The Achievements and Challenges of European Union Financial Integration and Its Implications for the United States

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I have been asked to approach this complex subject—the achievements and challenges of European Union (EU) financial integration and its implications for the United States—from a broad perspective. I shall thus not deal with technical points, and will instead focus on several macro considerations that can help the reader better understand some particular and important aspects of the subject.

I will address two themes:

1. The importance of the European market in financial services. This has become a major pillar of international finance and compares favorably with the other large markets of the world.

2. What are the implications of European Union financial integration for the United States?

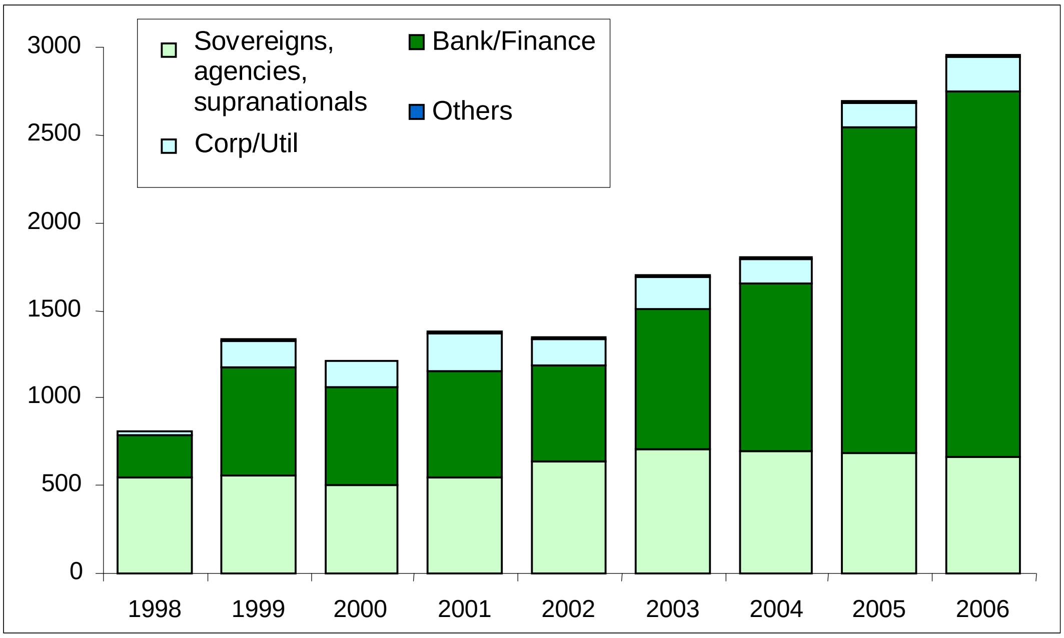
I. The Importance of the European Union Financial Market

The European financial market compares favorably with the other large markets of the world, in particular with the financial market of the United States. This is especially evident in the bond markets.

A. Bond Markets

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

Figure 1. EUR Bond Issuances, 1998–2006 (domestic + international markets)
(in billions of euros)



Source: Dealogic Bondware.

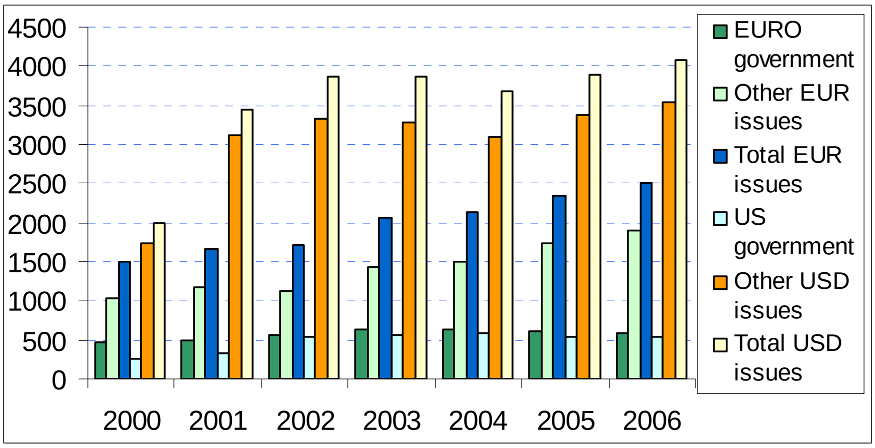
2. The market of bonds issued in euros represents about 60 percent of the U.S. dollar market. Since 1999, the new issues of bonds in euros amounted to 14.9 billion euros compared to 25.7 billion euros for bonds issued in U.S. dollars (see Figure 2) (BNP Paribas Bondware).

Table 1. Gross Issuances Government Compared to Nongovernment International + Domestic, EUR-USD, Maturities > 2 years

Billions Euros			Domestic + international						
EUR bn	1998	1999	2000	2001	2002	2003	2004	2005	2006
EURO government	518.0	528.7	477.2	500.6	573.1	638.5	633.4	612.0	592.0
Other EUR issues	668.9	1102.5	1020.8	1174.0	1132.2	1432.2	1508.6	1731.5	1906.8
Total EUR issues	**1186.9**	**1631.2**	**1498.0**	**1674.6**	**1705.3**	**2070.7**	**2141.9**	**2343.5**	**2498.8**
US government	377.0	311.4	263.0	328.7	528.8	566.7	591.5	533.0	541.0
Other USD issues	1591.5	1664.6	1726.7	3108.9	3327.2	3291.8	3084.8	3368.8	3547.6
Total USD issues	**1968.5**	**1976.0**	**1989.7**	**3437.6**	**3856.0**	**3858.4**	**3676.3**	**3901.8**	**4088.6**

Source: BNP Paribas; Bondware.

Figure 2. Gross Issuances, in Billion Euros, EUR-USD, Government and Nongovernment (international + domestic markets), Maturity > 2 years



Source: Dealogic Bondware; BNP Paribas Bondware.

3. 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 slowly changing), it is more significant to consider the *international role, respectively, of the euro and of the dollar*. When one adds up the bonds issued by "nonresident" companies, by foreign governments, and by the multilateral institutions on external markets (that is, in 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 compared to 5.7 billion euros).[1]

3. Moreover, if one adds to the figures above, which concern only bonds of more than two years' maturity, the short-term bond issues and issues on money markets, the net total issues in euros represented 54.9 percent of the global world market in 2005. The figure for dollar issuances of the same types is only 26.4 percent of the market (see Table 2).

[1] By adding to these "international" issues those of the "domestic" governments (of the Eurozone and the United States, respectively), the cumulative numbers show that the market in euros exceeds that of the dollar (since 1999: 9.9 billion euros compared to 9.6 billion euros) (BNPParibas Bondware).

Table 2.

Net issuance, gross issuance and outstanding in the international bond and note markets (% of world total)

	Net Issuance							
	1999	2000	2001	2002	2003	2004	2005	Q1-06
Dollar	46.8%	50.7%	49.4%	43.2%	32.1%	23.9%	26.4%	34.2%
Euro	45.9%	39.0%	43.7%	49.1%	56.3%	59.6%	54.9%	49.6%
Yen	-0.7%	1.1%	1.3%	1.7%	0.3%	1.7%	0.2%	-0.3%
Other	8.0%	9.2%	5.6%	6.0%	11.3%	14.8%	18.5%	16.5%

	Gross Issuance							
	1999	2000	2001	2002	2003	2004	2005	Q1-06
Dollar	43.9%	46.5%	49.1%	46.9%	40.6%	34.8%	34.3%	37.3%
Euro	38.4%	34.1%	36.5%	38.4%	44.6%	48.5%	47.9%	46.5%
Yen	6.7%	7.6%	5.4%	4.2%	3.6%	3.4%	3.0%	2.0%
Other	11.0%	11.8%	9.0%	10.5%	11.2%	13.3%	14.8%	14.2%

	Outstanding							
	1999	2000	2001	2002	2003	2004	2005	Q1-06
Dollar	47.0%	49.1%	50.8%	46.2%	40.5%	36.9%	38.5%	37.8%
Euro	28.8%	30.2%	32.2%	37.5%	43.5%	46.8%	45.2%	46.0%
Yen	10.4%	8.3%	5.8%	4.9%	4.4%	4.0%	3.4%	3.2%
Other	13.7%	12.4%	11.2%	11.3%	11.6%	12.3%	12.9%	13.0%

Source: BIS, October 2006

Of course, the dollar remains dominant as an international reserve currency—65 percent of international official reserves compared to 24 percent for the euro. The bond markets create a bipolar financial world where the euro plays the leading role.[2]

B. The Equity Markets

In contrast to the dynamic changes seen in the bond markets, Euro equity markets remain significantly smaller than the U.S. equity markets.

In terms of market capitalization, the Eurozone represented in 2005 16.8 percent of the global world capitalization, the U.S. share represented 41.6 percent, and the Japanese share represented 11.1 percent (see Table 3.)

Table 3. Market Capitalization Worldwide;
Average Capitalization as Percentage of World

	World	U.S.A.	Eurozone	Japan
2002	100.00	47.5	16.1	10.4
2003	100.00	46.2	16.1	10.5
2004	100.00	43.7	16.4	11.2
2005	100.00	41.6	16.8	11.1

Source: BNP Paribas.

In terms of market capitalization related to the gross domestic product (GDP) of the countries and monetary zones concerned, the Eurozone equity market represented 55 percent in 2005 (compared to 42.7 percent in 2003), while the United States represented 105.24 percent and Japan 84.9 percent (see Table 4).

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

Table 4. Market Capitalization Worldwide, Average Market Capitalization as a Percentage of Nominal GDP per Country

	World	U.S.A.	Eurozone	Japan
2002	67.9	99.4	53.2	57.1
2003	61.8	94.0	44.0	54.5
2004	70.6	105.3	49.9	68.0
2005		105.24	55.0	84.9

Source: BNP Paribas.

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

Furthermore, the share of equity in the investment funds held by "Europe 25" households has increased by 3 percentage points since 2002 and amounted to 26.5 percent in 2005, while the same share in the United States remained stable at 45 percent.[3]

Based on the above it is clear that the Eurozone equity market is still significantly smaller than that of the United States.

C. Financial Services

A recent study[4] shows that while Europe has certain fields where it still lags behind the United States (including managed funds, returns from investment banks, share transactions, hedge funds, private banking), the gap between the two markets is narrowing as European financial service providers continue to innovate. This period of "catch up" has been evident since 2001.

A few data points worth considering are:

- As regards insurance (life and non-life): the premiums received by European companies have exceeded those of their American counterparts since 2003 (1.3 trillion dollars for the former compared to 1.1 trillion dollars for the latter in 2005).[5]

- As regards banks, three findings are significant:

[3] *L'Observatoire de l'Epargne Européenne.*

[4] *Financial Market Trends,* "Europe vs. U.S.," International Finance Services, London, 2006.

[5] Ibid.

1. Revenues generated on average by a European customer of investment banks represent 71 percent of those of the American customer.
2. The assets of European commercial banks (42 trillion dollars) represent nearly four times those of their American counterparts (11 trillion dollars).
3. The outstanding amount of international (non-domestic) loans granted by European banks amounted, at the end of 2005, to 14 trillion dollars compared to 1.9 trillion dollars for American banks. If we subtract, the intra-European business from their international activities, it still appears that the external lending position of European banks vis-à-vis the rest of the world is three times the U.S. figure.[6]

These figures demonstrate the worldwide importance of European financial services markets and the competitiveness of the global European financial players in an increasingly integrated world. In certain financial service areas European players are dominant, while in others the United States has an edge. So it is appropriate to ask: “What are the challenges to better integrate European markets and to facilitate the global expansion of these European players?”

II. Implications for the United States

A. U.S. Financial Institutions Are Thriving in Europe

The rapidly developing European financial market has attracted U.S. financial institutions that are playing an increasing role in mergers and acquisitions, offering structured products and developing investment funds. The recent acquisition of the Euronext stock exchange platform by New York Stock Exchange is an illustration of this trend.

In 2005, among the 10 top banks involved in European mergers and acquisitions, U.S. banks have been advisers on more than 65 percent of the deals.

In 2006, looking at the five largest investment banking deal winners in France, four have been U.S. international banks (accounting for 60 percent of the number of deals and 76 percent of the totals involved).[7]

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[6] Ibid.

[7] 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 euros (28 operations).
5. Citigroup: 77 billion euros (23 operations).
(*Source: Fusion et Acquisitions* magazine.)

The thrust of the strategy of U.S. banks in Europe is to develop their fee-generating business from their existing structures. In contrast, European banks have been investing heavily in acquisitions in the United States.[8]

B. In the Integrated World, Regulatory and Supervisory Conditions Have a Major Influence in Shaping Competition

In this respect, the equity markets in the United States have recently lost a good deal of their attraction, notably because of new U.S. regulatory constraints. While these markets drove approximately 50 percent of all the initial public offerings (IPOs) during the 1990s, this percentage fell to 6 percent in 2005 (24 of the 25 largest IPOs took place in 2006 outside the United States, most of them in London).

This sudden fall can be explained by:

- The vitality and efficiency of European and emerging capital markets (see Aim, for example, in London);
- The new U.S. 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);
- The rising importance of private capital markets (private equity issues are practically free from mandated disclosure requirements);
- The high listing costs of the New York Stock Exchange compared with those of large non-U.S. markets; and
- The reluctance of foreign companies that consider being listed in the United States to do so because they worry about the difficulties of delisting should that ever be desirable.[9]

Conversely, a simpler and more coherent regulatory and prudential setting in Europe will help not only European but also U.S. financial institutions.

C. It is Essential that Basic Regulatory and Supervisory Constraints be Compatible on Both Sides of the Atlantic

There have been significant steps forward in this respect:

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[8] From 2001 to 2006, American banks acquired 865 million U.S. dollars in the financial sector of the European Union (27). During the same period European banks acquired 62.9 billion U.S. dollars in the U.S. financial sector. (*Source:* Bloomberg.)

[9] 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 U.S. Global Financial Services Leadership.”

- The new international financial reporting standards (IFRS)—although far from perfect—are at least leading to the harmonization 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 U.S. generally accepted accounting principles.
- Under the strong leadership of the United States, Basle II has modernized and refined capital adequacy requirements and has insisted on improving risk management. Europe has adopted the Accord in the form of a legislative directive. However, it is in the United States that application problems are now arising. It is important and urgent that U.S. 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.
- In terms of securities, a dialogue is underway between the EU and the United States that I hope will lead to a more level transatlantic playing field. In this regard, it is encouraging to note the recent amendment passed by the Securities and Exchange Commission (SEC) on March 21, 2007, concerning de-registration. This amendment would significantly facilitate de-registration by foreign firms (the SEC has estimated that about 60 percent of European companies could de-register).[10] This goes some way toward addressing one of the key complaints of the Hubbard report.
- 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.

Conclusion

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.

[10] De-registration had not been authorized for foreign companies having 300 or more U.S. shareholders! Now a company can de-register if it can show that the average daily U.S. trading volume of its shares has been no greater than 5 percent of its global trading volume over the previous 12 months.