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The achievements and challenges of EU financial integration and its implications for the US

I have been asked to approach this complex question from some distance and in a wide perspective. I shall thus not deal with technical points and shall focus on some major considerations that can help understand better some particular aspects of the subject.

I shall group my remarks around three themes :

- The European market of financial services has become a major pillar of international finance. It compares favourably with the other large markets of the world ;
- However, the present state of integration of financial markets in Europe remains insufficient. How can one enhance the development of European global players?
- What are the implications of this situation for the US ?

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I. The importance of the European financial market. It compares favourably with the other large markets of the world, in particular with that of the United States :

A. Bond markets:

1. The new issues (in gross terms) of bonds (of more than two year maturity) denominated in euros have considerably increased since the creation of the euro (1998: 800 million euros, 2005: 2.7 billion).

2. The market of bonds issued in euros represents about 60 % of the US dollar market. Since 1999, the new issues of bonds in euros amounted in cumulative terms to 14,9 billion euros against 25,7 billion euros for bonds issued in US dollars.

3. But given that the role of banks in the financing of the economy is much more important structurally in Europe than it is in the United States (although this is somewhat changing), it is more significant to consider the international role respectively of the euro and of the dollar. When one computes the bonds issued by "non-resident" companies, by foreign governments and by the multilateral institutions on external markets (i.e. on markets outside the countries or the monetary zones where these issuers are headquartered), one observes that the issues of

this type in euros represented from 1999 to the end of 2006 a cumulative amount practically equal to that of the comparable issues in dollars (5,1 billion euros against 5,7 billion). [1]

4. But if one adds to the figures above, (which concern only the bonds of more than two years maturity), the short-term bond issues as well as the issues on money markets, one observes that the net total issues in euros represented 54,9 % of the global world market in 2005 (against 26,4 % for the dollar).

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These are essential considerations. **They show that the euro market has considerably increased since the beginning of the years 2000 and that it constitutes today for all the corporates and the governments of the world a vast, sure and liquid source of funds, of a size henceforth wider than that of the dollar.**

While the dollar remains dominant as an international reserve currency (65 % of international official reserves against 24 % for the euro), bond markets have become bipolar with the euro playing the leading role.[2]

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B. The equity market:

By contrast, although they have developed since the 80s, the Euro equity markets remain significantly smaller than in the United States.

In terms of market capitalization, the Euro-zone represented in 2005 16,8 % of the global world capitalization, the share of the United States amounting to 41,6 % and that of Japan to 11,1 %. (See table III.)

In terms of market capitalization related to the GDP of the countries and monetary zones concerned, the Euro-zone equity market represented 55 % in 2005 (against 42,7 % in 2003) while the United States amounted to 105,24 % and Japan to 84,9 %.

As for the volume of share transactions ("turnover"), Europe represented in 2006 26 % of the global total and the United States 49 %.

Furthermore, if ones looks at the share of equity in the investment funds held by "Europe 25" households, one notes that it has increased by three percentage points since 2002 and amounts to 26,5 % in 2005, while the same share in the United States remained stable at 45 %[3].

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[1] By adding to these "international" issues, those of the "domestic" governments (respectively of the Euro-zone and the United States), the cumulative numbers show that the market in euros exceeds slightly that of the dollar (since 1999: 9.617 euros against 9.313 euros).

[2] In terms of average unit amount by issue, statistics show that in 2006 the average for the euro exceeded 500 million euros against 300 million for issues in dollars, and 400 million for issues in pounds sterling. See graph III.

[3] Data: L'Observatoire de l'Epargne Européenne.

Therefore, one sees that the Eurozone equity market is still significantly smaller than that of the United States.

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C. Financial services:

A recent study[4] shows that Europe, in the fields where it is still lagging behind the United States (eg.managed funds, returns from investment banks, share transactions, hedge funds, private banking), has not stopped catching up since 2001.

Some data are most interesting :

- As regards insurance (life and not life): the premiums of the european companies exceeded those of their american counterparts since 2003 (1.3 trillion dollars for the former against 1.1 trillion dollars for the latter in 2005);

- As regards banks, three findings are significant:

  revenues generated on average by a european customer of an investment banks represent 71 % of those of the american customer ;
  the assets of european commercial banks (42 trillion dollars) represent nearly four times those of their american counterparts (11 trillions) ;
  the outstanding amount of international loans (non domestic) granted by european banks amounted, at the end of 2005, to 14 trillion dollars against 1.9 trillion for american banks. If one deducts, as one should, the intra-european business from their international activities, it appears that the european bank's external lending position with the rest of the world would still be three times the United States figure.

This shows the worldwide importance of the european financial services markets and the competitiveness of the global european financial players in a increasingly integrated world. What are the challenges to better integrate European markets and to facilitate the global expansion of these players?

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II. The insufficient integration of the European financial markets and the ways of progress:

A. The present situation:

Without getting into details, I shall underline three elements:

1. If bond markets and money markets in Europe can be considered as well integrated, the "prospectus directive" constituting a rather effective base, as well as wholesale banking

[4] Financial Market Trends, Europe vs US 2006. International Finance Services – London.

business, this is not the case for retail financial activities which are the object of very differentiated national regulations notably as regards consumer protection.

2. Besides, Europe is characterized by the fragmentation of its market infrastructures. This is true for stock exchanges, some of which seem to prefer to be bought by american operators rather than getting together in a european framework, as well as for clearing and settlement systems, which count more than 25 institutions in Europe.[5]

3. Finally, Europe is the object of very diverse regulations and supervisory systems. The " Lamfalussy process" was intended to bring more coordination and homogeneity both at the level of the national transposition of the directives and at the level of the implementation of supervision. But force is to recognize that national differences are still significant. Some Member States have a systematic bias for gold platting.

These reminders show that in spite of the considerable efforts of harmonization achieved over the last years within the framework of the Action plan of Financial services, the European market of these services has not become a true "single" market, which would be in the logic of the creation of the euro. The single currency will only have reached all its potential when the European financial markets are really integrated.

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B. What are the ways to move forward ?

1. Before trying to answer this question, it is useful to recall the importance of the stakes at hand.

The fact that the retail financial services are still very fragmented means that european consumers cannot yet take advantage of a vast supply of pension related products, as well as of more secure and cheaper services offered by wider entities from unified platforms. For example, the increase of the size of investment funds – which is today five times lower than that of their American equivalents -that would result from cross-border mergers of funds, would allow to reduce significantly management costs and risk volatility.

In sum, in spite of the increasing consistency between the members of the European Union in terms of general orientations, national specificities remain the rule when it comes to transposition.

And there is an additional consideration: the complexity and the heterogeneousness of prudential regulations and of surveillance penalize not only the intensification of the cross-border relationships in Europe (it is often almost as difficult to expand in another european country than in some other place in the world), but also risk to hamper the global expansion of the large financial players of our continent.

[5] The "post-trading" activities are essential for the competitiveness of financial markets in Europe: the (avoidable) costs linked to the fragmentation of these infrastructures represent considerable amounts (2 to 5 billion euro a year according to the studies).

2. Two approaches are possible, in this respect, and should be combined:

a) The classic approach towards harmonization. It is obviously advisable to pursue it while knowing that progress is not easy. Indeed, at the heart of this question, lay difficult issues : the politically sensitive issues of consumer of protection, the structural diversity of behaviours as regards payments (i.e. use of checks…), the legally complex issue of harmonizing bankruptcy rules, contracts, company laws without mentioning taxation.

In this perspective, the European Commission, rather than proposing a new arsenal of directives, tends to focus on some priorities, notably:

- The constitution of a Single European Payment Area (SEPA) ;
- A limited number of financial products (consumer credit, mortgages, UCITs) (Understanding for Collective Investment in Transferable Securities) ;
- A code of good conduct for "post-trading" activities;
- The elimination of additional and superfluous provisions at the time of the transposition of the directives….

What I have just mentioned makes good sense and can foster the European market of financial services. But, it does not answer all the challenges and stakes which I touched on a moment ago. It is thus necessary to combine these efforts with another approach.

b) The approach consisting in strengthening the large European players so as to allow them to develop not only on a european but on a global scale.

This is where issues of regulation and supervision take all their importance.

European financial services taken as a whole - whether they relate to banks, to insurance companies or to the management of assets are facing a fierce global competition. They are confronted with common problems: fast technological evolutions, increasing mergers and concentrations, the emergence of new markets (China notably) where new financial "giants" are appearing.

To build financial Europe, it is necessary to favour competitiveness notably by offering, on a european scale, a status facilitating mergers between players whatever their nature : mutualist, cooperative or commercial. And Europe has to establish a solid base for financial players so that they can operate on the international stage and strengthen their positions as global institutions.

In this respect, regulation and supervision have a major role to play. Well designed and applied with consistency they can facilitate this evolution. Too fragmented, too complex or too heavy, they can, on the contrary, slow down this internationalization. We should not hamper this necessary expansion because of our complexities and our regulatory and supervisory fragmentations.

The stakes are high and the questions to settle of importance. What are the methods which would allow a homogeneous implementation of the regulatory requirements? How to assess the quality and the relevance of the internal risk assessment models in order to rationalize the new capital requirements without excessive rigidity and useless complexity? In what measure is the concept of a " lead supervisor " adequate? What to think of the recent and innovative proposal of the British Treasury tending to create a " lead supervisor" for insurance companies groups ?...

All this deserves reflection, open mind and a climate of confidence between political decision-makers, supervisors and financial institutions. The key of this indispensable trust lies in the definition and the sharing of a common vision of the impact of evolving financial techniques, of risk modelling, of the system processes to be implemented in case of crisis, all this in a more and more globalized and changing world.

EUROFI had proposed last June that a mission featuring public decision-makers and representatives of the industry undertake an open discussion on these questions. I wish that, after a phase of dialogue between the main financial players in 2007, this proposal can eventually succeed.

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III. Implications for the US :

A. US financial institutions are thriving in Europe :

The fact that the European financial market is open and developing so rapidly has attracted US financial institutions who are playing an increasing role in mergers and acquisitions, in offering structured products and developing investment funds. The recent acquisition of the Euronext stock exchange platform by NYSE is an illustration of this trend.

One can observe that, in 2005, among the 10 first banks involved in European M&A's, US banks have been advising more than 65 % of the total number of deals. In 2006, if one considers the top 5 largest deal winners in France, 4 have been US international banks (60 % of the number of deals and 76 % of the amounts involved).[6]

The thrust of US banks strategy in Europe is to develop their fee generating business form their existing structures. In contrast, European banks have been investing heavily in acquisitions in the US.[7]

B. In an integrated world, regulatory and supervisory conditions have a major influence in shaping competition :

In this respect, on should note that the equity markets in the United States have recently lost a good deal of their attraction notably because of new US regulatory constraints. While these

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1. BNP Paribas 108 billion euros (63 operations)
2. Goldman Sachs 98 billion euros (24 operations)
3. Merrill Lynch 93 billion euros (23 operations)
4. Morgan Stanley 87 billion (28 operations)
5. Citigroup 77 billion euros (23 operations)

Source : Fusion et acquisitions magazine.

[7] From 2001 to 2006, American banks have acquired 865 million US dollars in the financial sector of the European Union (27). During the same period European banks have acquired 62,9 billion US dollars in the US financial sector.
Source Bloomberg.

markets drove approximately 50 % of all the new public offerings (IPOs) during the 90s, this percentage has fallen to 6 % in 2005. (24 of the 25 largest IPOs took place in 2006 outside the United States, mostly in London).

This sudden fall can be explained essentially:

- by the vitality and efficiency of European and emerging capital markets (see Aim for example, in London) ;
- by the new US regulatory requirements (the average cost of section 404 of the Sarbanes-Oxley Act amounted in 2004, its first year of implementation, to 4.3 million dollars per company);
- by the rising importance of private capital markets (private equity issues are practically free from mandated disclosure requirements);
- by the high listing costs of the New York Stock Exchange (NYSE) as compared with those of large non US-markets;
- by the reluctance of foreign companies who consider being listed in the United States but fear that they could be blocked there for ever because of the regulatory obstacles to exists[8].

Conversely, a simpler and more coherent regulatory and prudential setting in Europe will help net only European but also US financial institutions.

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C. It is therefore essential that basic regulatory and supervisory constraints be compatible on the two sides of the Atlantic :

There have been significant steps forward in this respect :

- the new international accounting standards (IFRS) -although far from being perfect- are at least leading to the convergence of accounting and auditing rules for listed companies. But there is still work to do on mutual recognition equivalence and the removal of reconciliation requirements for IFRS and US GAAP. It is essential to keep the principal based approach and to resist against any attempt to the application of the "full fair value" –which continues to obsess the IASBord members. Continental European banking business model can for some aspects be very different from the American one, as in the former, banks keep for a longer period the larger part of their loans in their balance sheets ;

- under the strong leadership of the US, Basle II has modernised and refined capital adequacy requirements and has insisted on improving risk management. Europe has adopted the Accord in the form of a legislated "directive". But somewhat paradoxically, it is in the US that application problems are arising. It is thus important and urgent that US regulators -who appear more fragmented in this respect than their European counterparts- allow their international banks to abide by this new set of rules and principles so that there can be an orderly and synchronized implementation of the Accord on a consolidated basis. Convergence could be endangered by the US's Notice of Proposed Rulemaking on Basel II implementation when compared with the Basel

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[8]See: Interim Report of the Committee on Capital Markets Regulation " by Glen Hubbard, John Thornston and Hal Scott, November 30, 2006, and the McKinsey Report : "Sustaining New York's and the US Global Financial Services Leadership".

accord and the choices made in Europe. The current proposal would appear to force EU institutions with subsidiaries in the US to implement double systems. Particular concerns relate to the changes made in the US to the metrics of the Accord (the definition of default and the risk parameters); the gap year; and the mandatory status (banks using advanced approaches on a consolidated level and represented in the US will be required to use US advanced approaches) ;

- in terms of securities, a dialogue is being worked upon between the EU and the US. I hope it will lead to a more common level playing field. In this regards, it is encouraging to acknowledge the recent amendment passed by the SEC on March 21, 2007, concerning deregistration. This amendment would significantly facilitate de-registration by foreign firms (the SEC has estimated that about 60 % of European companies could deregister) [9] ;

- regarding insurance supervision, Europe is developing a modern system (Solvency II) based on internal risk assessments which -if adequately designed- could become a model for international regulators in this field ;

- it is interesting to look a the way the American and the European equity markets regulation evolve, while the transposition of the MIFID and the Regulation NMS[10] are going to occur more or less at the same time. When it proposed its draft of ISD in 2002, the European Commission has been inspired by the 30 year functioning of the American National Market System. The recent modification of the latter is intended to pursue the same targets as the MIFID does: better transparency of the markets, best execution of clients' orders and reduction of trading costs. As a matter of fact, the American legislation goes a step further as it could trigger a kind of reconsolidation of the markets facilitated by the existence of a consolidated infrastructure for clearing and settlement while the MIFID wants to favour the competition between the venues. Nevertheless it is interesting to see how experiments and, I hope, best practices can be shared on the two sides of the Atlantic. The attempt of the SEC to withdraw from its legislative excesses, following emblematic American failures due to the internet bubble, shows that European industry has been right in drawing attention of European authorities to resisting to the pressures to apply the same kind of rules.

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In an integrated world where capital moves freely and where competition for capital is increasing, it makes good sense for the regulators of the "two pillars" of the financial system to work together on an equal footing so they can develop consistent rules, share their best practices, promote fair competition and avoid regulatory arbitrage and extraterritorial temptations.

[9] Up to now, deregistration was not authorized for foreign companies having 300 or more US shareholders ! Now a company can deregister if it can show that the average daily US trading volume of its shares has been no greater than 5 % of its global trading volume over the previous 12 months.

[10] Regulation (on) National Market System. On June 2005, the Securities and Exchange Commission (SEC) announced changes to market structure to enhance and modernize the existing national market system (NMS) rules.