Financial Market Integration and Financial Stability

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The present study deals with the consequences of Austria's integration into the Common Market and into Economic and Monetary Union for its financial stability. It shows that financial stability has been increased by a more efficient allocation of capital (as a result of intense competition), a higher degree of risk diversification, a reduced probability of asymmetric shocks and enhanced influence on the establishment of a harmonized framework. These positive effects have to some extent been weakened only by the increased risk of cross-border spillover effects and the growing importance of systemically relevant institutions. Setbacks in the earnings of financial institutions brought about by the integration process seem to have been offset at least in part by measures leading to higher cost efficiency. The cooperation of European countries in the regulation and supervision of financial institutions has promoted the positive integration effects of financial stability while weakening those reducing financial stability.

1 Introduction

Austria's accession to the EU ten years ago and its related participation in Economic and Monetary Union (EMU) from 1999 onward have more closely integrated the Austrian financial market into the European one. Indeed, a large part of integration effects stemmed from the earlier period of Austrian participation in the European Economic Area (EEA), which had become effective in January 1994. In section 2, objectives and the state of play of the integration of European financial markets are presented. Chapter 3 is dedicated to the (potential) advantages and disadvantages of integration to financial stability and reviews the contribution of the supervisory cooperation of European countries to ensuring financial stability.

2 Integration of European Financial Markets

2.1 What is Meant by Financial Market Integration?

Markets are considered fully integrated when the law of one price applies, i.e. the prices for a given good are the same in two different national markets and/or supply and demand are directly affected by any difference in price. In the financial sector, two markets are considered fully integrated when the prices for financial instruments of similar risk, liquidity and duration are the same or differ only in the short run.[1]

By adopting the financial *acquis*, Austria paved the way for participating in the as yet not fully integrated common market for financial services. Since then, Austria has been part of the ever-closer integration of this European financial market.

2.2 Objectives of Financial Market Integration

The integration of national financial markets, which were formerly subject to entry barriers as well as different regulations, practices and currencies, aims at making competition more intense, reducing transaction costs and creating markets which are deeper, more liquid and more efficient. The geographical dimension involved in integration requires the removal of entry barriers, the harmonization of legal, supervisory and fiscal conditions underlying financial markets, the harmonization of financial standards and the creation of common payment, clearing and settlement systems. It is supported by progress in the field of communications technology and the efforts of advanced national economies to provide a broader regional basis for the risk diversification of their pension systems, which are increasingly based on funded schemes. Finally, the geographical dimension of financial mar-

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[1] *Cabral et al. (2002).*

ket integration is also implemented via the integration of financial institutions. This partly comprises the cross-border consolidation and expansion of financial institutions, the main purposes of which are to make use of economies of scale and scope, and to improve risk diversification. By merging, financial intermediaries of a similar type hope to reduce fixed costs. Modern financial innovations usually require considerable development efforts and large initial investment costs; they will pay off only if a critical mass is reached, i.e. if the high level of fixed costs can be matched by a large business volume. The merger of different financial intermediaries, e.g. of a bank with an insurance company into a bankassurance, is generally justified by the expected synergy effects and a higher degree of risk diversification.

2.3 Integration of European Financial Markets: State of Play

Since Austria's accession to the EU, European financial markets have been characterized by an ever-closer integration. This has been due in particular to the Financial Services Action Plan (FSAP) which was adopted by the European Council in spring 1999 and which took significant initiatives to develop a common legal framework for financial markets. These initiatives were to be implemented by 2005.[2]

The Financial Integration Monitor 2004[3] published by the European Commission in June 2004 showed that the integration of European financial markets had deepened considerably since the beginning of 1994. Yet, both this report and other studies[4] point out that the degree of integration differs widely among markets and market segments. The implementation of EMU has entailed the full integration of the unsecured euro money market, which has been reflected in the disappearance of differences in interest rates and in the growing percentage of cross-border transactions (now accounting for about 30% of the total volume of transactions). The secured money markets have not yet been fully integrated due to national differences in securities and fragmented securities settlement systems. A high degree of integration has been achieved in euro-denominated government bond markets as well. For ten-year government bonds, the maximum yield spread between euro area countries (except for Greece) has decreased from more than 250 basis points (1995) to between 20 and 30 basis points (1999 to 2005). As to these instruments, the remaining differences in interest rates within the euro area can be mainly attributed to varying levels of market liquidity apart from the varying financial standing of the respective issuers. In most other kinds of capital markets, in particular the corporate bond market, integration has accelerated as well, which has been reflected in reduced differences in interest rates within Europe and in the growing percentage of foreign market participants. As in the case of the secured money market, national legal provisions and fragmented securities settlement systems prevent the integration process in the stock and bond markets from deepening more fully. In the remaining financial market segments, cross-border transactions usually involve large volumes;

[2] *European Commission (1999).*

[3] *European Commission (2004a, b, c).*

[4] *See Hartmann et al. (2003) and Koskenkylä (2004).*

investment banking, syndicated lending and reinsurance are examples of this category.

In contrast to standardized money and securities markets and wholesale banking, market segments focusing on final consumers and retail banking differ considerably from country to country. The degree of integration is still low in deposit markets, insurance markets, mortgage loan markets, consumer loan markets and those in loans for small and medium-sized enterprises. The main reasons for this are the local marketing and distribution channels used in retail banking, customer relations that are still excellent in these markets and the better reputation of long-established institutions.

3 Effects of Financial Market Integration on Financial Stability

3.1 What is Meant by Financial Stability?

Financial stability is a condition where the financial system, i.e. financial institutions, financial markets and financial infrastructures, is capable of directing capital to its most profitable (risk-adjusted) use without major disturbances.[5] This definition implies that the following three main requirements have to be met: First, the financial system has to fulfill its functions in a satisfactory manner, even in the case of adverse disturbances. In other words, it has to be capable of absorbing shocks without leading to a collapse of financial institutions, financial markets, payment and securities settlement systems and the related detrimental impact on the economy as a whole. Second, it aims at allocating capital in the most efficient way; thus, financial systems which are stable but not efficient do not meet this stability definition. Financial systems characterized by a degree of regulation so high that they cannot take slight risks will hardly be able to allocate capital in an efficient manner.[6] Finally, the definition given above underlines the necessity of accurately assessing and pricing risks in order to prevent future financial crises.

3.2 Effects of European Integration Promoting Financial Stability

3.2.1 A More Efficient Financial System

According to the definition presented above, the stability of a liberalized financial system is part and parcel of its efficiency, i.e. the capability of allocating capital in the most efficient manner. Thus, increased efficiency brought about by the integration process will produce a higher degree of stability in the long run. The integration of the Austrian financial market into the European one and the ongoing deepening of the European market raised efficiency in several ways.

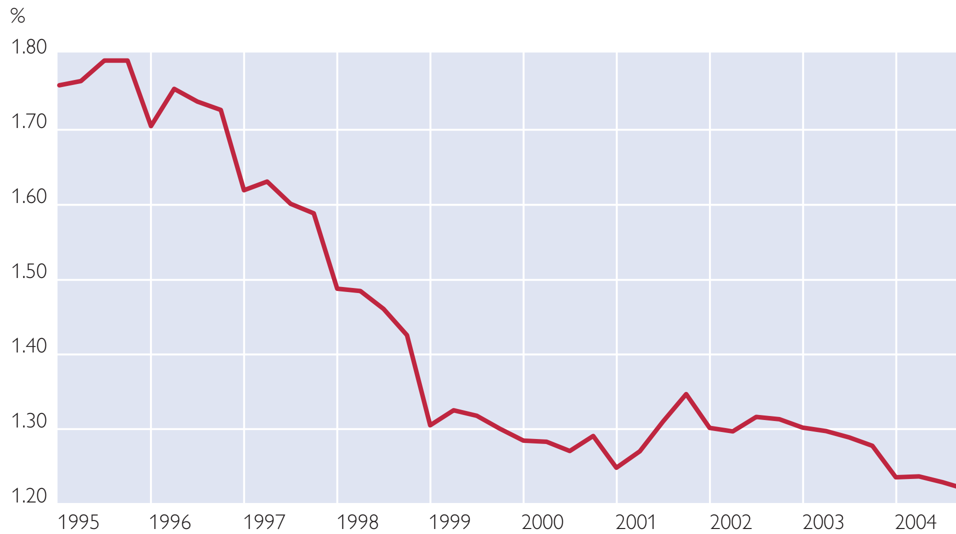
The complete elimination of entry barriers and the harmonization of regulations with those of the EU have intensified competition at least in parts of the Austrian financial market. Greater competitive pressure compelled financial intermediaries to offer price concessions to their customers, which reduced transaction costs and consequently facilitated a more efficient allocation of financial resources. The substantial narrowing of Austrian banks' interest margin is a case in point (chart 1). The introduction of

[5] *This definition largely reflects that used in the ECB's Financial Stability Review (December 2004).*

[6] *If the definition of financial stability did not contain any reference to the criterion of efficiency, financial stability and financial market inefficiencies could be considered perfectly compatible. Consequently, the former centrally planned economies might have had the highest degree of financial stability.*

Chart 1

Austrian Banks' Interest Margin



Source: OeNB.

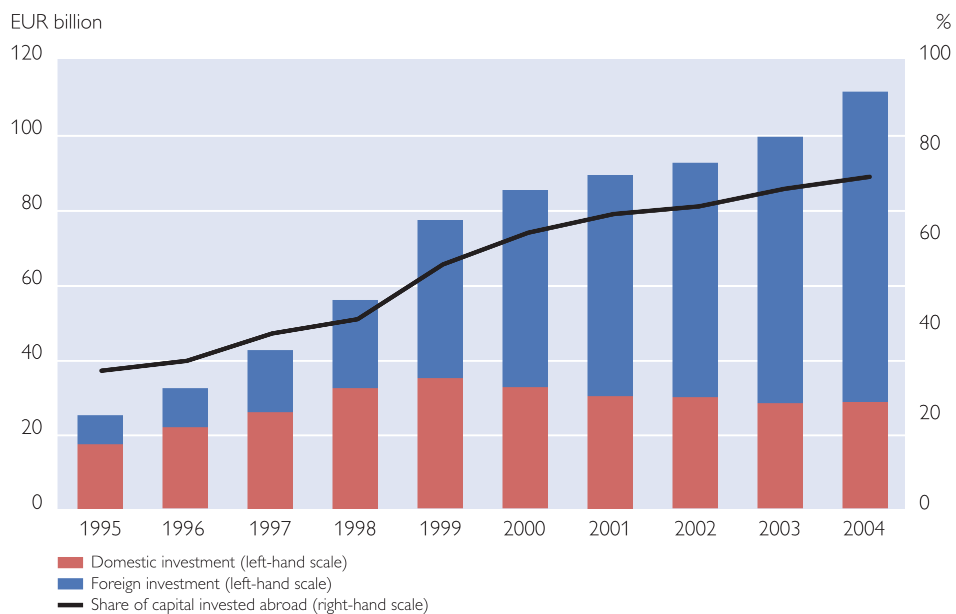
the euro also made capital allocation more efficient, since it eliminated the costs for foreign exchange transaction and hedging and made prices easier to compare. Thus, capital could be directed to higher risk-adjusted yields unhampered.

3.2.2 A Broader Regional Basis for Risk Diversification

Free access to the financial markets of the EU, roughly equal competitive conditions and the introduction of the euro enabled Austrian financial institutions and investors to diversify regional

Chart 2

Austrian Mutual Funds: Investment Volume and Capital Invested Abroad



Source: OeNB.

risk more broadly.[7] Thus, Austrian mutual funds saw the percentage of their capital invested abroad increase from about 30% in 1995 to almost 75% in 2004 (chart 2). The broader regional basis for financial investment made Austria's financial stability less vulnerable to asymmetric (country-specific) shocks than it would have been if financial investment had been concentrated regionally.

3.2.3 Rarer Occurrence of Asymmetric Shocks

Not only did the participation in EMU offer domestic financial intermediaries more possibilities of protecting themselves against country-specific shocks, but it also reduced the probability of large shocks which could endanger financial stability. The degree of asymmetry of country-specific shocks, for instance, has decreased simply due to the ever-closer economic relations between EU Member States. Economic disturbances brought about by exchange rate shocks, such as those that had affected Austria before EMU came into force when the Italian lira had heavily depreciated against the Deutsche mark and consequently against the Austrian schilling, are no longer possible in the euro area. The same holds true for interest rate fluctuations caused by speculative attacks against single national currencies, such as those that occurred frequently within the exchange rate mechanism of the European Monetary System (EMS).

3.2.4 Establishment of an International Framework: Taking Fuller Account of the Specific Characteristics of the Austrian Financial System

Equal conditions of competition for the market participants in all integrated countries represent one important prerequisite for the most efficient allocation of financial resources in integrated markets. Yet, in order to establish a truly fair and efficient framework for allocation, the different structures of financial systems in different countries have to be taken into consideration appropriately. For example, the establishment of the new capital adequacy framework (Basel II) has shown that the different financing structures of financial systems (bank-based versus capital market-based) and the differences in the size of businesses (mainly large companies versus small and medium-sized enterprises) will have to be considered, if the framework is meant to avoid putting some actors at a competitive disadvantage and to produce efficient allocation. As a member of the relevant EU bodies, Austria has been able to exert influence on the development of a new regulatory framework and to make sure that Austria's specific characteristics will not be greatly to the disadvantage of its financial system and financial stability.

3.3 Effects of European Integration that Affect Financial Stability

3.3.1 Setbacks in Earnings Caused by Integration

Apart from the positive effects of more intense competition on allocation mentioned above, competition has also had

[7] *These advantages can, however, be offset quickly by "appropriate" legal measures, as the case of the Austrian "Zukunftsvorsorge", a subsidized personal pension scheme, has demonstrated.*

negative effects on the earnings of financial institutions. Financial intermediaries that could not offset setbacks in earnings by cutting costs saw profits decrease and hence their risk-bearing capacity decline. When the institutions affected, however, responded to the setbacks in earnings by increasing their cost efficiency, financial stability was not compromised. A strategy of cutting costs which was frequently used in connection with the EU membership consisted in taking advantage of economies of scale and scope produced by vertical and horizontal integration of financial institutions.

Setbacks in certain types of earnings caused by the entry into force of EMU have been detrimental to financial stability as well. The areas of business which have been most strongly affected included international payments, money exchange, traveler's checks, eurocheques, interest arbitrage and hedging against exchange rate risks. But setbacks in earnings of suppliers offering these financial services have been accompanied by an improved allocation of capital, which again has promoted financial stability.

3.3.2 Increasing Influence of Systemically Relevant Institutions

Merging two or more financial institutions into one with a single management structure is an obvious strategy for companies which want to gain influence in the single financial market beyond their home region and to reduce costs. Mergers and acquisitions in the financial sector – regardless of their geographic dimension, i.e. national or cross-border[8] – result both in increasing market power and the emergence of large, systemically relevant institutions; the influence of these institutions may be so great that the whole financial system of certain countries is at their mercy. In the EU-15, the market share held by the five largest institutions (both in the banking and insurance sectors) amounts to an average of 60%. Aside from the problematic concentration of stability risks, in large financial institutions there is also a greater danger that their management is tempted to succumb to moral hazard by assuming (with some justification) that their businesses were too big to fail. On the other hand, large financial institutions usually have a more advanced risk management system, which promotes financial stability. When consolidating financial institutions of different sectors into financial conglomerates – in the EU-15, their market share in savings deposits and the volume of premiums has already reached about 30% and 20%, respectively – additional stability risks arise (risks of regulatory arbitrage, complexity and contagion).

3.3.3 Increased Risk of Crossborder Contagion in Case of Financial Crises

An increased risk of contagion exists not only for cross-sectoral integration, but also for cross-border integration. This is mainly the result of the expansion of financial institutions into other EU Member States. As a case in point, the share of the banking sector of the EU-15 belonging to foreign investors is about 30% of the total assets and capital of national banking systems.[9] Other

[8] *The number of national mergers and acquisitions is still higher than that of cross-border ones. According to the Financial Integration Monitor 2004, less than a quarter of the mergers and acquisitions which involved financial institutions of EU Member States were cross-border activities (European Commission 2004a, chart 2).*

[9] *European Commission (2004b).*

factors promoting cross-border integration of financial institutions are the common money market, common payment systems and the increasing importance of interbank business. From the perspective of financial stability, the increased risk of a spillover of foreign financial crises into the domestic market in the wake of integration mirrors the decreased susceptibility to asymmetric financial crises at home.

3.4 European Cooperation for the Purpose of Ensuring Financial Stability[10]

To intensify the effects of integration promoting financial stability and to weaken those reducing it, EU Member States have to cooperate closely in financial market regulation, financial market integration and crisis management. Only this can ensure that financial institutions, the organization and activities of which are more and more of a cross-border type, can be regulated and supervised in an appropriate manner and that regulatory and supervisory arbitrage can be prevented. The EU's approach in this context consists in bilateral and multilateral cooperation between national regulators and supervisors, which has been reinforced by the Lamfalussy process.

In the banking system, which the following description deals with, the supervisory regime within the EU is based on three pillars. The *first pillar* can be described as harmonization of minimum supervisory requirements and mutual recognition. It does not intend to comprehensively harmonize banking supervision legislation, but makes the licensing and operation of banks subject to minimum supervisory requirements. Aside from harmonized areas of legislation, national laws remain valid, which takes into account the specific characteristics of national banking systems which have developed over time. Licenses issued by national authorities and national supervision systems are recognized by the Member States as being equal.

The *second pillar* is based on the principle of national responsibility for the (operational) supervision of the financial institutions in question. This principle ensures that supervisors know the institutions to be supervised very well, which is necessary for supervision to be efficient.

The *third pillar* focuses on the cooperation between national regulators and supervisors. Within the ESCB, central banks and banking supervisors work together in the Banking Supervision Committee, which addresses mainly macroprudential issues. At the EU level, cooperation has been launched in the European Banking Committee and in the Committee of European Banking Supervisors, which primarily uses a microprudential approach.

Cooperation in risk management, i.e. efforts to minimize negative effects of inevitable financial crises, can surely be intensified. The second Brouwer report[11], which had been commissioned by the Council of Economics and Finance Ministers, confirmed that as well and stated that, above all, further improvements in information sharing were necessary. This proposal was taken up, for instance, in a multilateral Memorandum of Understanding between EU central banks and supervisors.

[10] *Gulde et al. (2005) and Hrdlicka (2005).*

[11] *Economic and Financial Committee (2001).*

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