Integration and regulation of financial markets in Europe

Richard Portes

London Business School and CEPR

The EURO: Lessons for European and Asian Financial Markets

Hong Kong, 24 February 2006

What is financial market integration?

- **European Commission definition**

  'A fully integrated financial market is one in which buy and sell interests in a given financial instrument can interact seamlessly and instantaneously across EU borders irrespective of the location of the market participants or the systems/means through which trading interests are expressed.'

  Commission Explanatory Memorandum on the proposal for a directive modifying the directive on investment services (para. 2.2.1)

- **Economists' definition**

  Law of one price: assets generating identical cash flows command same return regardless of domiciles of issuer and asset holder

- *So process versus outcome – many of the controversies in EU financial regulation focus on process without enough concern for the desirable final outcome*

So what do we want?

- A stronger, faster growing European economy from…
- …more efficient, deeper and broader security markets promoting efficient flow of savings to investment
- Lower transaction costs, greater market liquidity
- More diversified and innovative financial systems
- Greater economies of scale and scope in larger market
- Intensified competition among financial intermediaries
- More choice for users
- More opportunities to pool risk

The euro has promoted many of these objectives

It's all about global competition for capital (and the cost of capital)

And there is another form of competition – it is competition between customers, which is often forgotten too: competition for capital which ensures that good providers and good projects get funded, while bad providers and bad projects do not. Competition for capital is the vital financial discipline on which capitalism – in all its forms – ultimately depends. And unless you have efficient capital markets, that competition cannot take place.

Dominic Hobson, *Global Custodian Magazine* , September 2002

But that competition requires a regulatory framework: self-regulation and market discipline aren't enough

- *Asymmetric information* between counterparties endangers investor confidence and financial stability
- Marking to market and frequent portfolio rebalancing → volatility; rising leverage; off-balance-sheet activities, rising liquidity risk…
- so install 'safety nets': deposit insurance, lender of last resort (LLR)
- but they create *moral hazard*
- hence need *regulators* to monitor behaviour
- and *consumer protection* may require regulation

All regulatory intervention requires justification as a response to market failure

Regulation may go too far, even in dealing with genuine market failures: there are policy tradeoffs

- Between financial system *performance* (in intermediation) and *stability* – e.g., Basle agreements?
- Between *supervision* and *performance*: cost of compliance
  - Inadequate regulation may permit costly failures, endanger consumers – *e.g.*, Parmalat?
  - Overregulation may stimulate relocation of activities and firms to other regulatory regimes – *e.g.*, market participants say that new regulations are driving Asian equity issuers away from European exchanges
- But regulation can also be used to protect domestic financial sector – *e.g.*, Banca d'Italia's interventions to prevent foreign banks' takeover of Italian banks
- Should regulators actively promote 'fairness'? 'universal service'? – these are important issues in Europe

In EU, we have (too?) many players

- Market firms
- The users of capital (corporates etc) and the ultimate providers of capital (savers etc)
- The European Council and the Council of Finance Ministers
- Member States acting individually
- European Commission
- European Parliament
- National regulators and EU-level committees (ESC, CESR, CEBS, …)

Do we need a single regulator (an EU 'SEC')? – remember, the US has multiple and overlapping financial regulators too!

- Harmonization
- Mutual recognition

How does mutual recognition work?

- Each national regulator recognizes authority of counterpart in other member states
- Thus an institution authorized in one MS may operate in all others and offer same products
- Minimum harmonization of essential prudential rules – *e.g.* on financial solvency
- Home country supervision on the basis of harmonized rules

Mutual recognition involves genuine pooling of sovereignty: host country cedes regulatory role to home country

Sounds good – but conflicts among member states

- *on mutual recognition (based on harmonized core principles) – the UK preference – vs. more or less harmonization*
- *between exporters and importers of financial services*
- *between those more concerned with creating EU-wide wholesale markets and those stressing retail investment (cross-border trade in financial services)*
- Recently, these conflicts have focused on **process** – where to use one or the other approach, how to get legislation through, what structures for implementing it
- We are just beginning the difficult stage of implementation, and in many cases we have yet to see the desired **outcomes**

Example: a single market in equities – what would it be like?

- Market participants free to operate in all MSs
- Intermediaries authorized by home state free to compete (branch or cross-border service) in all national systems, with access to all essential infrastructures, possibly on a remote basis
- Intermediaries able to offer in any MS whatever products are licensed by their home authority
- Infrastructure providers (exchanges, clearing and settlement, etc.) may offer services across EU
- End users free to invest or borrow wherever they like
- EU-wide market for corporate control (no barriers to takeovers)

But obstacles

- ‘General good’ clauses in directives – so regulators can impose restrictions based on vague criteria, in the name of ‘consumer protection’

- Retention of quasi-protectionist rules

- Ambiguity in directives – bad legislation – *e.g.*, takeover directive may permit France or Spain to introduce ‘poison pill’ legislation to block politically objectionable cross-border M&A (‘economic patriotism’)

- Discriminatory national tax measures

- *Inadequate enforcement* of new legislation – or the converse: national ‘gold-plating’ of EU regulations

The result: not yet there!

- Many products authorised in one member state cannot be sold in another
- Prohibitive local registration and compliance costs
- Tax discrimination against non-domestic products
- Transactions between “professionals” sometimes subject to detailed regulation appropriate to “retail” customers
- Non-locals find access to local infrastructure difficult

Example: transparency in bond markets

- Markets in Financial Instruments Directive (MiFID) requires greater transparency in equity market trading
- Should these regulations be extended to bond markets?
- Many regulators (including government debt management offices) argue yes
- Most market participants argue no – indeed, some say that greater transparency in bond markets would kill off liquidity
- The US example is used by both sides!
- We see here several of the key conflicts: ‘buy side’ (fund managers) *v.* ‘sell side’ (DMOs and investment banks), wholesale *v.* retail (and at national level – e.g., UK *v.* Italy)

This wouldn’t matter so much if the euro had not brought such a substantial degree of integration of government and corporate bond markets and expansion of the latter

Some say we shall inevitably get centralized regulation…

- National protectionism: ESC = Council of finance ministers – with effective national vetoes for large countries
- Bureaucratic inertia
- Conflicts between Commission, Parliament, Council
- Weak legislation – FSAP pushed too fast, sacrificed quality
- Weak enforcement – member states will resist, Commission and private sector won't challenge
- EU enlargement will further weaken enforcement
- Mutual recognition = regulatory competition → deregulation, concentration – so will be seen as a 'Trojan Horse' for 'Anglo-Saxons', *i.e.* City of London (financial centre of euro area!)
- And this will intensify pressure for European SEC to 'control' the process

… So 'watch this space'!