EUROPEAN UNION

SECURITIES

SUMMARY

The European Union (EU) is attempting to create a single market for securities services among its fifteen member states, similar to the single market for banking discussed in the previous chapter. A series of EU "directives" have established the parameters of this single market, though implementation of some of the directives has been delayed, inconsistent or incomplete. The cornerstone of the system is the "single passport" to provide investment services throughout the EU, provided by the Investment Services Directive.

If taken as a whole, the EU market for transferable securities is larger than Japan's, but smaller than that of the United States, with total stock market capitalization in the EU-15 of US$3.8 trillion (45 percent of GDP) and total debt securities outstanding of US$8.7 trillion (103 percent of GDP). The potential for equity growth in Europe is considered to be tremendous, with huge unfunded (pay-as-you-go) pension liabilities, an aging population, low interest rates, improving economies, and undeveloped equity markets. The equity market capitalization of the euro-zone countries represents less than 50 percent of GDP compared to 140 percent for the US.

In the context of the GATS negotiations in the WTO, the EU committed to provide market access and national treatment to foreign financial services firms with reservations for certain member state laws inconsistent with these commitments. The concerns that U.S. firms have in the market are generally consistent with those of their EU competitors.

DESCRIPTION OF THE MARKET

As part of its program to develop a true single market for goods and services throughout its fifteen member states, the European Union is in the process of attempting to consolidate the securities markets of the member states. While some harmonization and consolidation have taken place, the market remains quite segmented, with some countries hosting modern, deep and globally active financial markets, and others much less so.

Stock and Bond Markets

The table below, based on IMF data, summarizes the size of the various national financial markets, and compares them to the markets of the United States and Japan. It shows that the largest EU equity market is found, not unexpectedly, in the U.K., with the deepest bond markets in Germany, France, and Italy. In 1996, 76 percent of all equity market turnover in domestic EU companies occurred in the UK and Germany. The EU-15 stock markets total about 55 percent of the U.S.

equity markets, and total bonds in the EU are nearly 80 percent of the U.S. total. This reflects the much greater historical reliance on debt, and commercial bank financing in particular, for financing throughout the European corporate sector.

European Union Securities Markets, 1995
(US$ billions)

	Stock Market Capitalization	Public and Private Debt Securities	Bonds and Stock Market (as a % of GDP)
Austria	33	211	105
Belgium	105	470	214
Denmark	56	329	223
Finland	44	144	151
France	522	1,485	131
Germany	577	2,179	114
Greece	17	105	108
Ireland	26	45	116
Italy	210	1,618	168
Luxembourg	30	17	248
Netherlands	357	388	188
Portugal	18	72	88
Spain	198	362	100
Sweden	178	419	261
United Kingdom	1,408	826	202
EU-15	3,779	8,673	148
United States	6,858	11,008	246
Japan	3,667	5,326	176

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The London and Frankfurt stock exchanges have announced plans for an alliance that will eventually provide a single electronic trading platform for the 300 largest European companies. Officials also indicated that they will pursue alliances with additional European exchanges in the future. However, Paris stock exchange officials stated they would seek alliances with other European exchanges. Other exchanges to date have expressed more interest in the London/ Frankfurt alliance as these are the top two equity markets in Europe.

Most EU stock markets still basically trade domestic securities. Only the Stock Exchange Automated Quotations system (SEAQ) in London has a sizeable amount of trading in foreign shares (around two thirds of total trading in London, 95 percent of total EU foreign share trading). While a large number of foreign shares are listed in Germany, trading is quite thin. Nevertheless, financial integration has over recent years translated into closer relations among national stock markets. Cross-border securities transactions (within the EU) have markedly increased and portfolios, particularly of institutional investors, have become more international.

The largest EU bond markets are by far in Germany and Italy, with together nearly half of all EU outstanding bonds. In most EU member states, the bond market is heavily weighted with public sector issues, and bonds do not provide a feasible alternative for company funding. Germany has the largest private sector bond market, mostly driven by mortgage-backed or other bank bonds. The main issuers on European bond markets are governments and financial institutions. Other corporate bonds are found in significant number only in France, the Netherlands, and Spain. Public issuers particularly dominant in Italy, Belgium and Greece.

EU derivatives markets are less developed than those of the United States, despite increased demand for hedging by institutional investors. At present, liquid interest rate derivative markets exist only for the currencies of Germany, Spain, France, and the United Kingdom, though the Deutschemark market serves as an adequate proxy for those currencies to which it is closely linked. All these markets have developed in the last six or seven years. Initially, only long-term contracts were offered, but short-term contracts (three-month contracts) have recently been extremely successful. Other financial derivatives contracts are based on European currencies and government bonds. Commodity derivatives contracts are available on such items as sugar, potatoes, wheat, and metals. The London International Financial Futures and Options Exchange (LIFFE), the Deutsche Terminbörse (DTB), the Marché à Terme International de France (MATIF), and the London Metal Exchange (LME) are the principal derivatives exchanges in the Community.

Small and medium-sized companies have traditionally had no alternative to commercial bank financing, typically short-term, throughout most of the EU. In the past few years, though, two alternative systems of stock exchanges for smaller European companies have been started. EASDAQ started in September 1996, but did not immediately attract many listers. The Euro-NM (for "new market") is a joint enterprise of organizations based in Paris, Brussels, Amsterdam and Frankfurt, with "New Markets" based in each city. The Paris NM opened in February 1996 and the

fourth (Frankfurt) in March 1997. The exchanges have struggled with listings still limited to a few dozen companies.

The universal banking model prevalent throughout the EU means that the large commercial banks remain important actors in EU securities markets. Most are developing more sophisticated retail marketing programs, commensurate with the deepening and harmonization of equity markets in particular, as well as a greatly increased demand for portfolio diversification among individual investors.

Single Market Legislation

The EU attempt to legislate a single market in the securities field is centered on two pieces of Community legislation: the Investment Services Directive (ISD) and the Capital Adequacy Directive (CAD). The Undertakings for Collective Investment in Transferable Securities (UCITS) Directive governs the provision of mutual funds. These directives, like the Second Banking Directive, are based on the principle of mutual recognition of home country regulation. In 1997, the EU approved the Investor Compensation Directive (ICD) to protect consumers from losses stemming from investment firm failures.

The ISD provides the single passport for investment firms. It spells out requirements for the authorization and supervision of investment firms, and lists covered services (brokerage, dealing, underwriting, and portfolio management) and instruments (transferable securities, money market instruments, futures, forward interest rate agreements, swaps, and options). The home country licensing authorities must ensure that investment firms meet minimum initial capital requirements, observe certain prudential rules, and adhere to capital adequacy standards with respect to market risk spelled out in the CAD.

On this basis, investment firms authorized in any member state may provide the covered services in the covered instruments in any other member state, under the supervision of the home state and without any additional authorization, although the home country must notify the host country of these activities. Services may be provided through branches or cross-border sales, and firms may advertise their services freely, subject to rules adopted "in the general good." Host member states must permit investment firms to become members of, or have access to, regulated markets and local clearing and settlement systems. Investment firms are subject to host country rules of conduct, and transparency and reporting requirements.

The CAD is one of the most technically complex of EU financial services legislation. The CAD serves the purpose of four directives in the banking area, namely the Own Funds, Solvency Ratio, Large Exposures and Consolidated Supervision Directives. A stated objective of the CAD is to achieve equality in the treatment of banks and investment firms with respect to investment services and activities. The CAD draws heavily on the provisions of the banking directives.

The CAD specifies minimum initial capital requirements for different types of investment firms, as well as rules governing capital standards for market risk for both investment firms and the securities activities of banks. In particular, the CAD establishes the concept of a "trading book." Detailed annexes in the CAD devise a system for measuring market risk in the trading book and the amount of capital to be held against this risk. Market risk is divided into four basic components: position risk (general and specific risks associated with debt and equity instruments, and underwriting risk); settlement and counterparty risk; foreign exchange risk, and "other" risks.

The CAD also sets forth requirements concerning the proprietary funds of investment firms, the monitoring and control of large exposures, the valuation of positions for reporting purposes, consolidated supervision and reporting requirements. The directive, however, does leave home country regulators considerable scope for interpreting or applying their provisions.

Originally inconsistent with international standards of capital adequacy (Basle conventions), the CAD in the process of being amended as this report was written. The intent was to bring CAD in line with Basle, though this has not been entirely successful, as there remain areas where even CAD II is inconsistent with current Basle standards. There is discussion underway in the Commission about amending the CAD yet again (CAD III).

The UCITS Directive, adopted in 1985, created a single market for UCITS (similar to mutual funds in the United States), effective October 1, 1989. The directive established minimum essential rules governing the authorization of UCITS, their structure and capitalization, the choice of depository, investment and borrowing policies and information to be provided to investors. These rules then allow for mutual recognition, permitting a UCITS authorized in one member state to market its shares in other EU countries without further authorization.

On July 17, 1998, the European Commission proposed several amendments to the UCITS Directive, aimed at promoting investor confidence and a pan-European market for UCITS. Under the proposal, UCITS would be permitted to invest in bank deposits (cash), money markets, standardized options and futures contracts dealt on regulated exchanges, and in shares of other funds.

In February 1997, the European Parliament and European Council approved the Investor Compensation Directive. The ICD requires that minimum safeguards be put in place to compensate investors (essentially small investors) in the case of failure of an investment firm, where the firm proves unable to refund to investors the money or securities belonging to them. Member states are required to ensure that at least 90 percent of each investor's claims are met by the compensation scheme. The "top-up" clause gives branches of investment firms established in a host country the right to join the host country's scheme if it provides a higher level of compensation than the home country's scheme.

EMU and EU Securities Markets

On January 1, 1999, eleven of the fifteen EU member states will abandon their individual currencies in favor of a single multinational currency call the "euro". The monetary policy of the euro will be managed by the European Central Bank, headquartered in Frankfurt, at the head of the European System of Central Banks, which is composed of the national central banks of the participating member states. On the changeover date, all outstanding sovereign debt will be redenominated in euros, all wholesale banking will be conducted in euros, and all new issues of securities will be in euros.

This monumental changeover will have deeply significant effects on all European markets, factor and product, goods and services. A detailed examination of these changes is beyond the scope of this report, but a brief summary of a few of the changes likely to occur in EU financial markets cannot be avoided.

First, the euro will eliminate the foreign exchange risk in long-term contracts between entities in EMU countries, and the relative importance of other types of risk will increase. Credit risk is likely to become the most important determinant of securities prices, but other factors (liquidity, settlement, legal and event risks) will also influence pricing. This will create an incentive for member states to improve their financial infrastructure.

Second, the elimination of multiple currencies will reduce the cost of cross-border spot transactions, reducing but not eliminating barriers to intra-EU financial transactions.

Third, some intra-EMU foreign exchange and investment restrictions that now apply to pools of capital such as pension funds will become irrelevant. The size and diversification of portfolios managed by EU institutional investors could increase rapidly as a result.

Fourth, as credit risk gets more attention, cross-border competition is likely to increase between financial intermediaries in bringing new issues to market, rating new credit, and allocating investment funds across national markets. There is also likely to be increased "policy competition" among sovereign borrowers who will be less able to rely on their "home-currency" market for captive investors.

U. S. PRESENCE IN THE MARKET

There exists no authoritative source for data on the presence of U.S. securities firms in the EU. Information from European regulators, the National Association of Securities Dealers, The EU Committee of the American Chamber of Commerce in Belgium, and an informal survey by the Treasury Financial Attache to the EU supports the following conclusions.

There are at least 50 U.S. firms involved in some aspect of the securities business in the EU, operating upwards of 100 separate branches, including multiple branches of a single firm in some countries. More than half of the branches were in the United Kingdom, with Germany, France and Italy following behind. These numbers are lower than the comparable figures in the last National Treatment Study, reflecting primarily consolidation in the industry.

Many U.S. securities firms are planning or are already involved in significant expansions in the EU, in preparation for EMU. One large firm that already has 7,700 employees in 11 countries has put more than 100 full-time employees, in 56 working groups, into its effort to prepare for EMU. Many U.S. firms are expecting EU securities business to grow very rapidly, both due to EMU (see above) and to other market trends including the growing need for securitization of pension fund assets. U.S. asset management firms are also engaged in mutual fund business in the EU, including Fidelity (with 1996 European assets of US$11.0 billion), Mercury (US$4.9 billion), and Citicorp (US$2.4 billion).

TREATMENT OF U. S. FINANCIAL INSTITUTIONS

In the context of the WTO multilateral financial services negotiations, the EU committed to provide access to its financial services market on an MFN basis, including the freedom to establish branches. The reciprocity provisions in the various EU financial services directives (banking, investment services, and insurance) are automatically superseded by the GATS commitments because of specific clauses in the EU directives. For example, the reciprocity article of the Second Banking Directive provides that "Measures taken pursuant to this Article shall comply with the Community's obligations under any international agreements, bilateral or multilateral, governing the taking-up and pursuit of the business of credit institutions."

As a result of these GATS commitments, there are very few strictly "national treatment" issues for U.S. financial services firms operating in the EU. To the extent that U.S. financial service companies have concerns in the EU market, they are usually concerns that are shared by all institutions in the market, both foreign and domestic.

For example, the issue of cross-border provision of services in the EU is increasingly sensitive for U.S. institutions, as they move to centralize their global activities. Several large U.S. institutions, for instance, are moving toward a system in which foreign exchange transactions – whether they are initiated in Paris, Rome or Athens – will be executed from a single location. If this business practice is restricted or hindered by member state application of "general good" provisions, these U.S. institutions will be commercially disadvantaged. But, this disadvantage is most strictly related to the choice to centralize, and not to the non-EU nature of the institution. An EU firm pursuing the same strategy might be equally disadvantaged.