

Chapter 1

Toward a Single Financial Market

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Europe has made considerable progress in integrating its financial markets.¹ In the 1957 Treaty of Rome, the founding fathers of the European Union (EU) set out to create a common market where goods, services, people, and capital could move freely. They thus put Europe on a course toward a single financial market,² one characterized by a free flow of capital and the free provision of financial services across borders. Fifty years later, European financial integration has made significant headway, with monetary union perhaps the most visible marker.

Major Achievements, but an Unfinished Agenda

However, the journey toward a single market for financial services is proving much harder than that for goods. Through the late 1980s, the European Union's capital and banking markets were highly fragmented. This changed with the opening of capital accounts and the quest for a single currency. Key markers for European financial integration include the Directive on the Liberalization of Capital Movements (1988), the Second Banking Directive (1989), and the Maastricht Treaty (1992) (Box 1.1). The 1988 directive liberalized capital

¹This chapter draws in part on Fonteyne (2006).

²The term "financial market" as used in the expression "single financial market" refers to the entire system of financial intermediation in an economy; it comprises banks, insurance companies, other financial intermediaries, money and securities markets, and so on. A single financial market exists when this system of financial intermediation is fully integrated, essentially offering all market participants access to the same range of products under the same conditions regardless of their location within the integrated geographical area.

flows, effective July 1990. The Second Banking Directive entered into force in 1993 and set out the key drivers of banking market integration: minimum harmonization, mutual recognition, and home-country control. These principles produced a “single passport”: any bank licensed in an EU country was free to open branches in any other EU country, subject only to the regulation and supervision of the country that had issued the license.³ The Maastricht Treaty set the stage for a single currency, which was introduced in 1999, and the eventual integration of banking and money and capital markets. As a result of these policy initiatives, capital can now flow freely across borders, financial services providers can operate across the European Union, and 13 EU countries share a single currency.

Nonetheless, Europe is still a long way from achieving a single financial market. While capital flows are now virtually unimpeded, the cross-border provision of financial services can still be difficult. Perhaps the most fundamental reason is that financial products are essentially legally binding contracts that reflect the legal system under which they are executed, and these systems differ deeply across countries. While some relevant legislation is specific, the functioning of financial systems typically is affected by broad areas of law that depend, in turn, on the legal fundamentals of a country, including its constitution. Not only do laws and constitutions differ across countries, but basic legal principles and judicial approaches reflect different traditions. As a result, financial integration policies now need to build a legal framework for a single financial market across 27 different legal systems that stem from four different families of legal tradition (Napoleonic, Germanic, and Scandinavian civil law traditions; and common law).

Moreover, the basic instruments of integration have in practice run into national resistance or against their own limitations. The integration process has been built on a number of basic policy tools: harmonization, mutual recognition (which allows competition between systems), competition policy, delegation of authority, and moral

³Exceptions to this rule exist. Most notably, host countries are responsible for liquidity regulation and oversight.

suasion. These tools, which are used in various combinations, have achieved mixed success, often running into the following obstacles:

- Full harmonization is often impractical and does not necessarily lead to best practice. Moreover, adapting harmonized legal or regulatory frameworks to changing circumstances can be a daunting and drawn-out process, requiring negotiations and consensus building among member states. When directives are put in place, ample room typically has to be left for differences in implementation at the national level.
- Many policymakers see full mutual recognition as posing a risk of a “race to the bottom” and therefore deem it unacceptable. In theory, the single passport—by virtue of subjecting foreign branches to home-country supervision—can unleash competition between national regulatory and supervisory systems and can promote convergence to a single standard. However, in practice this has not happened because banks have, in many instances, entered new markets with subsidiaries and thus subjected themselves to host-country supervision. Host-country supervisors have in some ways shaped these preferences.
- Competition policy needs complaints from market participants to be effective, but not all financial players consider complaining to the competition authorities (the European Commission or the European Court of Justice) about obstacles to integration to be an attractive option, because this may alienate their supervisors.
- Delegation of authority to a central or external entity has always been circumscribed.⁴

⁴Delegation of authority refers to the granting of certain regulatory or policymaking powers to independent parties. Perhaps the most notable example of delegation to a central entity is the granting of authority for monetary policy to the European Central Bank (ECB). A noteworthy example of delegation to an external entity is the European Union’s reliance on the International Accounting Standards Board (IASB) for its accounting standards.

- Moral suasion raises various questions, including about democratic accountability, and has mostly fallen short of expectations, in part because of its limited enforceability.

Yet, European financial integration policy has taken some giant leaps forward in the past decade. Around the time when monetary union became a reality, greatly facilitating cross-border financial transactions, one of the European Union's most comprehensive legal and regulatory endeavors got under way in the form of the Financial Services Action Plan (FSAP). This undertaking is probably on a par with what the single market ("Europe 92") meant for cross-border trade in goods. In addition, the past decade saw the economic and financial integration of Central and Eastern European countries into the European Union, a process that led to EU-15 financial institutions becoming dominant players in their financial markets. Much has been achieved under the FSAP by way of regulatory and legal changes. However, implementation at the national level is still ongoing, and thus this ambitious program's benefits for businesses and households will take some time to materialize.

In the meantime, the European Commission's White Paper on "Financial Services Policy 2005–10" (European Commission, 2005c) seeks to move this process along, with a focus on implementation rather than on new regulatory and legal initiatives.

This book takes stock of where the process of European financial integration stands today and the policy priorities that the European Union faces going forward, from two perspectives: growth and economic integration, on the one hand, and financial stability, on the other. European countries need to improve their growth performance, in particular by raising productivity, to better tackle the challenges posed by the looming demographic shock. The financial sector can play a major role in raising growth rates. An integrated financial market would also enhance the functioning of the monetary union, increase the benefits it delivers, facilitate monetary policy, and help reduce economic disparities between euro area countries over time. Financial stability, on the other hand, is a policy objective that is so important in shaping the legal and regulatory context in which the financial sector functions that it also inevitably shapes financial integration policies. Conversely, financial integration also affects the nature of risks to financial stability.

Concepts and Rationale

Financial integration is the process of moving toward a single financial market. In Chapter 2, Hamid Faruquee argues that there is no universal definition of financial integration and that existing definitions are often unsatisfactory. In his view, financial integration should be seen as a multidimensional process that takes a group of economies from “financial autarky” within their respective borders to a single financial market in which geography has become irrelevant (within the outer borders of the group of integrating countries). Financial integration is therefore a geography-specific concept. This matters because there is also an ongoing, albeit less advanced, global financial integration process that interacts with the European process in various ways. Of course, if the world were to head for a single financial market, the concept of a single European financial market would eventually lose its relevance. The complexities involved, many of which are discussed in this book, imply that European financial integration will likely remain ahead of global integration for the foreseeable future.

Financial integration spurs financial development. For the European Union, financial integration implies that the less financially developed countries will catch up with the more developed ones. Beyond catching up, financial integration also has the potential to produce further market development, including for the European Union’s most advanced markets. Chapter 2 discusses how financial integration produces better-functioning financial markets, in terms of access and competition, scale and structure, and scope and completeness. This forces financial sector players to become more efficient and provides them with various means to do so. It also provides scope for innovation and better rewards innovators. These incentives and opportunities in turn enhance financial markets further, producing a virtuous circle. The result is better and more complete financial intermediation at a lower cost.

Better financial intermediation improves economic outcomes, raises productivity growth, and enhances consumer welfare. For the economy, the increased availability of funding can foster greater risk taking and, therefore, faster innovation and technological progress. The better allocation of savings to high-value investment projects also enhances the economy’s productive capacity and, coupled with increased diversification

possibilities, allows improved risk-return trade-offs. Improved possibilities for risk sharing allow individuals to better smooth consumption over their lifetimes and render economies more resilient to shocks.

Chapter 2 presents various estimates of the benefits from European financial integration. Evidence of direct benefits comes from sectoral productivity growth rates for the euro area and the United States. These productivity data show that about half of the lower productivity growth in the euro area during 1996–2003, or just under 0.5 percent a year, can be accounted for by financial intermediation (excluding insurance). Indirect effects from intermediation on the productivity of other sectors are harder to quantify but may be even larger. In any case, evidence suggests that the European Union may benefit significantly from eliminating the role of geography in its financial markets, including in meeting the all-important objective of raising productivity.

By providing greater diversification possibilities, financial integration offers opportunities for risk reduction. However, it also generates evolving risks. Integrated financial markets allow shocks to spread across borders, through confidence, balance sheet exposures, payment systems, revenues and cash flows, or other mechanisms. Chapter 2 identifies two fundamental types of cross-border risk transmission: financial contagion and fundamental spillovers. In addition, the financial integration process involves a number of transition risks that are particularly relevant for countries that are catching up. Integration may also introduce risks that are not yet known and render risk assessment and management more difficult because of the organizational and financial complexity of cross-border financial institutions and transactions.

The Current State of Play

Monetary union and the FSAP have caused fundamental changes in European financial markets. In Chapter 3, François Haas assesses the state of integration across market segments and the impact of integration policies. He finds that Europe has made considerable progress in creating a single market for wholesale financial services. Markets for unsecured interbank lending, government bonds, investment banking, and several categories of derivative financial instruments have become essentially integrated, producing important benefits. The beneficiaries include governments, whose funding costs have been slashed because the integration of bond

markets contributed to the current historically low spreads between the yields on bonds issued by different governments. In most market segments, integration has increased competition, innovation, and depth—factors that have often led to rapid development in the quality and quantity of services being offered. Many providers of financial services and institutional investors now operate on a European (if not global) scale and apply European business and investment strategies.

However, various factors have held back integration in important market segments. The continued fragmentation of Europe's clearing and settlement systems has hampered the integration of securities markets and markets that use securities as collateral. Legal and tax differences also continue to be major sources of fragmentation, in particular in markets for securitization and in the asset management industry.

The European Union's retail financial markets are lagging behind and remain fragmented, although they benefit from the integration of wholesale markets. Banks continue to provide the bulk of retail financial services. With direct contact remaining important, these services are rarely offered across borders. Those financial institutions that are active across borders must still spend considerable resources adapting their retail products because of differences in consumer protection arrangements, contract law, product market regulations, and taxation. More fundamental factors such as language and culture also play an important role, as does the continuing fragmentation of retail payment systems. These difficulties have led financial institutions to rely more on foreign subsidiaries than on branches to organize their cross-border activities, thus forgoing important efficiencies.

Much of the impact of the FSAP is not yet evident. Important reforms under the FSAP are yet to become applicable or fully operational, and they will take time to make their mark on market integration. Hence, even in the absence of new initiatives, financial integration is likely to make progress in the years ahead.

Capital Market Integration and Development

Capital market development would allow a better symbiosis between banks and markets. In Chapter 4, Jörg Decressin and Beata Kudela point out that, relative to the size of their respective economies, the European

Union's capital markets are much smaller and bank balance sheets much larger than those in the United States. As a consequence, the EU financial system is often thought of as being bank based and that of the United States as being market based. In reality, however, this distinction is not clear-cut, as U.S. banks do not lend less than EU banks, and other indicators also point to both banking systems being at a similar level of importance for their respective economies. However, U.S. banks securitize a much higher share of their loans, thus taking these loans off their balance sheets. Europe's larger bank balance sheets and smaller capital markets are therefore directly related phenomena.

EU banks are also less profitable than their U.S. counterparts. Decressin and Kudela provide evidence that this lower profitability does not result from more competition but rather from EU banks being less specialized in high-value-added activities, because they are less symbiotic with markets than are U.S. banks. Banks in the United States pass standardized risks on to markets and limit their on-balance-sheet activities to more profitable, nonstandardized risks. European banks, by contrast, keep the bulk of their assets on their books and, as a result, they end up with much larger balance sheets, containing low-yield, low-risk assets. Higher leverage allows them to bridge part of the gap with their U.S. peers when it comes to returns on equity, but on this measure also they are less profitable. European banks do not necessarily follow their current business model by choice. They do so, in part, because EU capital markets, in particular those for securitization, are less developed, incomplete, or fragmented.

In Chapter 5, Faruqee shows that equity market integration remains incomplete, and partial integration of infrastructure risks creating diversion. Although a consolidation process is ongoing, stock exchanges remain firmly anchored in their home countries, even when they belong to cross-border groups. Cross-border trading also remains more expensive and less common than domestic transactions. Correlations between national equity markets have increased, but this could reflect factors other than financial integration.

Chapter 5 analyzes the shortcomings of correlation-based indicators and introduces a new way of measuring equity market integration, based on optimal portfolio theory. The methodology involves estimating the distance a country's equity portfolio is removed from the efficient portfolio frontier, an indication of forgone diversification

gains. The analysis shows that home bias remains pervasive in the European Union, although it is on a downward trend. In an interesting result, the chapter finds that some smaller Euronext countries have reallocated their portfolios to the other Euronext countries, but that this concentrated cross-border diversification did not benefit portfolio efficiency—that is, it did not constitute “good” diversification. This implies that, by causing investment diversion, partial integration of equity markets may stand in the way of EU-wide integration and the related benefits.

Integration of trading and clearing and settlement infrastructures remains necessary but challenging. Chapter 5 argues that the persistent strong home bias is in large part caused by the fragmentation of the market infrastructure and clearing and settlement systems, and overcoming this may require a combination of market-based and public-policy initiatives.

Banking System Integration and Risks

Banks remain the mainstay of the European Union’s financial systems. As noted in Chapter 4, on-balance-sheet bank intermediation is the main form of intermediation in the European Union. Banks are also the most likely conduit through which financial stability problems could spread and take on systemic proportions. Integration in the banking sector has thus far mainly occurred at the national level because the economics of within-border bank mergers have been much more compelling than those of cross-border mergers. The pace of cross-border bank mergers has picked up of late though, and the context for such mergers has improved. In many countries, banks have sought economies of scope and scale by merging with other financial intermediaries, in particular insurance companies. Hence, cross-border and cross-sector financial conglomerates have become increasingly important.

Using sophisticated econometric methods, Chapters 6–8 analyze the impact of financial integration on Europe’s financial institutions. Overall, the main message from these chapters is that financial system risks have converged and become more correlated, but they have not declined. In Chapter 6, Alexander Tieman, Gianni De Nicolò, and Robert Corker find that European banking systems have become increasingly integrated. However, at

the system level, the increasing diversification that this implies has not led to a structural decline in risk levels, as measured by market-based distance-to-default (DD) indicators. They also find that the risk profiles of banks and insurance companies have converged, but not to lower risk levels. This convergence has likely been driven by increasing similarity in income sources and growing exposures to common financial shocks, in which the integration of European capital markets may have played a role. The lack of clear improvement in risk profiles suggests that diversification benefits have been offset by higher risk taking. The similarity between the trends in the risk profiles of U.S. and European financial institutions suggests that there may have been drivers other than integration, such as technological developments.

Increased diversification does not seem to have led to a decline in the systemic risk of internationally active large banking groups (ILBGs) either.⁵ In Chapter 7, Tieman and Martin Čihák analyze a sample of 11 ILBGs. Although considerable differences persist, ILBGs have increasingly diversified across country borders. Income sources continue to differ across banks but tend to be more internationally diversified than assets. In addition, an analysis based on majority-owned subsidiaries shows that the most internationally diversified banks tend to focus on fee earning and financial market activities, and to achieve higher returns with lower volatility. Geographical diversification highlights different investment strategies: some banks are heavily invested in the new member states and others follow either more global or more domestically oriented strategies. The capital-to-assets ratio is generally higher than a decade ago but, for many banks, so is the volatility. At the same time, the ILBGs have increased their exposure to common financial cycles and income sources. Hence, the markets do not perceive the ILBGs' risk levels as having decreased; in fact, they are generally considered higher than those of other banks.

⁵The concept “internationally active large banking groups” as used in Chapter 7 differs from that of Large complex financial institutions (LCFIs) used elsewhere in the book mainly in its exclusion of financial groups that are not primarily banking groups and the requirement of a significant international presence. ILBGs typically are LCFIs, but the reverse is not always true.

Although diversification generally benefits individual ILBGs and has reduced the risk profile of some, it has not led to a decline in the systemic risk of the sample of 11 ILBGs as a group.

Bank developments across the EU countries are, to a large extent, driven by common factors. In Chapter 8, Decressin investigates the origin of the factors driving the profitability and soundness of European banks. He finds that common cross-border factors are at least as important as domestic factors. The analysis suggests that shocks to the EU banking system are mostly shared across countries. European developments are, from various perspectives, as important as national developments in driving banks' profitability and capitalization. In other words, the fortunes of banks are increasingly driven by factors that are cross-border in nature. This result is evidence of the increasing integration of banking systems and of the environment in which banks function, including greater business cycle correlation and a common monetary policy.

Financial Stability Arrangements

Undiminished risks and commonality in factors affecting financial institutions elevate the importance of adapting the European Union's financial stability arrangements to the requirements of an integrating market.

Currently, the European Union's financial stability framework is solidly grounded at the national level. To deal with cross-border financial institutions and cross-border risks, a set of arrangements has been put in place that govern cooperation, information exchange, and an EU-specific home-host division of labor between the national systems. The basic principle is that home countries regulate and supervise their banks' foreign branches within the European Union and perform consolidated supervision of cross-border banking groups, and host

countries regulate and supervise subsidiaries of foreign banks.⁶ Branches are also covered by the deposit insurance and insolvency arrangements of their home country.

At the national level, the European Union's prudential arrangements are generally good, but need to be adapted to meet the new challenges created by financial integration. In Chapter 9, Čihák and Tieman investigate the quality of financial sector regulation and supervision in EU countries, making use of assessments carried out under the Financial Sector Assessment Program of the IMF and the World Bank. They find that, based on compliance with international standards and codes, regulation and supervision are generally of a higher and more even quality in the EU countries than in comparable non-EU countries. Gaps remain, though, and occur more frequently in the new member states than in the EU-15 countries. Moreover, new challenges, the European Union's sophisticated and rapidly evolving financial systems, and the objective of creating a single financial market may require EU prudential arrangements to go beyond established international standards and codes in various respects. In particular, prudential arrangements need to adapt to the growing role of cross-border conglomerates and market infrastructures. In this regard, the IMF's Financial Sector Stability Assessments (FSSAs) have often urged continued work in the areas of crisis management, deposit insurance, day-to-day cross-border supervisory cooperation, and systemwide monitoring of risks.

Policymakers and national supervisors have been reluctant to transfer prudential responsibilities to the EU level. Although partly driven by a desire to preserve existing institutions, this reluctance is also based on fundamental questions about residual national responsibilities for financial stability and the organization of lender-of-last-resort support, deposit insurance, and taxpayer liability within a supranational setting. The legal

⁶For example, a German bank's activities in London are supervised by Bafin, the German supervisory agency, if carried out by a branch, and by the U.K. Financial Services Authority (FSA) if carried out by a subsidiary. In either case, Bafin would supervise group-level consolidated risk taking.

foundations of financial activity and accountability considerations are also arguments that can favor a national setup. Moreover, financial business used to be conducted overwhelmingly within, rather than across, borders, and to this day most financial institutions remain focused on domestic activity. However, Chapters 6–8 show that the international activities of EU financial institutions are increasing, that internationally active institutions comprise much of the financial system, and that the fortunes of domestically oriented institutions are being driven largely by cross-border factors. This makes a compelling case for more of a cross-border approach to supervision and for prudential authorities to achieve a greater degree of joint responsibility and accountability for financial stability in individual EU member states.

Substantial progress has already been made in tackling the Herculean challenge of designing a financial stability framework for a single financial market that comprises 27 sovereign countries. In Chapter 10, Wim Fonteyne and Jan-Willem van der Vossen note that over the past few decades, the substance of financial regulation has largely shifted toward the EU level. The FSAP has taken legislative and regulatory harmonization to new heights, producing a largely harmonized basic body of regulations. Moreover, the Lamfalussy process now provides a more flexible regulatory structure that can be used to adapt this body of regulations on an ongoing basis. Together, the FSAP and the Lamfalussy process also constitute a major breakthrough toward greater convergence in supervisory practices.

The EU countries also have gone significantly beyond international standards in developing cross-border supervisory cooperation and collaboration. They have put in place various multilateral entities, EU-specific home-host arrangements that pay special attention to conglomerates and banking groups, and a network of multilateral and bilateral Memorandums of Understanding (MoUs) that lay down practical arrangements for cross-border supervisory cooperation. They have also put in place arrangements for crisis management, which focus on coordination and information exchange, and have tested these in a series of “war games.” Finally, the European Union has established a set of rules to handle cross-border bank failures within national legal systems.

Nonetheless, major challenges remain. Most urgent is the need for a strong framework to deal with the risks posed by large complex financial institutions, while also reducing the costs and operational constraints that

present arrangements entail for these institutions. Current financial stability arrangements also need to be bolstered in their ability to deal with EU-wide risks and country-level risks, in particular in countries with a significant foreign bank presence. Moreover, aspects of these arrangements generate friction against integration: leveling the regulatory and supervisory playing field throughout the internal market remains a major struggle, and current arrangements leave significant, albeit declining, scope for prudential authorities to resist financial integration and also produce incentives to do so.

Underlying all of this are more basic challenges, including the absence of a fully developed common financial stability philosophy, complex decision-making mechanisms, and misaligned incentives generated by differences in the scope of supervisors' authority, responsibility, and accountability. Importantly, there is understandable unease about the dependence of host countries on the financial stability arrangements, policies, and decisions of home countries in a context in which host-country authorities remain responsible for domestic financial stability and cannot hold home-country authorities to account. This also complicates financial stability management in countries that have a substantial foreign bank presence. Progress in addressing these challenges could enhance the combined effectiveness of macroeconomic and prudential policies in containing risks to financial stability, reduce the risk of a financial crisis leading to policy reversals, and facilitate further financial integration.

Navigating the Course Ahead

Progress toward a single financial market will require that financial integration proceed along a broad front, successfully navigating around a number of difficult policy issues and obstacles. The supranational legislative phase of the FSAP was largely completed by the 2005 target date, putting in place crucial elements of the future architecture of European financial markets. What matters now is implementation of the different measures at the national level to maximize the integration of markets. The implementation of the Markets in Financial Instruments Directive (MiFID), the Capital Requirements Directive (CRD), and the Solvency II Directive, which overhaul the regulatory frameworks of financial markets, banks and investment firms, and insurance companies, respectively, is particularly important. Beyond this, progress in integrating retail markets and in building the Single Euro Payments Area (SEPA) is also essential in order to deliver more tangible benefits to consumers.

Europe's capital markets are another priority. To flourish, capital markets require a more complex and complete legal, regulatory, and market infrastructure than banks. Although capital markets can find ways around the hurdles that the differences among EU countries present, they cannot do so without significant costs to savers and investors, and, on some issues, public intervention is critical. While much progress can be expected from the implementation of the FSAP, additional efforts will be required to fully integrate the European Union's capital markets. An immediate priority should be the integration of clearing and settlement systems. The latest initiatives in this area are welcome, but may not be sufficient.⁷ Their likely impact will need to be evaluated and alternatives considered as necessary. Meanwhile, work needs to continue on removing the remaining Giovannini barriers⁸ and building an appropriate prudential framework for cross-border clearing and settlement systems as well as on removing obstacles to the consolidation of stock markets. In addition, an appropriate framework for cross-border investment funds must be put into place; and legal and tax frameworks need to be adapted, notably to facilitate the development of pan-European markets for securitization.

Finally, there is a need to bolster Europe's financial stability arrangements, adapting them to reflect the ambitions to make progress toward a single financial market. The current framework is cumbersome, involving a large number of players with conflicting responsibilities. Regulation is being designed at the European level but with close national involvement and many national specificities, including, for example, for deposit insurance. The European Union's home-host arrangements are reaching their limits, not least because LCFIs are increasingly organized along business lines rather than along jurisdictional lines. The limitations of current information-

⁷These initiatives are the Eurosystem's proposed TARGET2-Securities Settlement System and the Code of Conduct concluded between market participants in the sector.

⁸These are barriers to efficient cross-border clearing and settlement identified in two reports produced by a group led by Alberto Giovannini (see Giovannini Group, 2001 and 2003).

sharing arrangements, in combination with diverging incentives, will likely hamper EU countries' ability to handle a cross-border crisis effectively or raise the costs of doing so.

A more integrated and streamlined approach to dealing with financial stability issues is key to effectively and efficiently supervise large cross-border financial institutions, accommodate growing interdependencies and externalities, and build and maintain trust between home and host countries. However, doing all of this within an integration-compatible framework will require more joint responsibility and accountability for EU financial stability.

Joint responsibility and accountability for financial stability would in time need to be reflected in agreement on a number of foundation blocks:

- much greater information sharing, including with the ECB, which would likely require a European confidentiality regime;
- a common rule book of regulatory standards and supervisory practices;
- rules and tools for harmonized crisis prevention and remedial action, based on early intervention and expeditious decision-making procedures and designed around the objectives of limiting the risk and cost of crises;
- a credible and cost-efficient EU-level exit framework for systemic cross-border banks, supported by further harmonization and improvements in national crisis-resolution frameworks; and
- a shared commitment to minimize the (EU-wide) collective costs of a crisis, enshrined in prudential authorities' mandates, along with principles and arrangements to share any related fiscal costs.

None of these foundation blocks is easy to establish, but neither do they seem out of reach given what has already been achieved. Coming to agreement on them, and on the way they will work together, will require convergence toward a set of principles that amount to a sort of common "financial stability philosophy." Such an increased basic understanding will in turn facilitate agreement on concrete reforms and actions in times of crisis.

A variety of institutional arrangements—ranging from new, more centralized, prudential institutions to setups developed from existing institutions—could be compatible with these foundation blocks. To stay with the building analogy, various designs for houses could be built based on these foundation blocks. The spectrum of feasible and effective institutional architectures is also likely to evolve over time, partly as a function of progress on the foundation blocks. What is important is that the debate places due emphasis on what the architecture has to deliver, not on what is deliverable under the existing architecture, notably to provide a helpful sense of direction and a holistic framework for a reform strategy that can be pragmatic in its implementation. Concurrently, day-to-day work should continue on strengthening existing regulatory and supervisory policies and practices, as well as coordination and cooperation, with a focus on the systemic LCFIs.

Financial integration policies and financial stability arrangements are closely intertwined. Progress in one area depends in part on progress in the other. This book argues that, at the present juncture, the European Union's financial integration policies risk becoming increasingly constrained by issues related to financial stability. This presents the European Union with a challenge, but also with an opportunity to play a pioneering role in developing a regional approach to financial stability that could provide lessons for the rest of the world.

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Box 1.1 Timeline of European Financial Integration Policies

- 1957 Treaty of Rome
- 1964 Directive on the Freedom of Establishment in Reinsurance (Directive 64/225/EEC)
- 1973 Directive on the Freedom of Establishment for Credit Institutions (Directive 73/183/EEC)
First Coordinating Directive on Direct Non-Life Insurance (Directive 73/239/EEC)
- 1975 Directive on the Freedom of Establishment in Direct Insurance (Directive 76/580/EEC)
- 1977 First Banking Directive (Directive 77/780/EEC)
- 1979 Coordinating Directive on Direct Life Insurance (Directive 79/267/EEC)
Directive Coordinating the Conditions for the Admission of Securities to Official Stock Exchanges (Directive 79/279/EEC)
- 1980 Directive Coordinating the Requirements of the Listing Particulars to be Published for the Admission of Securities to Official Stock Exchange Listing (Directive 80/390/EEC)
- 1983 Commission White Paper on Financial Integration (COM(83) 207)
- 1986 Single European Act
- 1988 Council Directive on the Liberation of Capital Movements (Directive 88/361/EEC)
Second Coordinating Directive on Direct Non-Life Insurance (Directive 88/357/EEC)
- 1989 Second Banking Directive (Directive 89/646/EEC)
- 1992 Treaty on the European Union (Maastricht Treaty)
- 1993 Completion of the internal market
- 1999 Monetary union
Start of Financial Services Action Plan (FSAP)
- 2002 Introduction of euro notes and coins
- 2005 Completion of EU-level legislative phase of FSAP
“White Paper—Financial Services Policy 2005–10” (COM(2005)629)

Source: IMF staff.