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A banking and financial Europe after the euro

"The European share market and the need for integration"
Address by Mr Jacques de Larosière, Co-Chairman of Eurofi 2000, to the Entretiens Economiques in Brussels on 3 May 2002

Completion of economic and monetary union (EMU) is a decisive step towards the establishment of a powerful European capital market commensurate with the economic performances of the fifteen Member States. The single currency is creating the level playing field necessary for optimum functioning of capital-allocation mechanisms within the European economy that will put it on the same footing as the United States.

However, a great deal remains to be done in this field if recent studies (European Financial Services Round Table, February 2002) estimating that incomplete integration of the single market in banking and financial services will cost investors and consumers an additional € 15 billion a year are to be believed.

The share market is no exception. It has a very special place in the range of financing available to economic operators. By its nature, it provides the enduring share of capital on which firms can rely for their long-term development. It meets a wide range of their needs, from seed capital through private equity (start-up capital, risk capital, development capital, LBOs) to mature shares on regulated markets, viz. the famous blue chips. If an economy is to grow, it needs a deep, liquid and diversified share market alongside the market for bank debt and the bond market. While a substantial market does exist in Europe, its basis is essentially domestic.

It has to be said that for twenty years or more the progress made towards an integrated European financial market has remained uneven. The equity segment has expanded significantly but is expected to continue growing in the medium term before reaching levels of liquidity and competitiveness equivalent to those in the United States.

I. The euro, a factor contributing to faster integration of the European share market

EMU imparts additional impetus to the efforts that have been made over twenty years to promote the emergence of a genuine European financial market with a strong share component.

(a) Progress towards regulatory convergence

➢ At the beginning of the 1980s Europe had to contend with very serious handicaps relative to the US benchmark. It was characterised by a myriad of fifteen domestic markets, each with its own identity, and by fifteen different currencies. Hence:

the absence of a harmonised monetary and financial framework;

the existence of poorly developed domestic market infrastructures featuring a whole range of domestic dealing, settlement and regulatory systems and with company law provisions reflecting specific local circumstances, including in the tax sphere;

a weak equity culture in western Europe to the benefit of a "debt market" culture more in keeping with the economic conditions prevailing after the Second World War;

lastly, the absence of "guiding" market infrastructures at European level, apart from certain initiatives relating to securities and cash transaction settlement (Euroclear/Cedel/Swift) and limited for the most part to eurobonds.

➢ To remedy this fragmentation, which gives rise to extra costs and economic inefficiency, a major drive has been launched at Community level with a view to achieving closer regulatory convergence of market systems in Europe. The share segment has benefited from this programme, which has embraced all aspects of society. The main stages in this process include:

adoption of the Single European Act (1985), which set as one of its objectives the establishment of the internal market notably for banking and financial services by 1992;

the mapping out of a common market framework including the Investment Services Directive, the freedom to provide services, the "demutualisation" of stock exchanges, the introduction of common arrangements for investment funds (mutual funds, SICAV-FC), etc.;

a tidying-up exercise under the very important Financial Services Action Plan (1995-2004), with a number of priority texts in the course of being adopted (market abuse, investment services, etc.);

further encouragement of seed capital and development capital ventures, with the creation of dedicated regulated markets (AIM, Neuer Markt, Nouveau Marché, etc.);

moves to establish a European regulatory regime as part of the Lamfalussy approach (2001), with the establishment of the European Securities Committee (ESC) and the Committee of European Securities Regulators (CESR).

The above factors are resulting in some measure of convergence of the European framework, although the national bases remain strong.

(b) Important progress with market infrastructures has accompanied the emergence of this Community framework

Financial actors (investors, stockmarket firms ("entreprises de marché"), regulators, issuers, intermediaries) have exploited the potential of the Community framework to become active on a wider scale. Share markets have benefited.

The new stockmarket scene in Europe is in a state of flux. The euro has speeded up its restructuring towards what is a genuinely European critical mass. At present, the following main trends are discernible:

- There is intense inter-market competition marked by mergers at several levels of consolidation. At national and cross-border level (Euronext, a merger of the French, Belgian, Dutch and Portuguese stockmarkets) or at regional level (OM Group in Scandinavia), traditional stockmarkets are being obliged to regroup in order to secure the economies of scale essential if they are to become competitive at European level. At the same time, they are having to face new competition linked to the emergence, as yet with varying fortunes, of operators such as Virt-x, Jiway and Nasdaq Europe using new innovative models of technological organisation (Alternative Trading System (ATS) or Electronic Communication Networks (ECN)). This regrouping is far from complete and is expected to spread soon to the markets that are still domestic in nature (Madrid, Milan, etc.).

  The traditional world of stockmarkets based on domestic monopolies is now over following a three-stage process of monopoly, demutualisation and listing. By attaching overriding importance to business logic, this has given stockmarket firms genuine headroom to position themselves within the new European framework. The main stockmarkets (DBAG, Euronext, LSE) are already at the stage of initial public offerings (IPOs) and the others are expected to follow suit shortly. The clear objective is to offer investors and issuers optimum liquidity at the lowest cost of access and on the best possible terms.
- The race to achieve the critical size at European level involves not only players but also the real market infrastructures that need to be put in place for the different

segments of securities business (trading, clearing, settlement and delivery). Rationalisation of back offices is a key factor of competitiveness. The speed and security of the execution of stockmarket trades strongly influences the strategy of market systems, which are devising "guiding" infrastructure projects at European level.

Two trends are emerging:

"capital-intensive" consolidation, which is the essential financial precondition for the creation of efficient technical platforms;

"functional" consolidation, which operates at either vertical or horizontal level, with vertical consolidation bringing all the segments of securities business into a single "silo" (e.g. Euronext, which handles trading and clearing via Clearnet, or DBAG/Eurex) and with horizontal consolidation establishing a single functional link.

These trends can be combined geographically and can bring about some measure of interoperability. A great deal needs to be done to create a single pan-European system operating on the basis of several functional links or "interoperable" systems. The choice between these two approaches is clearly a matter for the market to decide. The recent stockmarket crisis should bring us back to a more objective economic assessment of the ambitions for such infrastructures, which should still be geared to providing a proportionate response to the needs of economic agents.

- The first results of this extensive restructuring point to an indisputable increase in the efficiency of share markets within the euro area. Although still differing widely, the main European markets have managed, thanks to their technological prowess, to match and even outstrip in terms of competitiveness the performances of their US rivals, primarily the New York Stock Exchange (NYSE) and the Nasdaq. All in all, transaction costs and liquidity are comparable in spite of lower trading volumes. A study (Elkins/McSherry) carried out in 2001 revealed that Euronext and DBAG were slightly more attractive than the NYSE (which is still largely an outcry market), with a price advantage put at five basis points as regards the costs of domestic transactions on a volume of trading albeit five to six times lower.

Several attempts are being made to forge closer alliances:

as regards settlement: Euroclear and Crest (UK);

as regards clearing: Clearnet and the London Clearing House;

as regards trading: the London Stock Exchange and the Nasdaq. One could ask the question whether this link-up should not encourage the other European trading platforms, and notably Euronext and DBAG, to cooperate with a view to preventing the LSE-Nasdaq alliance resulting in a large proportion of transactions in European shares being shifted at the end of the day to the United States.

More generally, the future of regulated markets in Europe should be looked at. The Investment Services Directive draws on a very liberal approach and the process of internalisation is leading to a situation in which financial institutions will increasingly settle their clients' orders, thereby inevitably reducing the turnover of regulated markets, which will be certain to react.

If this trend towards internalisation and hence towards the dominance of non-regulated transactions were one day to become widespread, we might end up in a situation where the share market would be modelled on the bond market, with ten to twelve major players accounting for the bulk of business. This would doubtless bring cost advantages but, as has been seen in the case of the bond market, where there is a preference for the most recent and most liquid batch of securities ("on-the-run"), this would presumably be to the detriment of small issuers of shares who seek a hard core of small stable shareholdings and would find it difficult to have access to a level playing field.

Before a decision is taken on the structures and rules for the platforms of the future, one needs to bear in mind their implications for the operation of European companies.

These factors, which are encouraging for the most part, point to new developments as and when a market structured at European Union level is established, putting an end to national disparities and guaranteeing the fluidity of cross-border transactions.

II. Substantial scope for further development on the European market in medium-term equity

Developments to date within the European financial area suggest that there will be closer convergence in the medium term between developments in Europe and in the United States. It is for the authorities and operators to create the conditions for a genuine European equity market that can hold its own against its transatlantic counterparts in terms of liquidity, competitiveness and security of transactions.

(a) Despite encouraging results, European share markets still lag behind US standards

➢ European share markets are still, to a large extent, organised along domestic lines. Close on 60% of share trades are still carried out on domestic markets. More generally:

the volumes traded fall a long way short of those in the United States. For example, the London Stock Exchange (LSE), which heads the list of European stockmarkets with a turnover of €4.8 trillion, had a level of activity in 2000 that was equal to only 23% of that of the Nasdaq;

stockmarket capitalisation has risen sharply since the 1980s but is still below that of the United States in overall terms (with the notable exception of the UK market). In terms of GNP, stockmarket capitalisation of the fifteen Member States of the European Union (with an equivalent economic weight) is still 16% lower than in the United States, although there are significant geographical differences:

Germany:	68%
France:	112%
Euronext area:	105%
United Kingdom:	150% (USA: 153%)

This is also true in value terms since, in 2001, the NYSE and the Nasdaq, with stockmarket capitalisations of more than \$11 000 billion and \$2 600 billion respectively, were larger than the LSE with \$2 100 billion. By creating a new entity with a stockmarket capitalisation of \$4 700 billion, the prospect of an LSE-Nasdaq alliance would have some effect without causing the NYSE any real concern.

This asymmetry (preponderance of still largely domestic stockmarket activity) is attributable first to cross-border transaction costs, which are still far too high. According to a recent study conducted by DBAG Clearstream (March 2002), the additional costs are 30% for wholesale transactions and 150% for retail transactions. Across the European Union, they are estimated to total €4.3 billion, 40% of which is due to regulatory, tax or technical disparities falling within the remit of the national authorities.

They are also attributable to a "cultural" factor of proximity prompting European issuers to attach greater importance to a preferential link with their domestic market, which they are determined to ensure will retain a guiding role. In Europe "multilisting" is often viewed as a threat to liquidity, whereas dual listing on the domestic market and in the United States is keenly sought.

Share placements, especially in mainland Europe, have grown substantially in recent years. Privatisations, the establishment of new institutional investment mechanisms (pension funds, life insurance) and a more propitious tax environment have contributed to this trend, which is still far from having exhausted its potential for expansion. The share of equity in households' financial assets rose from 22.9% in 1995 to 36.1% in 1999, while in the United States it grew from 25.7% to 45%. The share of equity that, under national rules, may be invested in the assets of life insurance companies also varies significantly between Member States, ranging from 20% in Italy to 35% in Germany and 60% in France. The actual level of such investment is well below these ceilings. For instance, the share of equity invested in life insurance companies in France in 1999 was 13.3% (including shares in UCITS). By comparison, the level of corporate equity (excluding units in UCITS) amounted to 28% in the United States in 2002.

In 2000 unregulated markets in Europe reached a new high, at over €20 billion compared with €160 billion in the United States. In 2001 there was a sharp dip in activity in the United States as the economy turned downwards. The decline was less marked in Europe. Nevertheless, private equity in the European Union was equivalent to only 0.3% of GDP (compared with 1% in the United States), albeit with very marked contrasts between countries (0.2% in mainland Europe, 0.9% in the United Kingdom). Here too there is enormous growth potential.

➢ The development of a European share market must take account of an important domestic component, and this explains the slow progress towards harmonisation in Europe.

The domestic framework is still a strong factor to be reckoned with. For example, protection of investors, beginning with individuals, is governed in each Member State by a whole battery of rules applied by one or more national regulators. As a result, approaches to supervision differ, giving rise to special technical features at local level that can hamper the liquidity of transactions and their cross-frontier expansion within the Community.

The development of the European share market is also still a function of the development of the Community framework, which is making laborious headway, reflecting the wishes of the Member States and the Community institutions. Tax convergence, so necessary for the fluidity of cross-border transactions, is being impeded by the unanimity requirement. Some Member States continue to have misgivings regarding the setting up of pension funds although, in practice, these have the potential of enormous holdings of shares. The fine aims of the ambitious Financial Services Action Plan are regularly thwarted by the vicissitudes of a decision-making process that is poorly adapted to rapid market developments. The components of the minimum common set of market rules are taking shape only very slowly (issuer's passport, European Company statute, market abuse). Progress in some areas has ground to a halt (e.g. the failure of the takeover directive, which has resulted in a "renationalisation" of the rules as in Germany), while other areas are still to be explored (diversity of corporate governance rules). One set of rules that was clearly announced and has been effectively applied is a key factor in the development of a credible equity market.

(b) The objective of a "European financial model" and the ways forward

The collapse of Enron and the more pressing requirements of the drive to combat money laundering in the wake of the events of 11 September have reminded us of the crucial need at global level for enhanced transparency and effective monitoring of financial practices. The European Union, which would like to have a share market with international dimensions, will have to draw the lessons from these of the malfunctioning of the US market as quickly as possible. The Oviedo European Council recently provided some encouraging signs in this connection.

There is no need whatsoever for Europe to copy this US "model", which has recently demonstrated real weaknesses notably as regards the lack of a clear dividing line between auditing and financial consultancy and as regards the most basic level of transparency; instead, it should aim to improve the functioning and regulation of its markets, something that will affect the majority of players (regulators, auditors, financial analysts, ratings agencies, corporate governance, etc.).

In other words, a structured financial market needs to be set up as soon as possible with a corpus of common rules that are applied and sanctioned uniformly.

There is one thing we must be aware of: if progress proves to be sluggish, the credibility of European aspirations for financial markets might be rapidly challenged.

As for enhancing the reliability of the European share market, a number of avenues were identified, notably at the Eurofi 2000 Symposium in September 2000. They are still valid and envisage radical improvements in the legal and technical environment for businesses. It is essential to pursue unremittingly the adoption of the key measures of the Financial Services Action Plan and to make very substantial headway in the tax field. **A company or investor must be able to do business across the European Union as if it constituted an integrated domestic market.** The preconditions for establishing a homogeneous financial area are well known:

For instance, the entry into force of <u>common accounting standards and corporate governance rules</u> in particular is essential for facilitating mergers/acquisitions, guaranteeing that markets receive the same information and ensuring that investors are properly protected. In this connection, the European Commission has stipulated that the new IAS accounting standards will be applicable as from 2005 to the consolidated accounts of listed European companies and as of 2007 to companies making public offerings.

> This wide-ranging reform will affect some 7 000 of the largest firms in the European economy. It will extend to all sectors but will have to take carefully into account the other constraints, notably in the prudential sphere, that are specific to some of them. For credit institutions, it seems clear that application of the new IAS standards will have to be the subject of close cooperation with the bodies responsible for the Basle II project and national banking regulators; a closer link-up between the latter is thus even more necessary than ever.

The establishment of a body of <u>European company law</u> drawn up and implemented as a coherent whole (company statute, takeover legislation, mergers, bankruptcy, public offerings, etc.) would make it easier for companies to set up wherever they wished within the Community.

The adoption of <u>a legal framework fostering the interoperability of pension funds</u>, in the interests of both companies and employees, is of crucial importance for the growth of European savings and for rectifying the imbalances of pay-as-you-go retirement schemes. It should lead to the setting up of pan-European pension funds that would benefit not only pensioners but also companies (economies of scale, increased capitalisation, common supervisory rules) and would facilitate labour mobility within the European Union.

The players involved are awaiting rapid and coordinated action to recast the overall market regulation framework. They would like to take an active part in this. To be competitive, the European financial area cannot afford to wait between five and seven years, the time needed to adopt and transpose a European directive. The Lamfalussy approach represents an important step forward here that we welcome and that now needs to become operationally effective. And yet, in the medium term, a more ambitious institutional approach will doubtless be needed to round off the work of unifying the single market in banking and financial services.

The current financial system in Europe suffers from an inability to respond properly to new rules and developments at technological and international levels. Its decision-making procedures are slow, hampering rapid adaptation of the legal framework, and the regulatory rules needed to facilitate the uniform nature of the European financial area are lacking. We thus need to step up a gear and even opt for a different method.

A regulatory framework should be rapidly introduced for cross-border transactions within the euro area. With clear, simple rules accessible to all, it would go beyond mere mutual recognition. It would offer equivalent guarantees to all players, together with common arrangements for companies wishing to do business in two or more Member States. This would demonstrate the need for a new approach to European regulation. The rules would clarify its role, objectives and instruments. They would help to reduce significantly the cost of cross-border share transactions as part of a stable regulatory continuum.

We need to move towards a European System of Financial Regulators (ESRF) that would guarantee uniform treatment of financial transactions. It would provide issuers and investors doing business in the European Union with a liquid market and would ensure that a common set of rules was complied with.

To be fully effective and to meet practical needs, such a process of financial integration must be based on cooperation between the banking and financial professions, which would need to be properly represented. This would doubtless entail moving beyond the limitations of the present Community set-up and having recourse, where appropriate, to the Treaty. The Convention preparing the way for the Intergovernmental Conference in 2004, which is chaired by Mr Giscard d'Estaing, affords a real opportunity to construct this European model of financial governance, which we earnestly advocate.

We must be able to seize this opportunity: thanks to the work of the Convention, the construction of a financial Europe can take a decisive step forward.