporations), iBoxx country indices for covered bonds (issued by banks) and country ten-year benchmark government bond yields. Owing to data unavailability, data only include observations for Austria, Finland, France, Germany, Ireland, Italy, the Netherlands, Portugal and Spain. The level shift in the dispersion of non-financial corporate bonds in early December 2015 is due to technical factors in the country index for Austria.

Looking forward, it is important that recent financial turbulences do not bring re-integration process to a halt

- All the more important that various policy steps and agendas continue

1) Unconventional monetary policy aimed at price stability also leans against the risk of financial re-fragmentation
2) Single Resolution Fund of the SRM became operational this year
3) SSM runs a large project that contains “national options and discretions” (O&Ds) in the European banking regulatory framework (Special Feature B)
4) Completion of the Banking Union through a European deposit insurance
5) Priority implementation of the Commission’s action plan for the European Capital Markets Union
6) Various steps of the 2015 Five Presidents Report for completing EMU

- Not clear at this juncture whether the financial re-integration trend has tailed off

Eurosystem supports the establishment of a European Deposit Insurance Scheme (EDIS)

- Commission proposal of November 2015
- ECB opinion published last Thursday
- Chapter 2 of this report reflects and further substantiates the opinion
- EDIS is a necessary component of a single European banking system
- It is also a natural complement of the single currency, ensuring the same level of confidence in the safety of deposits irrespective of their location
- EDIS would align control (SSM) and liability (EDIS) in depositor protection
- Appropriate mechanisms should be built in that discourage risk-taking of banks originating from their depositors being insured
- Should be accompanied by continuing risk-reduction efforts in the Banking Union

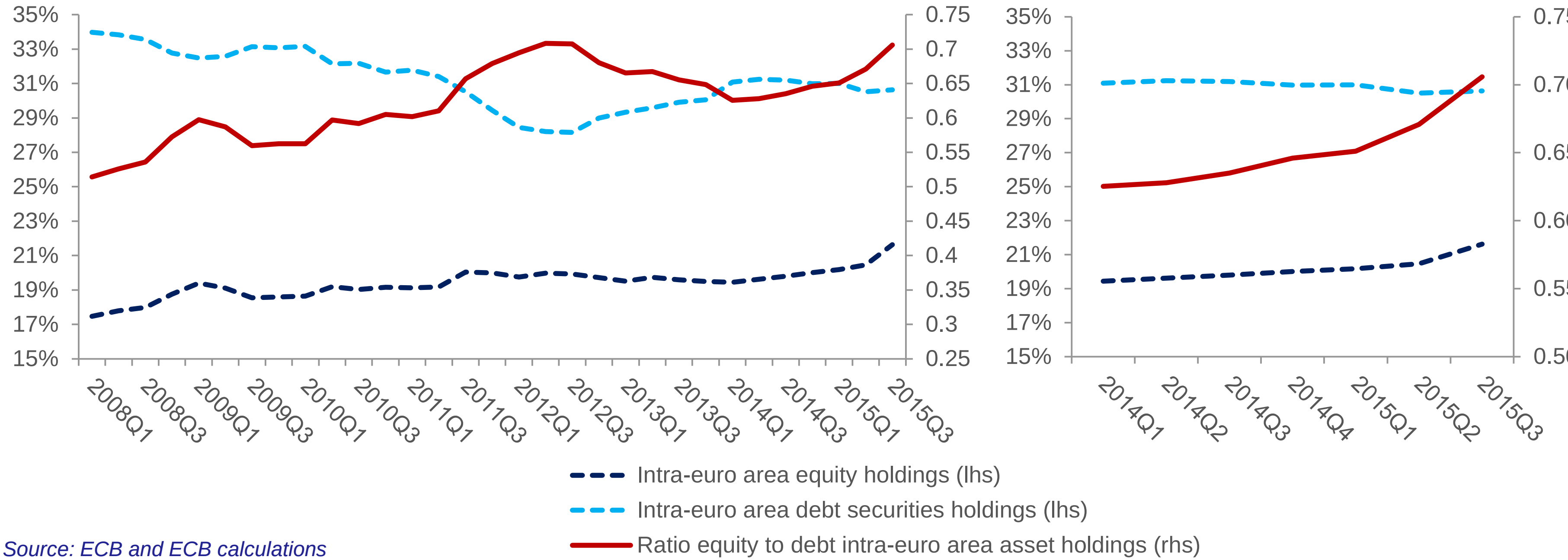
European financial system, which is more bank-oriented, needs to be strengthened by further developing and integrating capital markets

- ECB welcomes the Commission's action plan for a European Capital Markets Union (CMU) of September 2015
- We call for rapid progress towards the early actions therein
- For example, the European framework for securitisation is particularly important
- Eurosystem fully supports the need for a review of the macro-prudential framework given the implications CMU may have for financial stability
- Requires a comprehensive approach, involving a broadened supervisory perimeter that also covers systemically important non-bank financial intermediaries
- Overall, CMU would benefit from a long-term vision, paying significant attention to equity markets, and high levels of ambition
- Would enhance financial system's resilience against shocks, its contribution to risk sharing and ability to finance the real economy

In monitoring and assessing financial integration going forward, greater emphasis should be placed on how resilient integration is and whether it delivers the expected benefits

- Resilience: 1) equity versus debt; 2) long-term versus short-term debt; 3) retail lending versus interbank lending (see Special Feature A)
- These forms of integration have gained some ground in recent years

Foreign equity versus debt investments



Source: ECB and ECB calculations

Notes: The dashed blue line shows euro area countries' holdings of equity (including investment fund shares and other equity) issued by other euro area countries in % of total euro area equity holdings. The dashed cyan line shows euro area countries' holdings of debt securities issued by other euro area countries in % of total euro area debt securities holdings. The red line shows the ratio of the two shares. (See chart 1 in Special Feature A in report.)

In monitoring and assessing financial integration going forward, greater emphasis should be placed on how resilient integration is and whether it delivers the expected benefits

- Risk sharing: Cross-country asset holdings allow economic agents to better smooth income and consumption over time, because in a downturn (an upturn) in their home country they benefit from income streams of the assets they hold in countries that have an upturn (can lend to countries that have a downturn)
- Research suggests that equity holdings and retail credit are particularly valuable for this purpose (see Special Feature A)
- Risk sharing somewhat increased with the introduction of the euro but remains at relatively low level and is unstable → should improve further

- Both risk sharing and resilience of integration highlight the importance of Capital Markets Union (and Commission initiative on retail financial services)
- Both “quality” measures of integration should be monitored going forward

Financial integration in general would benefit from further harmonisation of financial market data standards

- A comprehensive system of internationally accepted identifiers is important (see Box 2 in Chapter 3)
- There should not be any security that does not have an International Securities Identification Number (ISIN)
- The issuer, guarantor and offeror of a security should be identified by the Legal Entity Identifier (LEI)
- Moreover, the ECB supports the development of Unique Transaction Identifiers (UTIs) and Unique Product Identifiers (UPI)

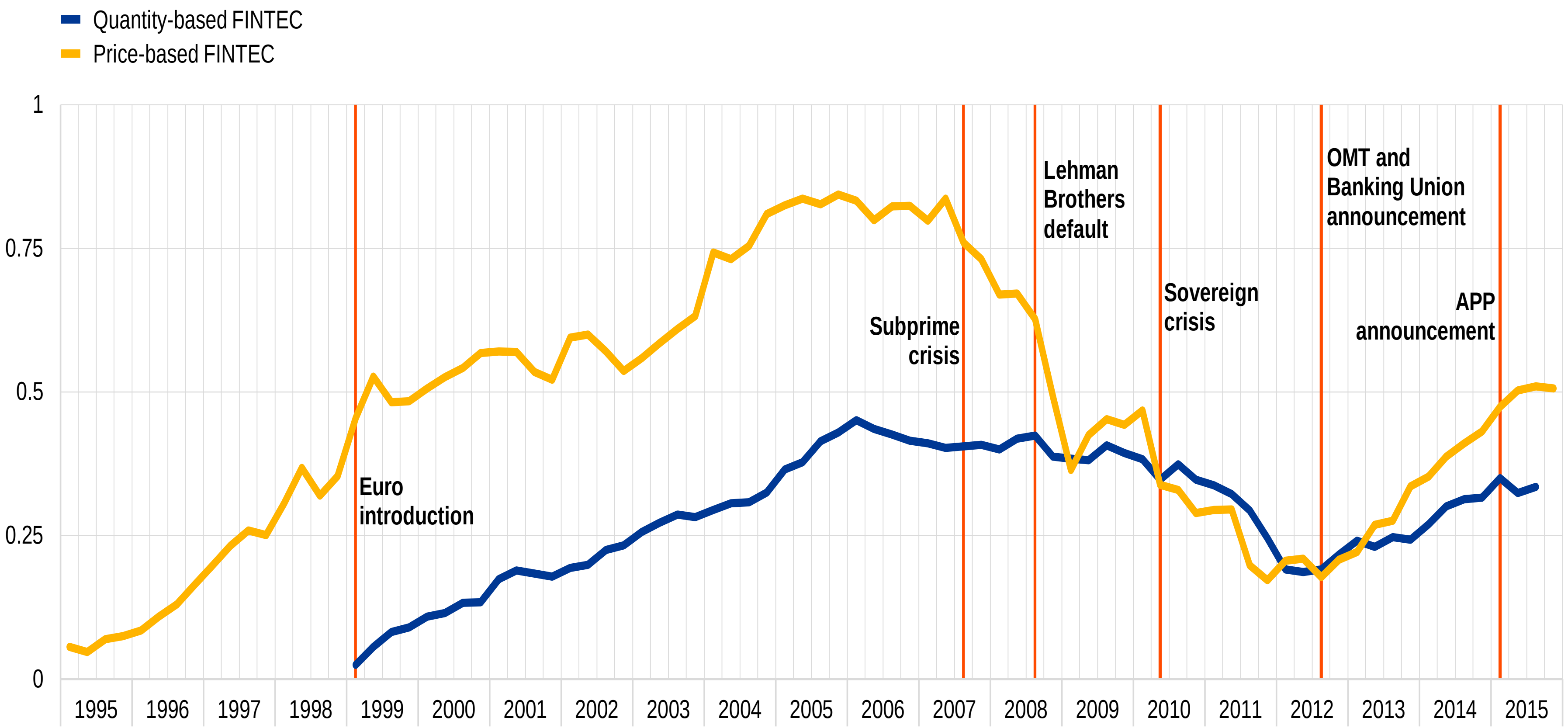
In the field of retail payments, there is a need to ensure that innovative solutions do not give rise to fragmentation and develop Europe-wide

- Recent retail payment innovations, including
  - instant payments,
  - person-to-person mobile payments or
  - contactless proximity payments
- But solutions typically start at national level
- Resulting diversity may lead to fragmentation and incompatibility in the European payments landscape
- Requires work at the strategic level to allow pan-European reach and achieve a single retail payments market (see Special Feature C)
- Euro Retail Payments Board has been established to facilitate an integrated, innovative and competitive euro retail payments market in the EU
- Includes high-level representatives of the demand and supply side and is chaired by the ECB
- Made important steps towards the above goals in the recent past

Annex

FINTECs and specific events

Price-based and quantity-based Financial Integration Composites (FINTECs)

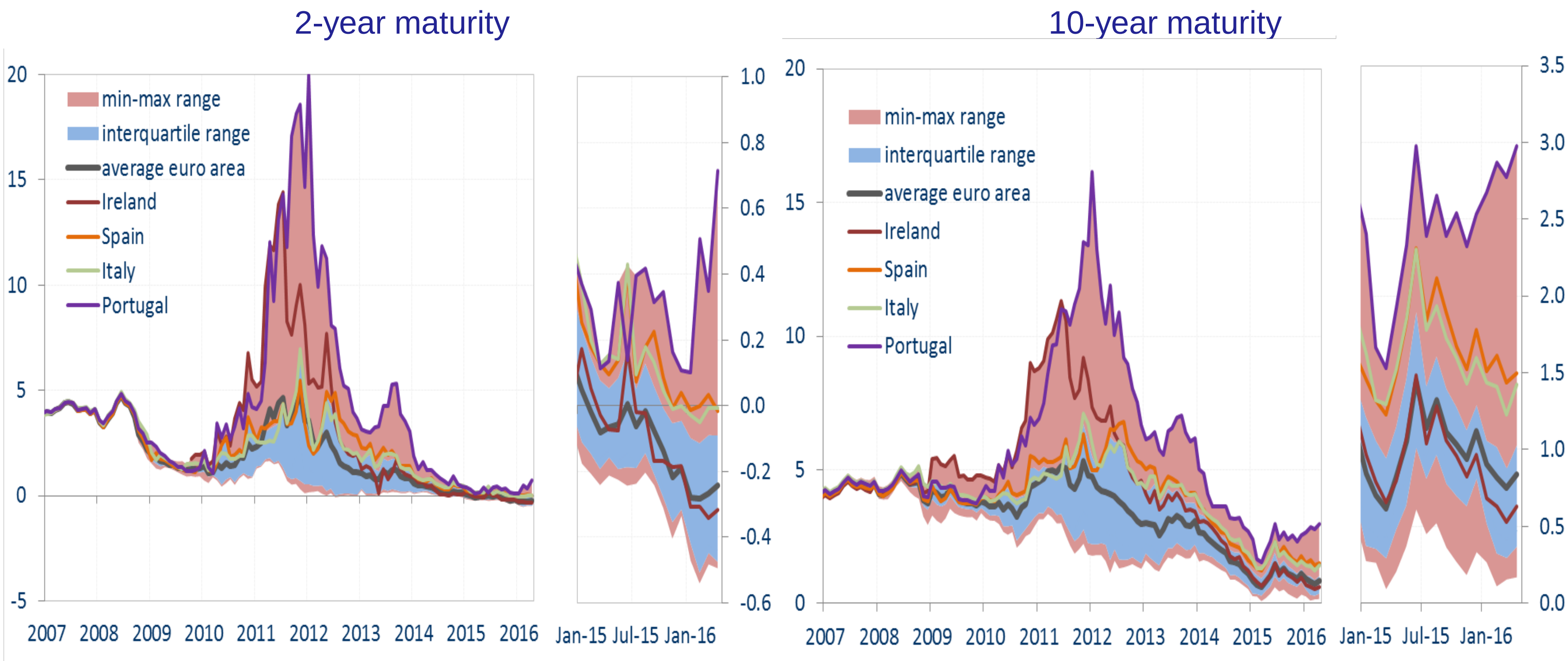


Sources: ECB and ECB calculations.
Notes: The price-based FINTEC aggregates ten indicators covering the period from the first quarter of 1995 to the fourth quarter of 2015, and the quantity-based FINTEC aggregates five indicators available from the first quarter of 1999 to the third quarter of 2015. The FINTEC is bounded between zero (full fragmentation) and one (full integration). Increases in the FINTEC signal higher financial integration. For a detailed description of the FINTEC and its input data, see the Statistical Annex.

Government bond markets

- Recent increase in cross-country yield dispersion
- But mostly due to one country

Dispersion of euro area sovereign bond yields (%)

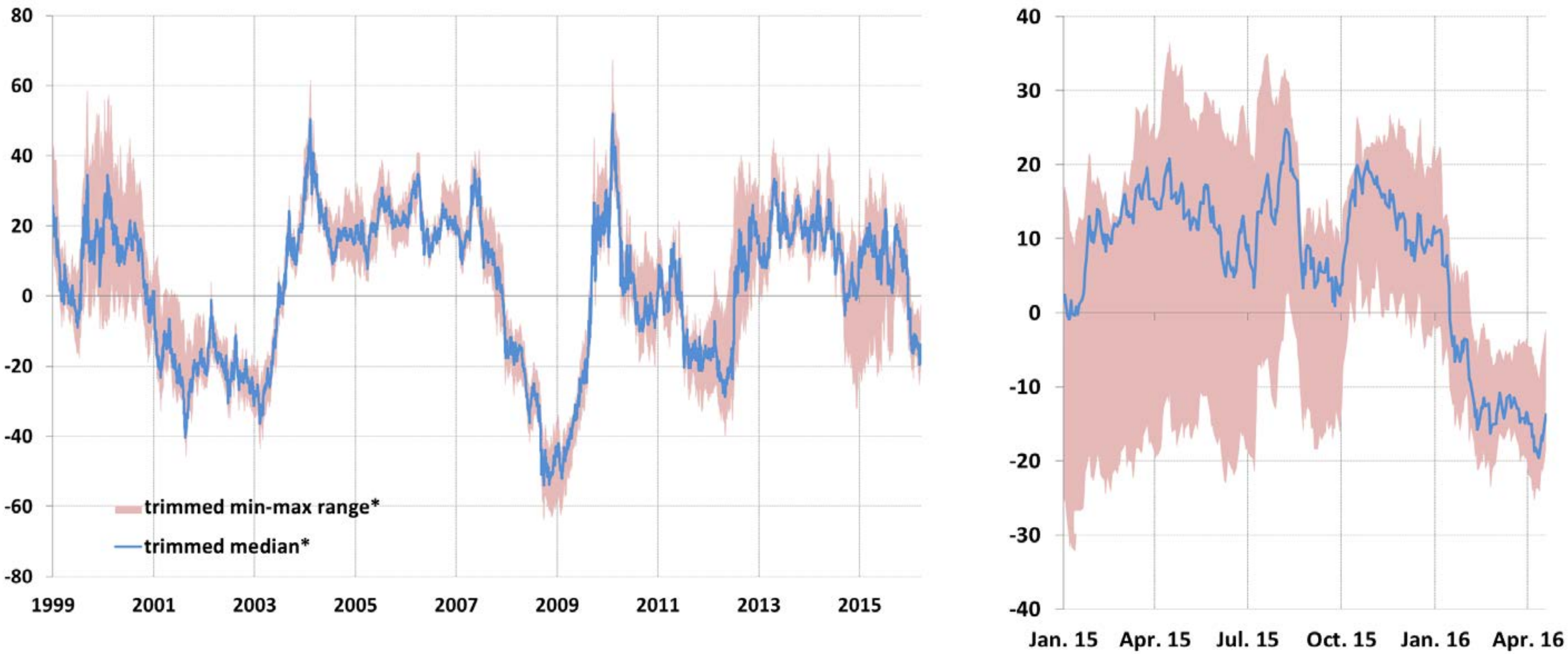


Sources: Thomson Reuters and ECB calculations (see charts 9 and S19 in report)
Notes: The data used are based on the euro area country composition as in 2011. The yields for Greece, Cyprus, Estonia, Luxembourg, Malta and Slovenia are excluded owing to infrequent or lack of observations.

Equity markets

- Significant dispersion end 2014 to mid 2015
- But not necessarily for most recent data (quite general declines)

Dispersion of euro area countries' equity index returns (% p.a.)

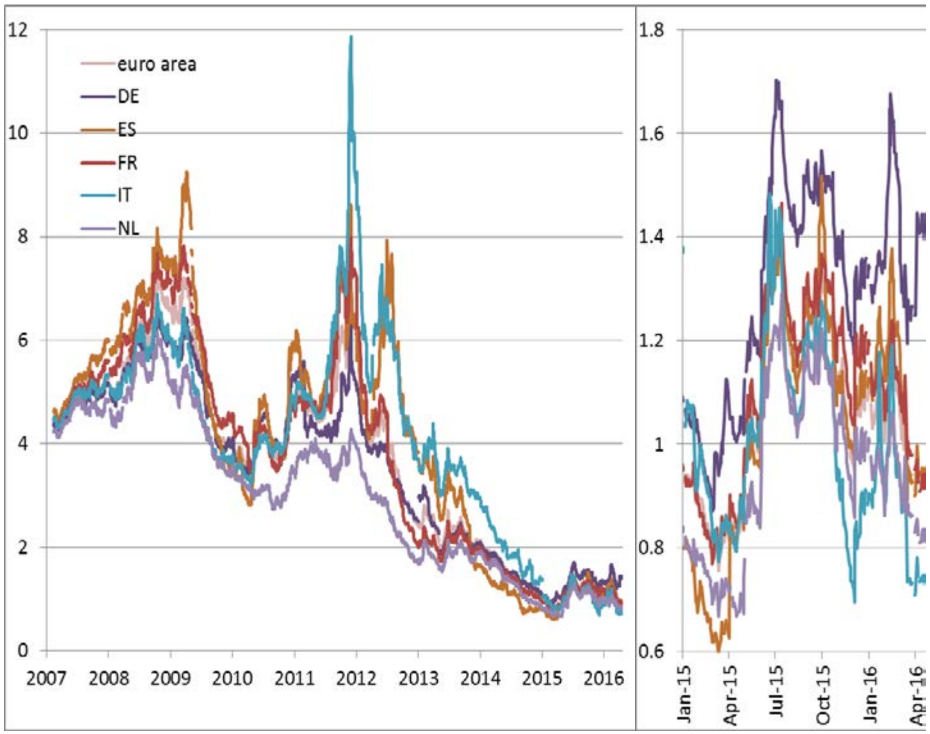


Sources: Thomson Reuters and ECB calculations (see chart 18 in report)
Notes: Median, minimum and maximum are trimmed, excluding for each observation the highest and the lowest annual country stock market returns. Countries included: Belgium, France, Germany, Greece, Ireland, Italy, Portugal and Spain.

Banking markets 1

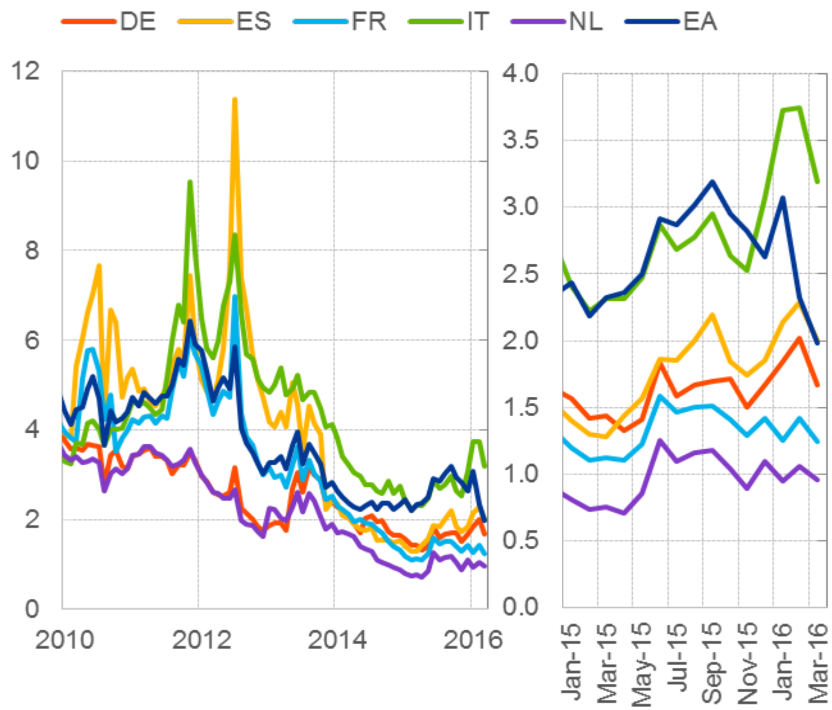
- Bank bond yields increased, but not really diverged across EA countries
- And lately correction again

Yields with daily iBoxx data (% p.a.)



Sources: Markit iBoxx and ECB calculations
Note: Investment grade, based on the individual bond data, country averages - weighted by bonds' respective market value

Yields with monthly Merrill Lynch data (% p.a.)

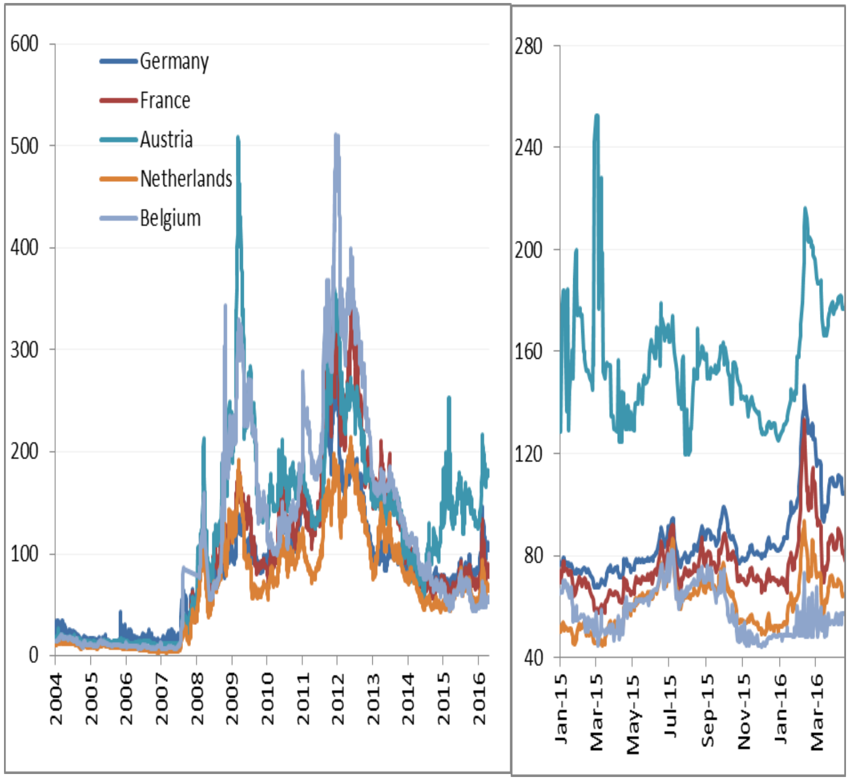


Sources: Merrill Lynch Global Index and ECB calculations (see chart 22 in report)

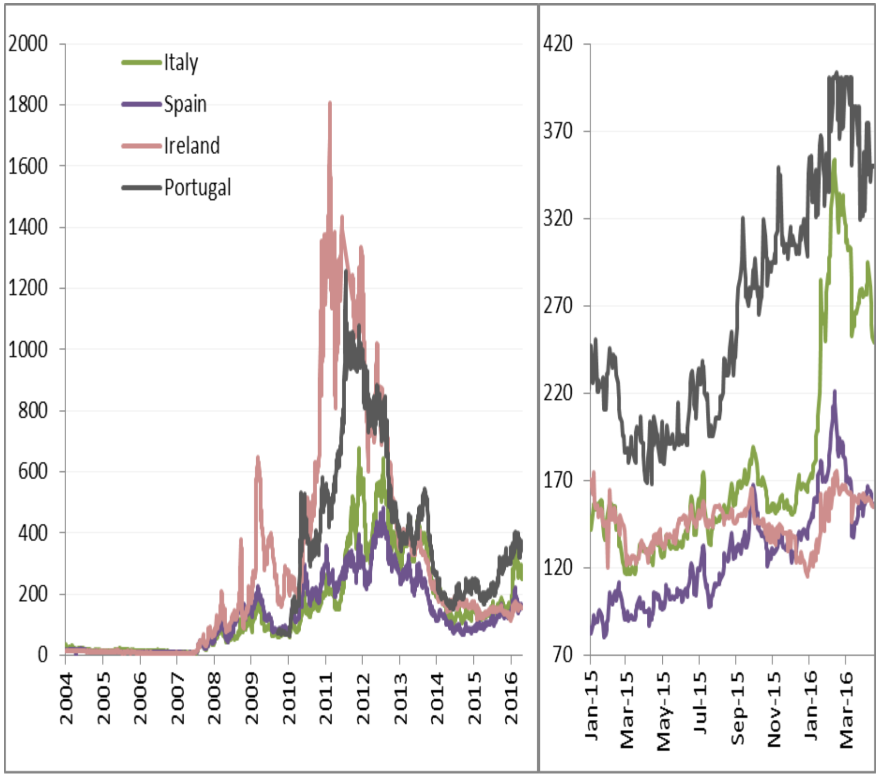
Banking markets 2

- Euro area countries' bank CDS premiums increased
- Signs of divergence, but effects of single/few banks and recent correction

Group A countries' CDS premiums (b.p.)



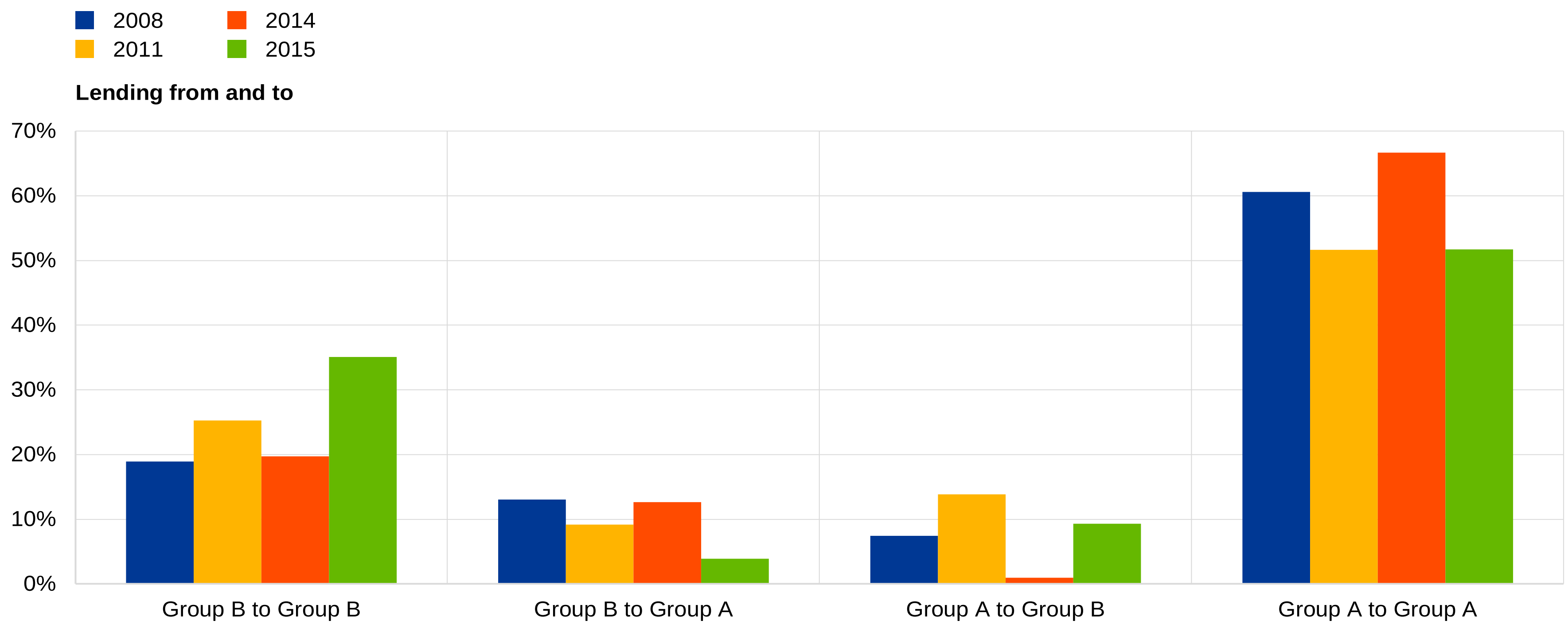
Group B countries' CDS premiums (b.p.)



Sources: Bloomberg, Thomson Reuters, Credit Market Analysis Ltd (CMA) and ECB calculations (country breakdowns of chart S35 in report)
Notes: For each country the indicator is the unweighted average of EONIA panel banks' daily CDS premiums

ECB public sector purchase program contributed to a re-distribution of unsecured overnight transaction towards group B countries

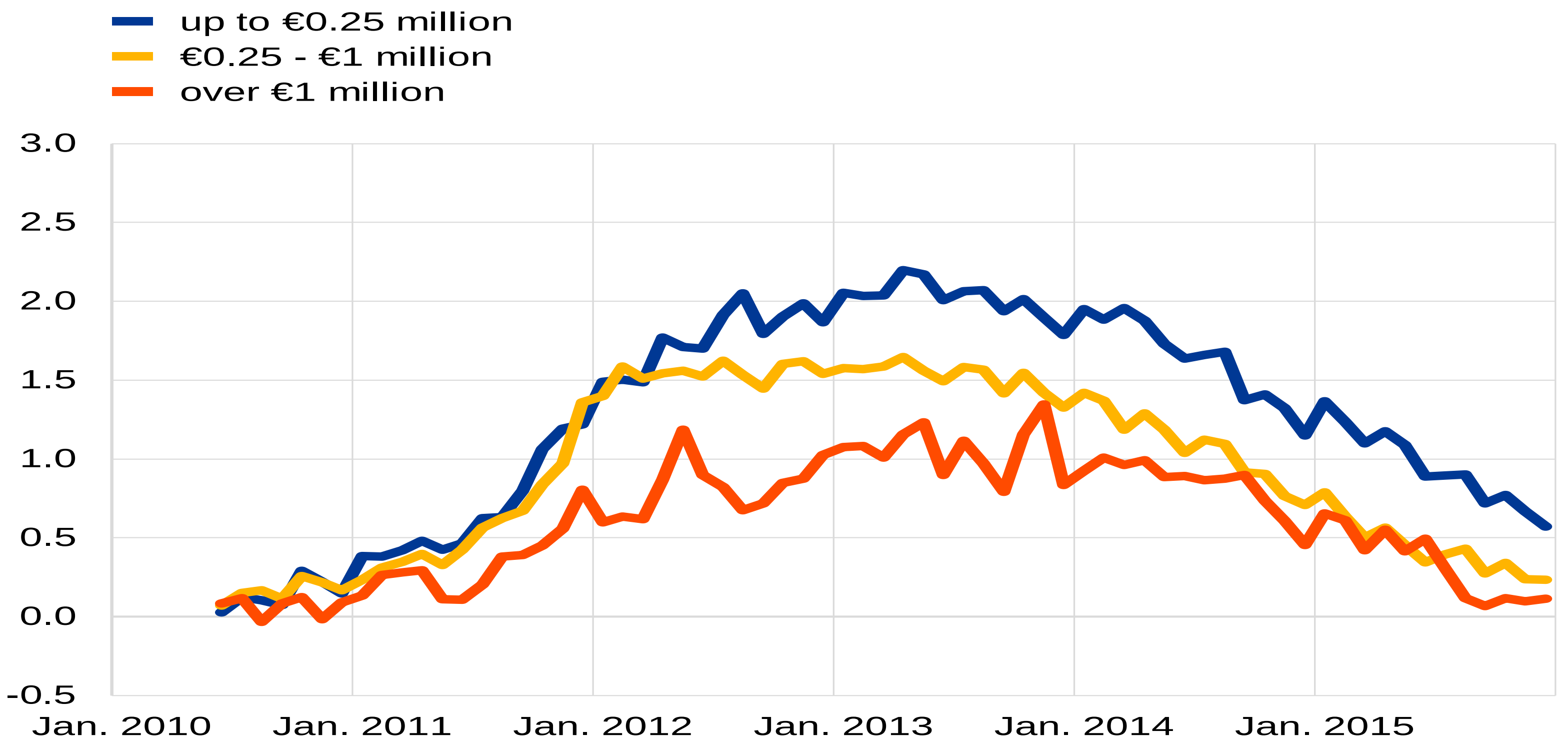
Overnight lending and borrowing volume for Group A and Group B countries (percentage shares of total)



Sources: TARGET2, DBRS, Fitch, Moody's, Standard & Poor's and ECB (see chart C in chapter 1 of report).
Notes: The maintenance periods included in the chart are 2008MP6, 2011MP11, 2014MP1 and 2015MP8.

Price discrimination against SMEs in Group B countries is continuously disappearing

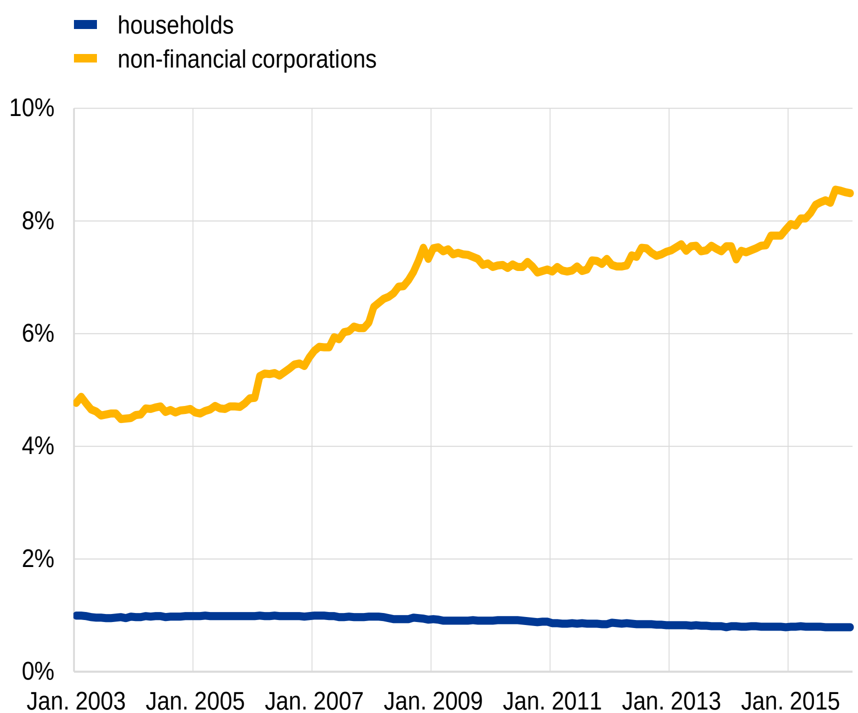
Spread between Group B and Group A countries' composite rates for small, medium and large bank loans (% p.a.)



Sources: ECB and ECB calculations (see chart 25 in chapter 1 of report).
Notes: Based on a fixed sample of ten countries. Group B countries are here ES, IE, IT and PT. The Group A countries are AT, BE, DE, FI, FR and NL. No data are available for GR and LU. Within each country group, national rates are aggregated using 24-month moving averages of new business volumes as weights. At the beginning of the sample, weights are fixed at the first computable value.

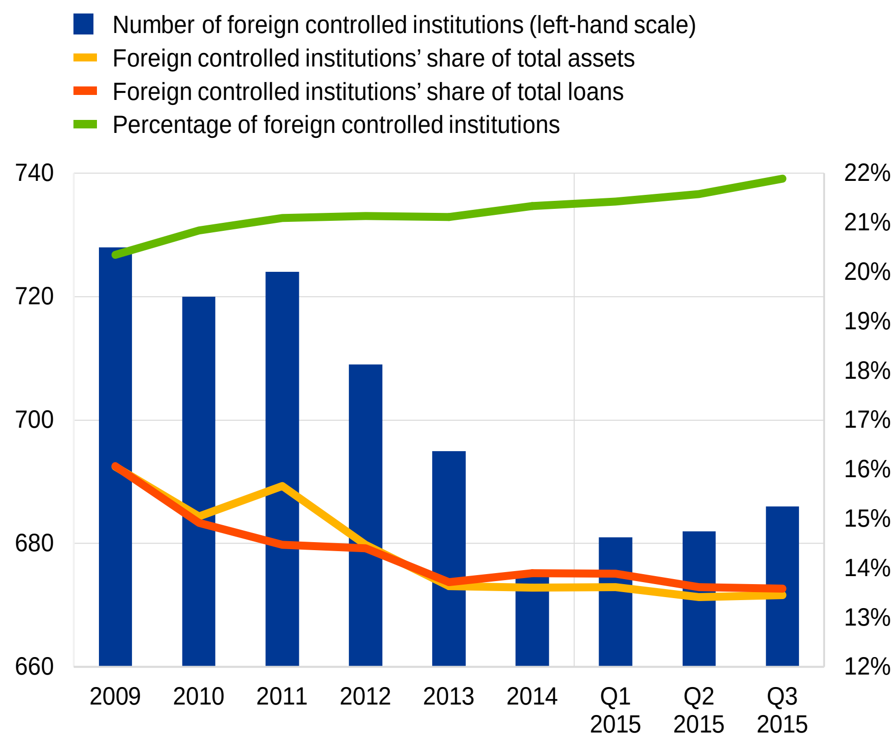
Cross-border retail lending to firms recently increased (from a low level), but the domestic lending share of foreign-controlled institutions stays flat

Share of cross-border loans in the euro area by sector (%)



Sources: ECB (BSI statistics; see chart 27 in report).
Notes: Cross-border loans include loans to other euro area countries for all maturities and currencies. Interbank loans do not include central bank loans.

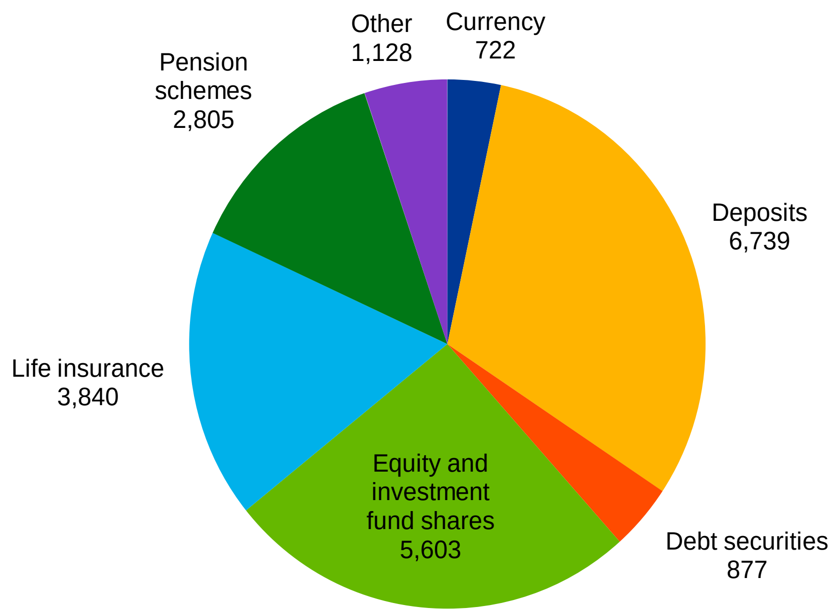
Foreign affiliates in euro area countries (left scale: total number; right scale: %)



Sources: ECB (consolidated banking data; see chart 26 in report).
Notes: Foreign-controlled affiliates comprise branches and subsidiaries (from EU and non-EU countries).

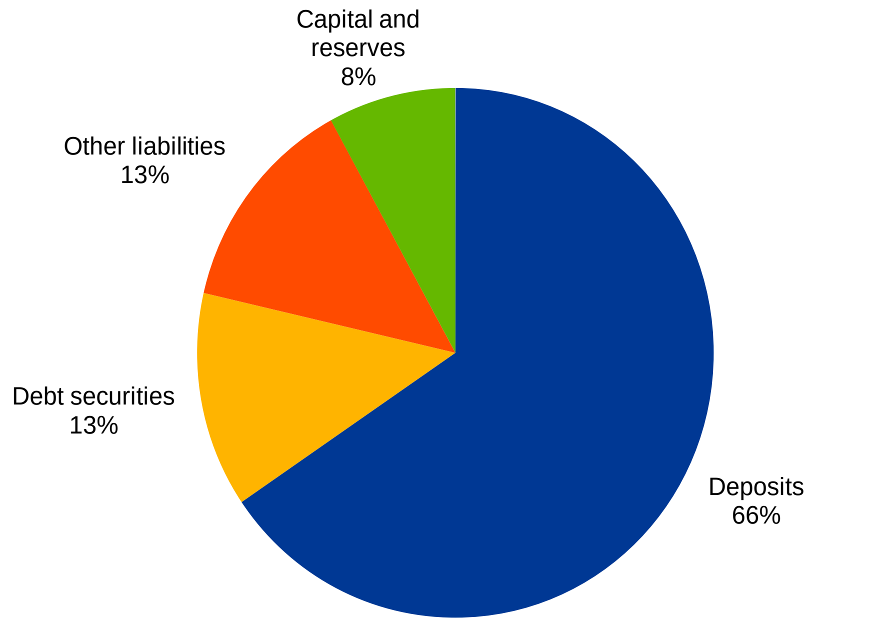
A very large share of households' financial assets and banks' liabilities in the euro area/banking union are deposits

Breakdown of euro area households' financial assets (bn EUR, Q2 2015)



Sources: Statistics Bulletin – Euro Area Statistics Online (see chart 1 in chapter 2 of report).
Notes: The member states of the euro area and the banking union are currently identical.

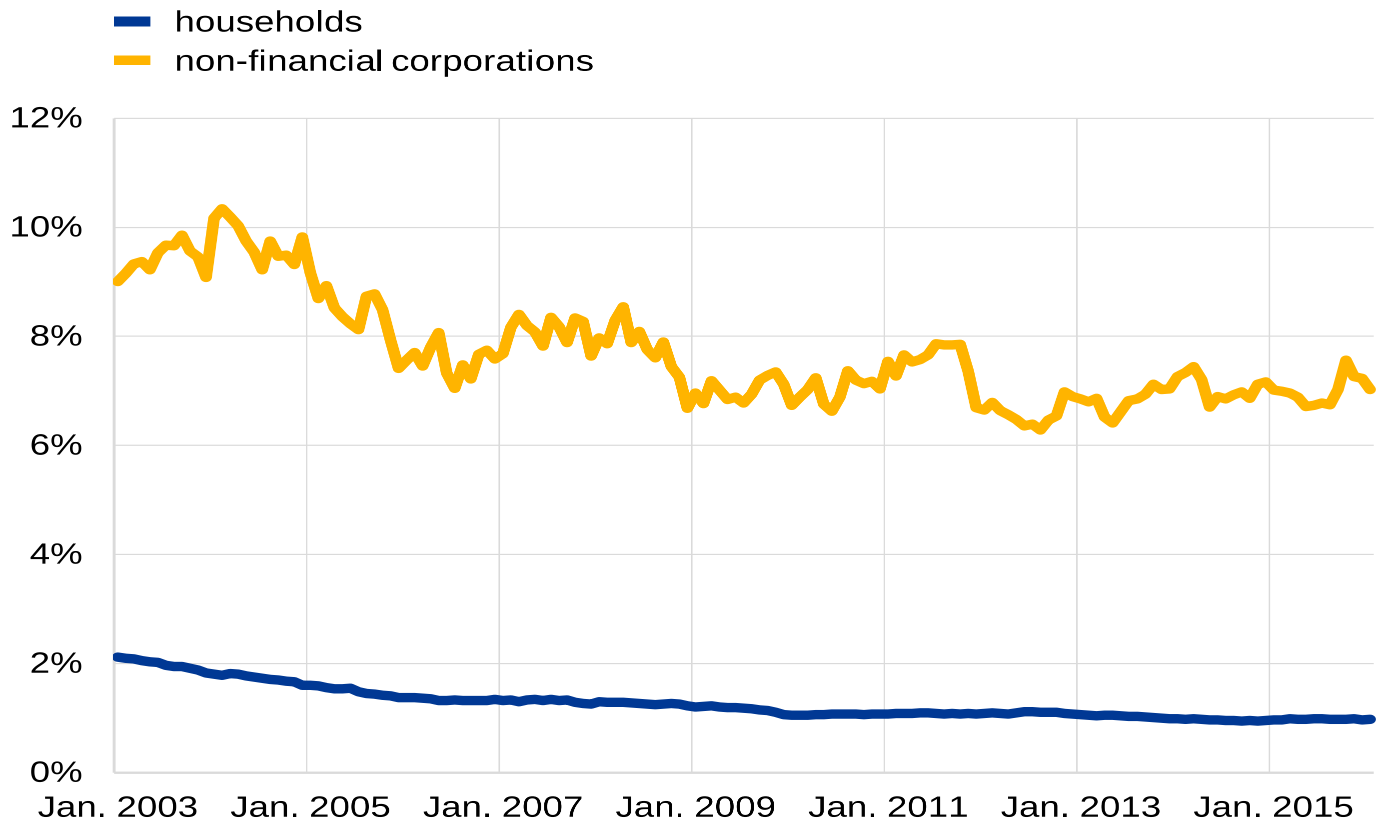
Breakdown of euro area banks' liabilities (%, Q2 2015)



Sources: Statistics Bulletin – Euro Area Statistics Online (see chart 1 in chapter 2 of report).
Notes: The member states of the euro area and the banking union are currently identical.

Cross-border retail deposits of firms do not increase (from a low level) and cross-border deposits of households are almost non-existent

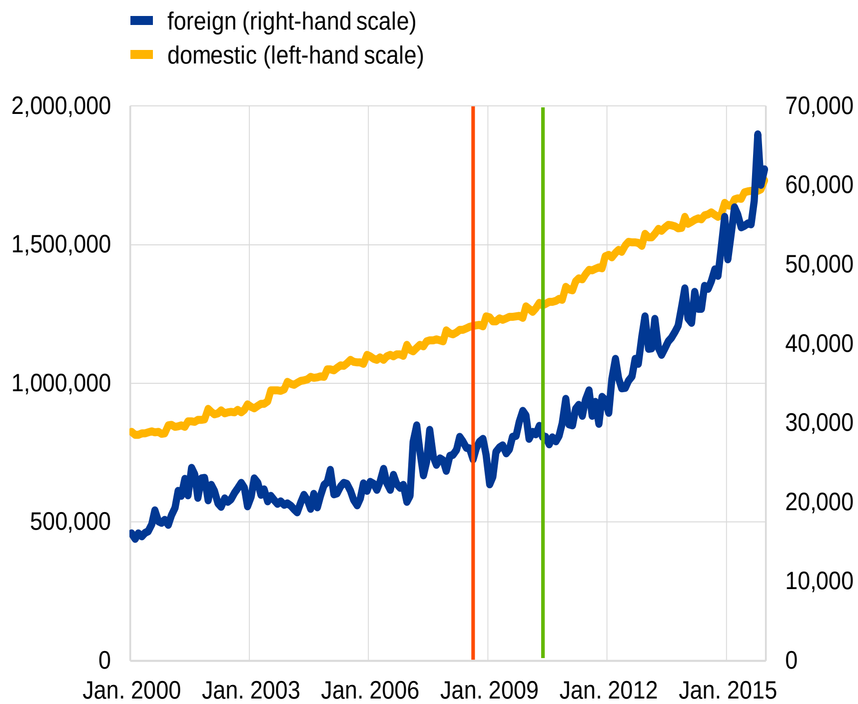
Share of cross-border deposits in the euro area by sector (%)



Sources: ECB (BSI Statistics).

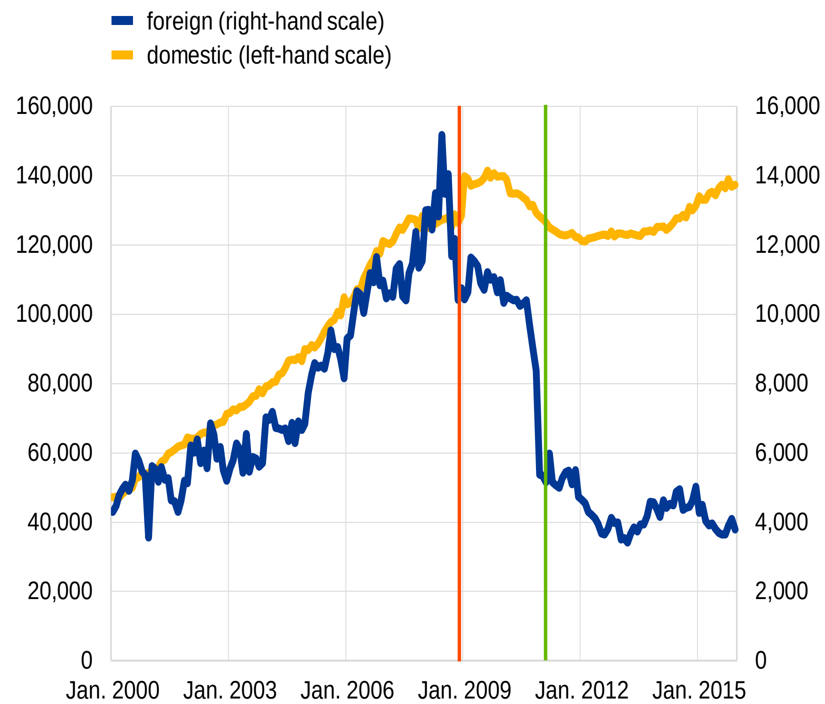
Sovereign-bank nexus: the fiscal stability of a sovereign can give rise to significant deposit flows

Euro area firms’ and households’ deposits at French MFIs (million EUR)



Sources: ECB Statistical Data Warehouse (BSI statistics; see chart 4 of chapter 2 in report).
Notes: The red line marks the beginning of the financial crisis in September 2008 and the green line the EU-IMF agreement on a bail-out package for Greece in May 2010.

Euro area firms’ and households’ deposits at Irish MFIs (million EUR)



Sources: ECB Statistical Data Warehouse (BSI statistics; see chart 4 of chapter 2 in report).
Notes: The red line marks the beginning of the financial crisis in September 2008 and the green line the EU-IMF agreement on a bail-out package for Ireland in November 2010.