"THE TRANSFORMATION OF THE EUROPEAN FINANCIAL SERVICES INDUSTRY: FROM FRAGMENTATION TO INTEGRATION"

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CONTENT

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I. INTRODUCTION

On two points a consensus in the global financial community appears to have emerged: one, that we are witnessing a historically unparalled transformation of the European financial services industry and two, that the complete integration of Europe's fragmented financial markets will take longer to achieve than by the morning of January 1, 1993. In other words, a long, complex, and irreversible process of change is unfolding across European financial markets.

This chapter is an attempt to synthesize the evolving structures and dynamics of the EEC's financial sector and to evaluate the effects of various factors of change on European users and providers of financial products and services. Faced with a choice between a broad coverage of all aspects of the financial services industry or an extremely detailed analysis of one particular sub-sector, we have chosen somewhat a middle path. We have limited our examination to the two most vital sub-sectors of activity from a borrower and investor standpoint : banking and securities markets. In our discussion of securities markets, we have incorporated elements that affect investment management. Likewise, we touch upon the increasing "assimilation" of the European insurance industry into a universal financial services conglomerate in our concluding discussion on the strategic implications of financial integration for participants in the European financial services industry.

While non-EEC European countries are not considered, recent regulatory changes and market developments in those countries indicate a large degree of "assimilation" and convergence into the overall transformation process that is occurring within the EEC [1]. Moreover, our analyses of the banking and securities markets sectors are made on a comparative European level. As

such, specific country remarks are made only to clarify significant deviations from the European perspective.

The rest of this chapter is structured into four parts, Section II begins with a brief overview of the various historical and current elements that have come together in formulating and driving the notion of European financial integration. In Sections III and IV we individually consider each of the two sub-sectors, banking and securities markets. Relatively more emphasis is placed on the banking industry due not only to the importance and multi-faceted nature of this activity in Europe but also to the fact that the on-going developments of this industry will profoundly affect every level of the European economy, from the individual consumer/investor to the largest pan-European corporation.

The second and third sections cover two major topics. The first is a synthesis of the current structure and dynamics of the banking and securities markets sub-sectors and the second is an examination of the aims and implications of the main EEC directives that concern each sub-sector. We conclude in Section V by laying out, in the form of a series of hypotheses, various strategic implications of financial integration for the major participants (financial intermediaries, retail consumers, institutional investors, corporations, and governments) in the European financial sphere.

II. THE FORCES DRIVING EUROPEAN FINANCIAL INTEGRATION

A popular view holds that the integration of European financial markets was simply "dictated" into existence by various legislative efforts of the European Commission in Brussels over the past three decades. Indeed it was the 1957 Treaty of Rome which clearly stated the desire to create a customs union among the signatories, which for the financial sector meant freedom of establishment, of provision of services and of capital movements [2]. But this view strongly presumes that the transformation process in European financial markets has been following some neat time-table of actions and that divergent financial regulations and structures of all national markets have readily given up centuries of well-entrenched practices.

Historical realities of European financial integration show a rather different picture : one of fits and starts, of national political interests or fears of economic domination by major powers providing obstacles. Numerous chicken-and-egg arguments were expounded : true financial integration cannot be realized unless monetary union is established first; monetary union is impossible without a convergence of national economic/monetary policies; national economic/monetary policies cannot converge without some form of political union. Each argument raised further debates and pushed behind the possibility of achieving any form of financial integration [3].

Why did this rather bleak scenario change dramatically over the last decade? Four key interlinked reasons seem discernable :

(1). Rising Economic Inter-dependence.

As European cross-border trade, investment and capital flows increased, the need for greater harmonization of divergent national financial regulations became more evident [4] . Europe increasingly came to view itself as an "economic bloc" with a handicap : the state of economic and financial fragmentation was perceived to be a "cost" that lowered the productivity and economic efficiency of European businesses vis-à-vis players in the integrated markets of the U.S.A. and Japan.

(2). Fall-out From Global Financial Deregulation.

U.S. and Japanese deregulation in financial services from the mid-1970s onward had a strong "ripple effect" on the major European financial centers, especially London. Fears of rising competition from American and Japanese institutions armed with skills gained in more liberal and competitive markets had the effect of promoting the calls for European deregulation. Although the U.K. lead the process, other European countries quickly followed so as not to be left behind.[5]

(3). Increasing Technological Progress and Applications.

Technology affected the European financial sector two-fold. First, it enabled non-regulated firms to provide financial services at a lower cost than established firms (e.g., the OTC markets in securities or non-bank consumer credit firms). This phenomenon brought about competitive distortions which led, for all practical purposes, to effective de-regulation. Similarly, as Llewellyn (1988) points out, the use of technology by securities firms in New York to service U.K. investors was a major factor undermining the self-imposed regulation of the London Stock Exchange [6]. Second, advancements in tele-communications and decision-support systems for trading, investing, and transaction data processing have had the tangible effect of integrating banking and securities markets across Europe.

(4). Modification of the EEC Legislative Processes.

The June 1985 publication of the White Paper on the creation of a unified European market greatly altered the past "consensus" approach that European commissioners took in the legislative area of financial integration. Instead of waiting for thousand of national regulations and practices to be harmonized perfectly, they opted for a "dynamic disequilibria" approach [7]. This fundamentally entailed three aspects which remain the guiding philosophy behind the current directives in the financial sector : harmonization of the most basic rules in the provision of financial services, mutual recognition of each Member country's supervisory criteria and home-country supervision of the foreign activities of financial institutions.

While the first three factors had slowly gnawed away at the fringes of national regulations, the realization that the European Commission had an innovative and somewhat heretical de-regulatory approach (and had even established a target date) galvanized the European financial services industry into somewhat bewildered action. As this transformation process accelerated, two questions were frequently raised : What are the potential benefits of financial integration? And can they be estimated in any tangible fashion?

Numerous academic and non-academic studies have been undertaken to answer the first question [8]. Basically, the benefits discussed can be summarized as follows :(1) an improvement of the allocative efficiency of savings and investments; (2) a pooling of national capital markets will lower the dependence on financial centers outside the EEC and hence reduce its shock-sensitivity to external economic developments [9]; (3) a reduction in the risks of capital investments through increased diversification opportunities (true for both investors and financial intermediaries); (4) the lowering of the cost of funding for borrowers as they diversify their sources of funds in an increasingly competitive financial environment; and (5) stronger (and potentially larger) financial institutions can be fostered to compete in with global giants from the U.S. and Japan.

The second question was answered by the results of a study commissioned by the EEC, and executed by Price Waterhouse in 1988, to evaluate the opportunity cost of not having a financially integrated Europe. Table 1 presents the results in a summary form. The study covered various products within the banking, securities and insurance sub-sectors and involved only eight countries; in addition, several key methodological shortcomings have been identified [10]. Nevertheless, the study served a vital purpose as an illustrative example of the differences in prices for financial products/services across Europe.

Potential price reductions were indicated for all eight countries and in every sub-sector (with a range of 9 percent to 34 percent). Adjusted for the possibility that the European markets may not soon become perfectly competitive and integrated, more realistic price reductions in the range of 4 percent to 21 percent were estimated as shown by the "indicative price reductions" row. Across all sub-sectors and on a country basis, Spain and Italy reveal the greatest potential for price reduction (34 percent and 29 percent) with the U.K. and the Netherlands proving to be already quite price competitive (with potential reductions of 13 percent and 9 percent respectively).

The most revealing nature of these estimations, however, is not in the total figures for all financial services or even by sub-sector. Rather, they

lie in examining each product line which reveals a checker-board picture of efficiency across European financial services. For instance, relatively efficient Germany in private equity transations seems to be leading Europe in inefficiency in consumer credit. Similarly, the U.K. is extremely efficient in institutional securities trading (due to thin pricing on large transactions made possible by large volumes traded) and life and motor insurance but is highly priced for private equity transactions or for home insurance and consumer credit.

Hence, from a retail or corporate consumer's standpoint, the benefits of an integrated Europe in financial services will be seen in different product categories, different sub-sectors, and different countries. The challenge for intermediaries will be to understand this checker-board of opportunities, formulate strategies that capitalize on micro-skills, often at the product or functional level, and execute these differentiated strategies on a European-wide basis.

III. EUROPEAN BANKING : INTEGRATION UNDER DYNAMIC DISEQUILIBRIA

That an integrated European banking system will be the life-blood of an integrated European economy almost goes without saying. Yet today European banking is far from integrated. Neither is it fair to conclude that European banking structures and systems are stagnant and closed. In reality, as we shall discuss below, the European banking industry is in a complex state of turbulence.

Our observation of the market reveals that this somewhat "messy" state of affairs can be boiled down to three phases of change of which the current market structure and dynamics roughly corresponds to the second phase. These are: (1) pre-1975 phase in which traditional functions and client segments were closely followed by all banks; (2) the 1975-1992 phase which is witnessing the blurring of functions and some shake-out and consolidation at the national level; and (3) the 1992-and-beyond phase in which shake-out and consolidation at the European level should take place. We will touch upon these phases of change in our discussion below.

1. The Evolving Structure and Dynamics of the European Banking Sector

1.1 Comparative Market Sizes and Types of Institutions

Two words may sum up a consolidated view of the European banking industry : diversity and fragmentation. As a result, European banking today is characterized by a rich mosaic of national institutions with different historical origins, functions, and corresponding structures. Yet it is possible to form broad categories from this 'pot pourri' of institutions.

As shown in Table 2, in each country there are "commercial" banks (traditionally, deposit-taking for corporate lending), "savings" banks (traditionally, retail deposit-taking for general investments), and "specialized" banks serving a very focused client group (including municipal credit institutions, mutual and co-operative institutions, building societies and finance companies of all types). In terms of number, commercial banks represent approximately 21 percent of the total, savings banks 15 percent and specialized banks 64 percent.

Three countries account for almost 90 percent of Europe's specialized banks: Germany (3,600 co-operative banks), France (over 1100 special "financial institutes") and Italy (over 800 co-operative banks). While the asset breakdown by category of banking institution is difficult to obtain, we estimate that in the four major countries (Germany, France, Italy and U.K.) approximately 62 percent, 65 percent, 70 percent and 90 percent, respectively, are controlled by both commercial and savings banks [11].

These categories, however, should not be construed as being definitive functional or client segment divisions of activity. Within most European countries over the past decade market dynamics have shown that, as one category after another exhausted its traditional product or client base, they entered each other's sphere of business.

For example, municipal credit banks in France, Germany, and Belgium were originally established by the local communes to finance local investments from medium-and long-term bonds issued under governmental

guarantees. Over the past five years, as demand for local public investments has stabilized or even declined, these banks have aggressively pushed into corporate, consumer and mortgage lending to maintain profitability.

In addition, new non-financial entrants (such as retailers and captive finance companies of manufacturing firms) are rapidly penetrating traditional banking activities (such as deposit-taking and consumer lending) by either leveraging upon their superior cash-flow positions or by tapping the distribution potential of their client segments.

Similar instances of "blurrings of roles" can be cited within practically all areas of European banking, and more recently even certain areas of securities and insurance activities have been blended into the general sphere of "banking". This erosion of traditional roles within national European banking markets has had the effect of worsening the "quality" of the state of fragmentation: instead of 10,000 European bank with broad traditional categories of specialization we currently are observing 10,000 banks all more or less beginning to engage in similar activities. As we shall see in our discussion of market concentration, this current market structure is not viable, neither within country markets nor on an integrated European level.

Taken on a consolidated basis, European banking activity measured in total assets (ECU 6.9 trillion) exceeds slightly that of Japan (ECU 6.2 trillion) and the U.S. (ECU 5.6 trillion). In Table 3, the European figure is broken down by EEC countries. Not surprisingly, the top four major economies, containing 70 percent of the Community's population and 81 percent of its GNP, also control 78 percent of the total banking assets. Similarly, in the next group of economies, Netherlands, Spain and Belgium, a clear relationship exists between GNP (15 percent of total EEC) and banking assets (15.7 percent of total EEC). The final 6 percent of banking assets is spread out among the five smaller nations with Luxembourg considerably ahead due to its role as a European banking center.

1.2 Comparative Ownership Structures

In comparison with the U.S. and Japan where state involvement in banking is generally limited to their respective central banks, governments play a major role in European banking. Table 4 provides an indicative ownership breakdown for the top 162 EEC banks[12]. Approximately 40 percent of the top 162 banks are central- or local-government controlled, another 16 percent are co-operatives and mutuals, leaving 44 percent in the hands of private independent shareholders. Among the top four countries, the U.K. banking sector is most "private", whereas in France and Italy government ownership is paramount among the top commercial banks and in Germany the relatively powerful regional Landesbanken are owned by the local state governments.

In terms of their comparative financial positions, European state-owned banks are somewhat smaller in asset size (mean size of ECU 27 billion versus 33 and 36 billion for private and co-operatives), are less profitable (both on ROA and ROE measures) and are less well capitalized (based on capital to assets ratios).

Two key implications can be drawn from this ownership profile of the European banking sector. One, large government-owned banks will find it increasingly harder to compete with private and co-operative banks of the same size league. Their capital position is already low and raising new funds for significant acquisitions or higher risk banking activity requiring higher capital will be difficult at best [13]. The pressure to de-nationalize and to publicly float these giant banks in France and Italy hence may become stronger, both from within the bank's management and from cash-strapped governments. Two, co-operatives and mutuals, by their very closed-share ownership structure will be unlikely candidates for acquisition; indeed some are large enough to be acquirors of medium-sized private banks. Similarly, in the years ahead we should be witnessing more strategic alliances between private, co-operatives and mutuals that wish to maintain their legal independence.

1.3 Branch Density and Industry Profitability

The European banking sector is characterized by an extremely dense branch network in the more developed economies. Figures 1 and 2 relate GDP and bank intermediation spreads to branch density (measured as number of inhabitants per branch). Except for the case of Spain[14] in Figure 1, both Figures show strong positive relationships between increasing GDP and increasing number of bank "outlets" and between high bank intermediation spreads and increasing branch density.

Interpreting these apparently logical relationships is not a straightforward task. Numerous factors can be drawn upon to explain differences in branch density among the twelve EEC countries, including: 1) varying government regulations on the opening of new branches; 2) inefficiency of the retail banking sector, the costs of which are generally not understood by the banks themselves and usually passed on to clients; 3) the level of sophistication and development of disintermediation in the country (e.g., direct mail mutual funds); 4) the retail activities of other non-bank financial institutions (who themselves may have a vast branch system); and 5) the level of development of non-traditional means of client relationship maintenance (e.g., ATMs, direct mail, or home banking).

In broad terms, it can be expected that in the higher density countries, increased competition resulting from financial integration, will lead to a greater interest among the banks in undertaking branch profitability analyses. In turn, and in certain inefficient markets, such knowledge will be used to assess the necessity for branch rationalisation. In others, this understanding will enable top managers of these banks to better evaluate the macroeconomic effects of the above factors so that the activities of the entire branch network may be restructured to capture "micro-marketing" specificities of different local marketing zones within the country.

Two interesting implications may be hypothesized for the currently low density countries. While the first relationship would indicate that increasing economic wealth should increase branch density, one could argue

that in an integrated European financial area, the effect of the above factors, especially the fifth factor, would negate any "natural" trend towards increased number of banking outlets. In the second relationship, the horizontal factor of higher bank intermediation spreads evident in countries such as France, Germany, U. K., and Italy could be viewed as being excessive economic rents which may be competed and regulated away in the post-1992 era. As such, it could be argued that as competitive conditions "equilibrate" across the EEC, the current low-density countries may not count upon the development of this factor to warrant increased branch proliferation.

The profitability of European banking varies greatly by country as revealed by Table 5. Three markets appear to be most profitable on an inflation-adjusted ROA and ROE bases: the U.K., Germany and Netherlands. On the other extreme, the high inflation in Greece, Portugal and Spain more than destroys the moderate levels of nominal ROE. As with branch density, one must draw implications with care. For example, any "blanket" application of ROA or ROE may neither indicate banking efficiency nor the attractiveness of the sector from investors' standpoint. Differing accounting, tax, and regulatory practices from country to country make these comparisons difficult. For instance, while Spain has a relatively low ROE of 10 percent, the Spanish banks tend to leave higher provisions for bad debt and have higher capitalizations. German banks on the other hand tend to be more highly leveraged (if one excludes the hidden reserves) and hence have higher reported ROE [15].

Additionally, certain markets which show low ROA figures may still be attractive for new entrants if they are, for example, able to improve the product "business system". In fact the very process of European financial integration should result in a gradual "arbitraging" away of these wide differences in profitability measures. Furthermore, expected convergence of accounting standards should enable more valid comparison of these figures.

1.4 Market Concentration

On a consolidated basis, the European banking sector lies in between the U.S. and Japan in terms of market concentration. As Table 6 indicates, the top 3 European banks (Credit Agricole, Banque Nationale de Paris and Deutsche Bank) control 8 percent of the entire sector's assets with comparable figures of 7 percent for the U.S. and 12 percent for Japan. These generally low concentration levels vis-à-vis the Japanese and individual EEC country markets, may be considered normal in light of the fragmentation of the banking market at the national level. Similarly, in the U.S., the prohibition of inter-state banking and even limitations to the level of unit banking have kept a "forced lid" on the size of any given bank with consequent low concentration ratios; conversely, nationwide banking has produced the higher concentration ratios in Japan.

While the concentration ratios are low on an EEC level, they are indeed higher on the national level; this is especially true among the smaller European economies as indicated in Table 7. For instance, the top 3 banks in Belgium, Denmark, Greece, Netherlands and Portugal control anywhere from 42 percent to 62 percent of their respective country's banking assets. Luxembourg is a notable exception due to the presence of large number of foreign banks. Among the major four countries, only France has a relatively high concentration ratio (37 percent for the top 3 banks). Observing the spate of merger and acquisition activities in the last half of the 1980s may allow one to draw the following implication of these current national and EEC-level concentration ratios. The integration process is most likely to initially further increase national concentration ratios, especially in large and less developed banking markets, as major local banks strive to protect home markets. Only after a certain period of acquisition "digestion" and observation of the developments of a unified financial market will we see concentration ratios increasing at the EEC level. Until that period, "strategic alliances" made in the next few years will be the main form of guarding future options.

1.5 Economies of Scale/Scope and Bank Mergers

Interpreting these branch density, profitability and market concentration ratios raises the vital question of whether there are economies of scale and scope to be captured as the European banking sector integrates. Several key studies have been undertaken on the question of economies of scale in financial services with a mostly U.S. background [16].

Most of these studies focus on the more traditional areas of banking activity, as for example, deposit-taking and lending than the more technology-based product areas as, say, credit card business or cash management. The fundamental issue underlying all these analyses is whether there are operational advantages to be gained from product-type proliferation and product volume expansion in banking which can be assessed independently of the quality of any given bank's management.

The general conclusion appears to be that, on average, economies of scale in banking are at best elusive, limited, and seem to be exhausted at a fairly low size of bank [17]. In other words, a bank that is moderate in size should not be at a significant cost disadvantage relative to a large bank. [18] Economies of scope have often been used to justify diversification of banking activities but in the U.S., diversified banks neither seem to be more stable nor more profitable than those banks limited in scope of activity. In fact, diseconomies of scope may even exist [19].

It is doubtful that current European banking structures are conducive to economies of scale or scope. In some ways, with Europe's highly differentiated financial and cultural markets, diseconomies of scale and scope may serve as arguments <u>against</u> increasing assets and diversifying across activities. In fact, size does not appear to be a prerequisite for profitability. Table 8 summarizes the results of a study done by Steinherr and Gilibert (1989) of the correlation between asset size and profitability for the largest banks of each of the EEC countries. They conclude: "the correlation between size and profitability is either negative or, at best, a very tenuous one" [20].

These studies do not mean, however, that European banks should not (or will not) merge. It simply means that they should not blindly point to economies of scale and scope as their sole justification and wait for profitability improvements. Other reasons may justify future European bank mergers and acquisitions.

For example, Steinherr and Gilibert (1989) distinguish between mergers/acquisitions within one country that enables operations streamlining and rationalisation of, say, the number of branches, and cross-border mergers of banks where these efficiencies and synergies are more difficult to capture [21]. Their comments are corroborated by recent evidence provided by Hawawini and Swary (1989) on the differential stock market reactions to takeover announcements that concern intrastate and interstate cases. The results indicate that "the market reacts to the announcements of interstate mergers less favorably than to the announcements of intrastate mergers and that the differential market reaction is stronger for bidding banks than for target banks" [22].

Finally, Revell (1989) discusses two other viable explanations for the growth of larger banks: the need to be able to effectively serve large customers and the need to match the growing sizes of foreign banks [23]. These justifications will need to be empirically tested as to whether they will result in more competitive (than just large) banks.

1.6 Specialized Banks Versus Universal Banks

A related question to the one of economies of scale/scope is that of whether universal banking will become the norm in an integrated Europe. As we will see in the next section, the EEC's Second Banking Directive will, in essence, enable universal banking across Europe. Already, unlike the U.S. and Japan, "restrictions on security underwriting are virtually non-existent in European countries in a great majority of which securities business is regarded as an integral element in commercial banking" [24]. And theoretically, after 1992, banks will be allowed to own shares of non-financial corporation (within some limits); now only Germany, Luxembourg, Spain and the U.K. have no specific restrictions [25].

The verdict is still out on whether universal banking is the "ultimate" natural development in the provision of financial services. Some bank strategists have argued that "one-stop banking" is what clients in a future integrated Europe will desire; others have undertaken market surveys to point to a growing sophistication among buyers of financial products with a trend towards "shopping around" for the optimal price/value formula. Steinherr and Gilibert (1989) discuss numerous pros and cons for universal banking and conclude in the middle: "in an integrated European market it seems safe to expect a proliferation of both specialised and universal banking structures" [26].

1.7 Degree of Internationalization of National Banking Markets

One way of assessing how much further European banking markets need to travel towards financial integration is to observe the current "degree of openess" of the various EEC-12 countries. Table 9 presents two measures of "foreign" banking activities; unfortunately, breakdowns for inter-EEC banking activity alone was unavailable. Measure 1 estimates the control of total banking assets by foreign banks in the host country. Luxembourg with 91 percent, U.K. with 60 percent and Belgium with 46 percent appear to be most "receptive" to foreign banking presence.

But caution in interpretation is warranted here: these figures do not mean that foreign banks have successfully penetrated the local retail and corporate banking markets. In the case of Belgium, favorable tax incentives to encourage the use of Brussels as a financial "service center", coupled with efficient inter-bank settlement systems, have resulted in foreign banks (especially the Japanese) booking and trading vast portfolios of money market (as bank CDs or liquid inter-banks funds) and longer term debt paper. The U.K., based on its importance as a world financial center with an extremely high concentration of banks, is now the de-facto origination and booking center for international syndicated loans and Eurobonds. And Luxembourg, which has built its economic mainstay on attracting and maintaining foreign financial institutions has now become a key center for private banking with its consequent reputation as a tax haven for booking individual securities portfolios.

Measure 2 estimates "international" activity of domestic banks (as measured by the share of total assets in the form of foreign and domestic currency claims on non-residents and foreign currency claims on residents). As such it answers the following question: "of the same total recorded banking assets as in Measure 1 above, what share can be attributed to the international business of the country's domestic banks?" Here Belgium leads with 25 percent, followed closely by Netherlands and Denmark (both 23 percent) and France (21 percent). Germany, Italy, the U.K. and Spain all have less than 20 percent. In comparing Measures 1 and 2, it is interesting to note that the importance of the foreign presence for the U.K. and Luxembourg banking sectors vis-à-vis their own international activity; not surprisingly, these two countries have been most defensive of any EEC legislation that would jeopardize London or Luxembourg as international centers of finance [27].

1.8 Buyers, Suppliers, and Intermediaries in the European Banking Industry: Shifts in Relative Power

Up to roughly the beginning of the second phase of change (1975) discussed earlier in this section, the European banking industry could have counted on a somewhat "captive" and rather passive group of retail depositors on one hand and retail/corporate borrowers on the other. The first group had few investment options as deposits were paid little or no interest and retail mutual funds were still a rarity. The second group was relatively ignored by most banks who did not understand individual and middle and small market corporate risk assessment and hence ended up charging excessive lending spreads.

Various de-regulatory and market factors converged in most industrial countries in the early 1980s to start off a chain of reactive changes among the banks as financial intermediaries and these two "client" groups. On the liability side, the rise of money market mutual funds and deposit interest rate de-regulation increased funding volatility and costs for the intermediaries but at the same time opened new avenues of retail investment opportunities. Simultaneously, on the lending side, banks were finding that their large corporate clients were increasingly tapping international

capital markets thereby directly diminishing the banks role as financial intermediaries.

As profit margins in these once stable businesses declined, banks rapidly turned their attention to those client segments that they had once ignored: consumer borrowers and small and middle market companies. As nearly all the large European banks have begun to serve the needs of these groups, competition for their business rose and consequently fueled the financial capacities of these groups for discerning the best providers, in terms of price/values of various products/services.

The overall outcome of these changes has been a dramatic shift in relative power of the various market participants in European banking: buyers and suppliers of the banking sector now hold the weapon of "product substitution" and banks, faced with this prospect have had no other recourse but to looking for internal improvements in operational efficiency and for a sharper strategic mind in assessing the external market for their services.

2. Current Regulatory Barriers and EEC Legislative Efforts

The obstacles to pan-European banking (both from a consumer and intermediary standpoint) do not lie in visible barriers that individual countries establish in favor of domestic versus foreign participants. Instead one has to look to the diverse practices that each country applies equitably to all participants within its borders. In the past, these lay in areas as capital controls, limits on equity participations in corporations, solvency and capital requirements, limits on paying market interest rates on certain types of deposits, restrictions on securities transactions, differences in tax treatement of interest and dividend income and varying bank secrecy laws.

As noted in the introduction, the efforts of the European Commission, at least until the June 1985 publication of the so-called White Paper on European economic unification, was to obtain consensus among all member countries in order to "harmonize away" these vast differences. Realizing that in the European context this would take from "a long time to foreever"

and that consensus would in practice result in incorporating every country's cumbersome regulatory practices, the Commission opted for the triple-axed philosophy for integrating European banking: 1) minimum harmonization, 2) mutual recognition and 3) home country supervision.

Exhibit 1 summarizes the key directives which concern the European banking sector. Of these, two directives stand out as "foundation", and rather revolutionary pieces, of legislation: the Capital Movements Directive of 1988 (an extension of a 1986 directive) and the Second Banking Directive of 1987. The first enables free capital flows of all types [28] and lays the groundwork for the second which, if achieved in its entirety, will result in a unified European banking market.

Assessing the likelihood of realizing these directives is at best a difficult task: numerous country-specific factors intermingle, both for and against the banking sector's integration, pushing confident statements one way or another into the realm of sooth-saying. Nevertheless, certain "guarded" comments may be made and some outcomes can be anticipated:

(1) Despite historical national aversions to releasing full control of national money supplies, strong pressure from investors (private, corporate and institutional), and banking institutions will probably result in the realization of the directive on capital movements. In fact, as integration progresses, countries that resist full liberalization of capital movements may, in reality, find themselves faced with hidden outflows[29].

(2) Most of the directives on harmonizing various banking definitions, accounting rules and standards will most probably be realized and enforced within the next three to ten years (for some of the newer member countries). Often these rules are part of a larger framework of international harmonization of banking standards (as BIS, bi-lateral central bank agreements and the OECD) and there is no intrinsic country resistance towards such harmonizations.

(3) The most crucial directive, the Second Banking Directive, will also prove to be the most controversial in negotiation. Nevertheless, the

directive in some form will be approved; the true difficulty will come in enforcement. There are numerous high conflict-raising issues as, for example, limits on bank equity participation in non-financial businesses, the practical split of supervision by home and host authorities and the level of freedom to be given to non-EEC institutions. In realities, we anticipate that enforcement will take place in a checkered fashion for at least five to ten years after 1992.

3. Summary

It is only partially fair to state that the character of European banking industry reflects the level of economic advancement of various individual nations. But that only accounts for the size aspect and does not express the "personality" of each country's banking system. For that aspect, we have to look to differing roles of the government sector, national attitudes to concentration of economic power in any one sector, traditional patterns of consumer savings and the degree of openess towards foreigners; these reveal a complex-mosaic of banking institutions, regulations and consumer attitudes that defy generalizations.

Moreover, European banking over the past decade has undergone tremendous positive change: markets are de-regulating, retail and corporate clients are becoming more sophisticated and are demanding more "choice" and financial institutions are all entering each other's traditional core business attempting to improve on the other's business system.

Without the "integration mandate" of the European Commission, the smaller European markets may have contented themselves with past structures and systems; 1992 has galvanized even them into changing, often at double speed in order to catch up with the more developed financial and industrial markets. The picture of European banking markets then, is not one of stagnation, but of development and greater cohesiveness stemming from various elements of change

IV. EUROPEAN SECURITIES MARKETS: BUILDING LINKAGES FOR PORTFOLIO DIVERSIFICATION AND CORPORATE GROWTH

With the notable exception of the U.K., European securities markets appear historically to have assumed a secondary role in private sector financing vis-à-vis the banking markets. Bank intermediation provided not only long term funds for corporate growth, but also fed the seemingly unsatiable borrowing needs of the omnipresent central and local governments. In many countries even institutional funds were, by legislation, forcefully channeled into the holding of government paper. Not surprisingly then, European corporate bond and equity markets remained rather emaciated and country bound.

As we broadly discussed in the introduction, it was not simply the calls for 1992 that woke these dull markets and stirred them into action. Rather, until the middle 1980s, two factors of change were already acting on European securities markets: (1) technology and tele-communications advances and, (2) competition among key European financial centers in building a role as the European "link" in the increasingly global issuance and trading of securities. Then, from the middle 1980s onwards, an additional and indeed equally vital change factor emerged in the form of EEC initiatives in creating an integrated securities market by year-end 1992.

As we shall discuss below, while European securities industry is far from integrated, the upper end of the equity markets (e.g., large corporate) is already well on the way to integration. This phenomenon is characterized by consolidation of activity in major European financial centers. We shall also see that the very competitive struggle among the major centers for market share, coupled with the EEC efforts of harmonization/standardization of regulations, should lead to positive benefits for middle to small-size corporations and significant portfolio diversification opportunities for investors. As the literature on the Eurobond market is both vast and its pan-European and international scale and scope extremely well documented [30], our main assessment here shall be of major European domestic bond and equity markets.

1. Evolving Structure and Dynamics of European Securities Markets

1.1 Government and Corporate Bond Markets: Basic profile

Market Sizes and Types. As shown in Table 10, European domestic bond markets are different in scale and in scope. Seven major national bond markets exist in Europe and in terms of comparative size of outstanding issues are approximately 60 percent of the U.S. market and 120 percent of the Japanese market. The four major countries account for 80 percent of the total outstandings and Germany alone accounts for 32 percent.

Except for Germany, the government sector (both central and local) is paramount in European bond markets accounting for, on average for the seven markets, 50 percent of the outstanding bond issues of all types (the comparable figures are higher in the U.S. (74 percent) and Japan (68 percent)). However, in four countries, Italy, France, the U.K. and Belgium, the government share is approximately 80 percent. In the case of Germany (as well as in France), it should be noted that most of the non-government bond paper is primarily occupied by financial institutions with "true" corporate bonds gravitating towards the Eurobond market [31].

International bonds (Eurobonds and foreign bonds) exceed the purely domestic non-government issuer bond markets only in the U.K. where it is almost three times larger. It should also be noted that the private placement market for long term paper is significant in both Germany and Netherlands (and probably in other countries where market data is totally unpublished). And considering the traditionally strong role of commercial banks in European corporate financing, it is likely that much of the long term borrowing needs of fairly large middle market companies (which in the U.S. could go the bond issuance route underwritten by small regional investment banks) is being met by private placements.

Despite the recent efforts of some U.S. investment banks to introduce the technique, the European bond markets do not have a distinct high-yield or "junk-bond" category, either of new issuance or of the "fallen angels" variety. This had frequently been attributed to investor preferences for

capital preservation and anonymity rather than for short-term high risk-return portfolio strategies.[32] In addition to this reason, we observe that European investment banks are poorly capitalized and act more as brokers and hence have neither the capital nor the legal right to undertake mammoth bridge financing to hold the paper before off-loading on the markets (assuming that investors were receptive). The U.K. could prove to be an exception to this as revealed by the recent efforts of introducing high risk mutual funds for the LBO market.

Growth Prospects for Corporate Bond Markets. Table 11, indicates the size of new issuance of corporate bond paper of all European companies over the 1985-1987 period. Again domestic bonds accounted from approximately 70 percent to 80 percent of all issues with growth in the total issuance size noted for each of the three years. The interesting question of whether European domestic corporate bond markets will continue to expand is also a complex one. Walter and Smith (1989) argue that the traditional reliance on banks is appearing to diminish due partly to the growth of Euromarkets and the growing familiarity of corporations with capital markets [33].

While that is indeed true, several other key driving factors should also be assessed: the crowding out effect of government bond issuance, the ability of banks to become more efficient intermediaries and the possibility for banks to hold and trade securities after 1992, the relative importance of the Eurobond market with its attractive anonymity feature, the trend towards leveraged financing and mergers and acquisitions, and future portfolio mixes of Europe's growing institutional funds. These factors are briefly examined below.

As we saw in Table 10, government bonds today occupy a significant position in national bonds markets. There are few reasons to believe that this share will diminish over the next ten years: tax levels are typically already high in Europe and the EEC efforts at harmonization of tax standards generally has tended to go for the lower common denominator [34]. On the other hand, future freedom for capital movement and the ability to move financial activities anywhere will make it more difficult for government to hand twist institutional investors (as requiring certain percentages of

pension funds to be kept in government bonds or limiting bond auctions to local players who then are forced to bid for the output). Governments will then, theoretically, be on equal footing for capital funding with domestic corporations; if this were to happen we can expect upward pressures on borrowing rates in those countries where the government debt as a percentage of GNP is already high (see Table 10)[35].

As we discussed in the section on banking, EEC legislation in that sector should create more competition at national and European levels and hopefully result in efficient producers (i.e., lower borrowing costs for corporate and retail consumers). One possible implication is that banks will try harder to keep core corporate clients: offering ample low-cost long-term capital which they then may try to off-load through asset sales. On the other hand, 1992 will also enable them to underwrite, hold and trade securities. Realizing that the returns are typically higher than on their government bond portfolios coupled with the fact that they have a close knowledge of the credit risks involved and the fact that liquid corporate bonds are useful for asset and liability management, may push banks into underwriting bonds instead of equity.

The Eurobond market remains a large and the single most important unified corporate bond market (see Tables 11 & 12). Its peculiar attractiveness in the past was the anonymity it provided retail investors from national tax authorities; consequently the borrowing costs were often lower for corporations than if they issued in national bond markets. Walter and Smith (1989) offer several reasons for the continuing importance of this market [36]. But they add that post 1992 may see a "blending" of the Euro and domestic bond markets as the tax and regulatory differences will be harmonized away. It remains to be seen whether the recent proposal on a 15 percent interest income withholding (at the source) which specifically excluded Eurobonds, may not result in favoring that market vis-à-vis the domestic bond market.

Recent developments in the U.K., France and the Benelux countries indicate a growing use of the LBO financing technique. In addition, many observers expect substantial increases in pan-European merger and

acquisition activities as EEC integration accelerates, and despite strong distaste in most European countries for hostile takeovers, the presence of well entrenched management in numerous European corporations will in all probability necessitate that form of acquisitive activity [37].

The implications for the bond markets are two-fold: (1) while LBO debt financing has typically been bank funded in the U.S. and U.K., the lack of sophistication and risk aversion of many continental banks may lead to deal arrangers (as U.S. and U.K. investment/merchant banks) to structure special purpose bond financing and (2) the expected reluctance of most European banks to finance hostile takeovers considering their traditional close "relationship" banking with corporations may lead to investment banks designing and placing acquisition paper with sophisticated investors in the form of transferable bond paper. It is most probable that the initiators of these potential developments will be U.S., and to a lesser extent, U.K., investment banks who may then become tough competitors to continental banks on their home turf.

Lastly, the growth of European bond markets will heavily follow the growth and mix of institutional portfolio investments. Many factors point to a greater role and importance of institutional funds (to be discussed below). It is expected that the managers of these funds will be increasingly oriented towards improved performance under a more "scaled" level of risks; in other words, instead of placing 50 percent-70 percent of their portfolio in government bonds, the mix may contain graduations of corporate risks, equities, venture capital and say, LBOs. Additionally, as we discussed above, EEC liberalization will make it harder for governments to force institutions to be "captive" investors of their bond paper.

1.2 Government and Corporate Bond Markets: Operations

Primary Market Mechanisms. As noted above, the bulk of the European bond markets is occupied by government paper; this is true in terms of paper outstandings as well as liquidity [38]. As we will see below, most governments have their own established market procedures for issuance and trading of their paper. In addition, a significant portion of all domestic

non-government bonds involve the financial institutions sector; as such, many of the banks are able to undertake the issuance of their own paper and ensure active secondary markets. As a result of this heavy concentration of issuer type and the frequent combination of the issuer/underwriter roles, in most European bond markets the number of active participants in the primary markets is limited.

Primary market practices vary from country to country. In Germany, a fixed syndicate of banks led by the Bundesbank underwrites new issues. Currently 93 banks are involved including 20 foreign-owned banks who are allocated 20 percent of each issue. In the U.K., France, Italy and Netherlands, a tender bid system (known popularly as the "Dutch Auction") is utilized whereby authorized banks or brokers submit bids for a certain number of bonds at specific prices. The fundamentals vary somewhat: in France the government announces the coupon, redemption features and an approximate amount of all the year's issues at the beginning of the year; in Netherlands the size of the issue is decided at the end of the tender [39].

Secondary Market Participants. Secondary market mechanisms vary as well. Bonds in general have to be listed on the various national stock exchanges but, depending on the type of bond, trading is mostly undertaken on an OTC basis (as Germany's "geregelter Freiverkehr or Italy's "parallel market"") [40].

In France, bond trading is dominated by the Agents de Change who are brokers on the Paris Stock Exchange; they perform a function similar to that of specialists on the NY Stock Exchange and until 1987 they operated a system of bond price fixing at midday. Since 1987, 13 government-appointed dealers make continuous OTC prices for government bonds. Furthermore, after 1992 the legal monopoly of the Agents de Change is to be terminated and from 1988 on, French and foreign banks may purchase shareholdings in these brokers [41].

In Germany and Netherlands, banks act as brokers; all orders reach the stock exchanges via these banks. In the U.K. the 1986 "Big Bang" of deregulation initially boosted the number of gilt market maker from 2 to 29;

a shakeout since then has reduced this to 24 and it is expected to further reduce itself to 19 [42].

In Italy, participants in the official secondary market must be licensed stockbrokers who act as brokers and hence cannot trade on the exchanges for their own account. Ninety-five percent of the trading, however, occurs on the parallel market which is totally unregulated and is conducted on an over-the-counter basis and includes major participants as institutional investors, banks, insurance companies and the major industrial companies [43].

Commission Systems, Clearing and Settlement. Secondary market commission structures across Europe are tending towards the negotiable system evident in U.K. after "Big Bang": in Germany they are already negotiable, in France and Netherlands they vary by deal size and in Italy as most of the trading is done on the OTC, commissions are basically negotiated among players [44]. It is important to point out however, that in assessing "true" commissions involved (especially for the retail buyers and sellers of bonds) one needs to take into account the current access to immediate price quotation comparability in each country, the lack of which can serve as a means for intermediaries to add hidden commissions in the form of higher prices. European securities settlement systems are discussed of greater length in the European equities section below.

Bond Derivative Markets. European bond-related derivative markets are concentrated in five financial centers: London Traded Option Market (LTOM), London International Financial Futures Exchange (LIFFE), European Option Exchange (EOE) of Amsterdam, Marché des Options Négociables de Paris (MONEP) and Marché à Terme International de France (MATIF). Products available range from options, futures, and options on bond futures, all on government securities; trading is most active on long term government bonds. Germany modified its gambling laws in 1988 in order to establish organized markets for derivative instruments; futures contracts on debt instruments are expected to begin trading in 1990.

1.3 Equity Markets: Basic Profile

Market Sizes and Types. European equity markets are characterized by far more diversity, fragmentation and historical idiosyncracies than their bond markets counterparts. There are two good explanations for this difference: (1) governments are major participants in bond markets, have borrowed heavily on international capital markets and have consequently tended to adopt international market techniques and (2) the highly integrated Eurobond markets has had a strong spill-over effect onto national bond markets. Yet, as we shall see below, European equity markets are showing signs of integration as well.

As revealed in Table 12, the International Stock Exchange of London (ISE), formerly the London Stock Exchange, is clearly the leading market both in terms of market capitalization and number of domestic and foreign stocks listed. ISE's domestic and total market capitalization of approximately ECU 0.6 and ECU 1.8 trillion, respectively, at year-end 1987 places it third internationally after Tokyo (ECU 2.3 trillion) and New York (ECU 1.8 trillion) [45].

In Europe, ISE holds the leading position as the most "international" of the various equity markets: over 587 foreign stocks listed; (it leads the second most international of exchanges, Frankfurt which has 474 foreign stock listed). Frankfurt is Europe's second largest in terms of market capitalization (ECU 213 billion) but thanks to its high turnover ratio vis-à-vis London (2.16 as compared to 0.15), it holds the first position in Europe in terms of sheer annual transaction volume.

There are various reasons for London's supremacy today as Europe's premier equity market: historical head start in terms of capital accumulation and trading of shares stemming from early industrial development; continuous technology interchange with New York and Tokyo in areas of tele-communications, settlement systems and product innovation; beneficial linkages with other areas of capital markets in which London also maintains a key role, notably debt and foreign exchange; progressive self-initiated reforms as evidenced recently by "big Bang" in 1986 [46].

Growth Prospects for Equity Markets. Equity financing in most European markets outside of London has traditionally been wealk and has taken a secondary role to debt financing of all forms. Several factors can explain this situation: (1) the heavy government ownership of industry in many states, (2) the holding of shares by banks in the states with universal banking, (3) the lack of liquidity in Continental exchanges, and (4) the general lack of sophistication of most retail investors who concentrated their financial assets in bank products or, at most, bonds.

This situation is changing rapidly; Table 13, reveals the rather dramatic growth in equity financing by all European companies for the three-year period 1985-87. All three categories of equity have risen: domestic equities have more than doubled (from ECU 25 billion to ECU 64 billion) and foreign (non domestic companies issuing in local markets) and euro-equities (shares issued in the euromarkets) have also shown tremendous growth. This trend is expected to continue for several reasons that concern both primary and secondary markets:

(1) Several governments are undertaking privatization programs in order to liberalize the economy and raise capital. Between 1985 and 1987 approximately ECU 35 billion was raised in Europe from the sale of shares in public-sector corporations [47]; considering the general success that governments have had in tapping these once dormant capital markets, there is no reason to believe that this trend will not continue.

(2) Universal banks after 1992 may be restricted by EEC legislation, as to the amount of shares of any particular company they can hold; off-loading of such paper may accelerate in the next few years to comply with the liklihood of the approval of these requirements and hence may promote secondary market liquidity. In fact, in some countries, as Germany, where banks have held on to major quantities of corporate shares for decades, this off-loading process can in some ways be construed as a form of privatization.

(3) The traditional lack of liquidity in Continental exchanges was mostly due to regulation that prevent intermediaries from trading for their

own account and to engage in market making activities as well as from the undercapitalized nature of the intermediaries themselves; increased competition from London may force Continental exchanges to change their prior stance of investor protection and the entrance of better capitalized universal banks should enable players to capture these new opportunities.

(4) Four, European retail investors are increasingly diversifying their financial portfolios away from bank products; for instance, in all major markets bond and equity holding mutual funds are showing phenomenal growth rates at the expense of traditional deposits and bank certificates of deposits [48].

1.4 Equity Markets: Operations

Trading Vehicles and Price-setting Mechanisms. As shown in Table 14, with the exception of London, most Continental equity markets are still of the organized type (similar to New York and Tokyo) whereby official floor trading and hours are maintained and where order are centralized and executed in a single location. Nevertheless, even in Continental markets an interesting development is occurring: off-floor trading for large blocks of shares is tending to drive a significant portion of trades out of the stock exchanges towards brokear/dealer offices, or towards London's ISE where liquidity of large blocks of foreign shares is often higher than on the local market of origin [49].

There are different price-setting mechanisms in the various European equity markets; the dominant batch system is expected to be increasingly replaced by a continuous market system with computer-assisted trading and quotations. Under the former system (used in most Continental exchanges), orders are not transacted immediately but stored and transacted in a "batch"; under the latter system (prevalent in London) transactions occur when two traders' order cross: price setting is automatic and occurs "continuously".

Stock Exchange membership. With the exception of Italy, stock exchange membership in Europe does not require the purchase of a "seat" (as in the

U.S. or Japan). Table 14 indicates the current number of brokers in the major equity markets. Membership is usually granted by the ruling stock exchanges public or private authority and typically membership comes with a stockbroking monopoly (except in the U.K. where entry is free even for foreign firms). Elsewhere, foreign firms are generally prohibited from national markets, or, if admitted, are submitted to stricter requirements than national brokerage houses [50]. All countries have established minimum capital requirement for firms, a few countries have done the same for individuals with London having detailed requirements according to the nature and scale of business. Likewise, all countries require an annual financial report for listed companies, and a few require more frequent reports (italy, Netherlands and the U.K.) [51].

Commission Systems and Taxation. As we saw in the discussion on commissions in European bond markets, the tendency is towards negotiable commissions in European equity transactions. As shown in Table 14, in most of the key European markets, commissions are either totally negotiable (U.K.), Germany and Denmark) or partially negotiable with a ceiling on fixed commissions (France, Luxembourg and Portugal). Others, notably Italy, Netherlands and Spain, continue to have a fixed system with pricing gradations based on transaction size [52].

Another cost of trading, taxation of capital gains, dividends and transactions, reflect divergent practices across the markets and result in distorsion in the flow and allocation of capital. Capital gains are normally taxed where the investor resides; dividend payments are sometimes subject to withholding; transactions tax is usually proportional to the amount transaction or to the commission charged by brokers. The harmonization of these taxes will remain a difficult issue well beyond January 1993 considering that tax issues are still decided by the unanimity rule among EEC member states.

Clearing and Settlement Systems. There are numerous clearing and settlement systems in European equity markets; in itself this poses tremendous problems for the integration process. Some countries (Belgium, Denmark, Portugal, Spain and Germany) still practice physical delivery of

securities with associated long delays and higher transaction costs. A few countries have a centralized system of clearing and settlement as France's SICOVAM (also Luxembourg and Netherlands); others (Italy and the U.K.) continue to maintain a network of multiple systems [53]. It is hoped that the integration process will assist in the creation of bridges between major Continental stock exchanges and the ISE; some efforts are already underway (as between France and Germany and the Interbourse Data Information System which aims to link all major European excahnges). Without this integrated clearing and settlement system European markets will indeed remain quite fragmented.

Equity Derivative Markets. There are currently few active equity-related derivative markets in the EEC (see the discussion of derivatives in the bond market for a listing of markets). Equity-related derivative securities can be option contracts on individual common stocks as well as option and future contracts on stock market indices. Option contracts are traded on the LTOM, the EOE, and the MONEP, while futures contracts are traded on the LIFFE and MATIF [54]. There is also an OTC stock option market in Frankfurt which, however, is relatively inactive due partly to the fact that Germany modified its "gambling" laws only in 1988 to permit the creation of organized derivative instruments.

Equity Markets Efficiency. Various studies have been undertaken to assess the informational efficiency of European equity markets; a recent review of the evidence concluded that they could be considered informationally efficient on the three forms of the efficient market hypothesis: weak form, semi-strong form, and strong form [55]. In other words, in European equity markets (1) current prices fully and instantaneously reflect all the information implied by the historical sequence of prices, (2) prices adjust rapidly and fully to publicly available information (limiting the use of such information to earn above normal profits) and (3) potential access to "inside information" does not translate to earning abnormal returns (as indicated by the inability of institutional investors to outperform the market under the assumption that they may have had more favored access to information).

2. European Corporate Finance Today: The Cost of Market Fragmentation

The "splintered" nature of European securities market has had one major effect on corporations taking a pan-European approach to corporate finance: it has effectively managed to contain all but the largest corporations within the confines of national financing sources. As we saw in the introduction, there is a cost to businesses of not having ready access to various types of institutions than those found within the borders of any given European state. How far away are we today from a scenario of pan-European securities market fund raising?

Currently, only large multinational corporations tend to take a pan-European, or indeed global, approach to raising funds via the securities market. For the vast majority of European middle market and large national companies besides their pool of initial shares outstanding, which may or may not be widely held, the main source of funding is their "house bank".

These limited funding options can be explained by two fundamental reasons. Firstly, unlike in the U.S. or Japan there has been no great desire on the part of thinly capitalized investment banks to take the risk of underwriting bonds or equities for these companies, especially in light of the fact the investor demand up to now has at best been lukewarm for anything but well-known bank or government paper. And secondly, exchanges didn't help matters either: the hassles of undergoing cumbersome listing, issuance procedures sent most corporations back into the hands of their reliable (even if more expensive) banks. Hence, for most European companies even accessing their national securities market remains a daunting challenge, let alone considering a pan-European approach.

This "stagnant" situation is changing across European securities markets, beginning with the major financial centers and progressively spilling over to the smaller markets. As we will see below, EEC legislation in the securities field is as revolutionary as in the banking sector: competition for business from all providers will increase dramatically. And as margins at the large end of the corporate business dwindles, these

providers will increasingly look to the middle market segment, first in their home countries and then on a pan-European basis.

There are signs today that the securities industry is already reacting. Continental exchanges are liberalizing and modernizing their practices to gain a head-start over other exchanges and perhaps to chisel away London's supremacy. Even, the demand side is improving: retail investors are drawing out low or zero interest bearing bank deposits to invest in mutual funds; as mutual funds grow in number and competition for business accelerates, their portfolio competition will change to incorporate bonds and stocks at the higher end of the risk spectrum. Hence, one can almost say with a fair degree of confidence that within the next five to ten years what was once the preserve of major corporations will become within reach for the vast majority of middle size companies.

3. European Portfolio Investors: The Evidence of Diversification Opportunities and Current Obstacles

European investors have long recognized the benefits of portfolio diversification based on the sizable evidence from research done at the international level. Recently, more work has been undertaken on the particular subset of the global stock markets that Europe represents [56]. The evidence presented by Hawawini and Jacquillat (1989) indicates that during most of the 1980's, European equity markets have shown correlation coefficients, between their equity return measured both with and without exchange rates, of average magnitude. They conclude, "a dynamic asset allocation strategy across European equity market would have brought about high risk reduction benefits without a sacrifice in total returns." [57]. Similar studies on diversification across European bond markets reveal similar opportunities although somewhat less pronounced. [58]

Two key questions arise: one, what are the obstacles to building a pan-European portfolio of investments and two, will integration reduce these diversification opportunities by increasing correlation coefficients significantly? Our discussion above on the highly diverse set of rules and practices in the operations of both bond and equity markets answers the

first question: except for the bonds and stocks of the largest corporations, much of which is issued and traded in London (eurobonds or euroequities) pan-European portfolio investing remains quite an adventurous task today.

Hawawini and Jacquillat have answered the second question in the affirmative: "it is quite possible that European integration may result in statistically significant increases, over the next five to ten years, in correlation coefficients between major European equity market returns." [59]. Nevertheless there are several factors that more than offset the reduction in diversification opportunity: increased operational and informational efficiencies as well as the possibility of future European investors taking a "focused diversification" approach. Said otherwise, as markets integrate many of the obstacles mentioned in the above paragraph will diminish; furthermore, portfolio diversification in an integratred Europe could take an "industry sector", "company size", or "economic/geographic pockets" approaches [60].

4. Current Regulatory Barriers and EEC Legislative Efforts

Unlike the banking sector where indirect barriers (different standards in each country) are the biggest obstacle to pan-European offering of services, the securities field is also burdened with direct barriers. Exchange controls, while being phased out in most EEC countries, made multi-country portfolio investing extremely difficult. Numerous exchanges had (and many still do) regulations preventing foreigners from being licensed as brokers. In some countries (as Germany and Belgium) in order to offer just securities trading it used to be necessary to obtain a full banking license and offer a full range of services. Insurance companies and pension funds in many countries are limited as to the amount of foreign securities they allowed to hold. These various tangible barriers were on top of the numerous differences in practices and regulations in European securities markets that we discussed above.

The EEC directives in the securities sector attempts to create a level playing field for intermediaries and investors. As shown in Exhibit 2, a vast effort to define standards and harmonize practices is underway. If

successful, this effort will bring about a number of developments such as: (1) more efficient and standardized rules for admissions to exchanges, (2) listing of company particulars, (3) publication of prospectuses, (4) the control of insider trading, (5) disclosures of major ownership changes, (6) regulatory scrutiny, (7) the ability for investors to purchase shares in mutual funds across Europe and, perhaps most importantly, (8) the ability for intermediaries licensed in one EEC state to offer pan-European securities services without obtaining further approvals.
Similar to the various directives proposed in the banking sector, it is most likely that the securities directives concerning "standardization" or "harmonization" of regulations and practices will be approved in some form or another. There would be little vested interest for any one country to vigorously oppose the creation of a level playing field. Nevertheless, as seen above, enforcement of some "harmonization" directives could prove to be a problem.

For instance, in order to realize the disclosure of large shareholdings directive, honesty on the part of the shareholder will need to be relied upon in some countries (e.g., France and Germany have bearer securities cleared electronically). And the directive on insider trading, despite its efforts of defining "insider" will in all probability create monitoring nightmares. It is therefore likely that the EEC will need to create a strong-arm agency like the SEC in the U.S. with a mandate from the EEC for monitoring compliance across European equity markets; there may be strong opposition to such a move in certain countries (especially the U.K. which had long had a "self-discipline" philosophy).

The directive on investment services is indeed the "core" directive in the securities field; in range and depth it is modeled after the Second Banking Directive which we discussed in the banking section. Indeed much of the comments we made as to that directive's successful passage through the legislative process to implementation is applicable here: while it should be approved in some final form, the various states will spend many years beyond January 1993 struggling with the "dynamic disequilibria" it will no doubt create.

5. Summary

Despite its current fragmented character, the European securities industry is showing distinct signs of structural and operational integration. Competitive forces are at work across the various national markets and among all categories of participants.

Retail and institutional investors are growing in number, becoming more sophisticated and are willing to cross borders to deal with intermediaries that offer the optimal price-value service.

Traditionally undynamic and protected national exchanges are being jolted by the realization that preparations for 1993 by other exchanges may leave them as stagnant backwaters of finance; they are self-liberalizing and modernizing as never before in their history.

And intermediaries, long used to a cosy existence of monopolistic service provision, are finally realizing that their home governments are opening their markets to foreign participants and that each basis point of even domestic commission income will have to be competed for on the basis of efficient service.

Considering these factors, it is most likely that European securities industry will have already gone a long way towards an "integrated character" even before 1993.

V. STRATEGIC IMPLICATIONS OF AN INTEGRATED EUROPEAN FINANCIAL MARKET FOR MAJOR PARTICIPANTS

Prophesizing, even in the form of hypotheses, is a dangerous game especially in the context of European financial integration. As we have seen above, numerous economic, technological, political, and even global factors converge at different speeds and importances in making or braking the integration of European financial markets. In this section, we attempt to lay out, in a rather broad fashion, some of what we consider are key

strategic implications for various participants in an increasingly integrated European financial services industry.

(1) **a. The current process of "role assimilation" evident among European banks cannot result in a sustainable market structure.**

b. The shakeout of this process, coupled with the effects of EEC integration, will lead to market consolidation: first at the national level to be followed later at the European level.

c. The strategic roles chosen by the remaining participants will require the acquisition of different managerial skills than those that served them well during the period to 1992.

As we discussed in the banking section above, European financial intermediaries, to the period up to roughly 1975, played rather specialised "roles" caused by the impact in each country, at different speeds, of national and international financial de-regulation and market competition. As "deepening" the scale of operations became difficult (due to market saturation in core banking businesses), banks increasingly turned to diversification of products and services.

That 10,000 formerly specialised European banks are all moving toward some form of universal banking is not negative per se, especially if all of them can provide cost-effective products at competitive prices. But, in practice, this is highly unlikely: managing product range complexity to tap product synergies is an extremely difficult endeavor. Moreover, as we mentioned in our discussion on economies of scale and scope, it is most probable that such economies may exist in non-traditional banking business: precisely some of the areas where the diversification is occurring.

The initial effect of this "herd strategy" of diversification will be a downward pressure on product margins as competition increases. As margins in these "new" areas are squeezed and continued subsidising of losses from the slim-margin traditional business becomes impossible, only the most innovative or highly efficient small banks will survive. And unless even

such banks focus their managerial effort in certain market niches (as a strategy of "offer all things to some people" or vice versa), they will find that the demands of multi-business management in banking too complex and costly in terms of attracting the necessary trained management.

This excessive competitive environment is being exacerbated not only by the appearance of new non-financial entrants (as retailers and industrial company "financial" subsidiaries) but also by the EEC legislation in the financial area. The shakeout of this process is already leading to national consolidation of participants (either through mergers and acquisitions of entire banks, or through the sale of individual non-strategic business units).

On the European level, "balance-sheet type consolidation" will probably not take place until a period nearer to 1992 and even well beyond that. In the meantime, the larger European banks may opt for "strategic alliances" (ranging from the vaguely defined versions to the very specific joint business development in a particular product or client segment), while the smaller banks may seek to be acquired by larger foreign "white knight" banks. Interestingly, to date, very few banks (regardless of size) have deliberately taken a truly pan-European approach: most have contented themselves with a wait-and-see strategy to deal with the "1992 question" while pursuing an active defense strategy for their home market positions.

What type of banking intermediaries will successfully emerge out of this consolidation process and what skills will they need to build to survive and prosper in the post-intergation environment? We argue that three "generic" types may be discernable in the future of European banking, with differing levels of success (as we are limiting this discussion to the European sphere of banking, the issue of these generic type of banks' international scope of activity (i.e., non-EEC), which is undoubtedly important, has not been discussed): (1) pan-European universal banks, (2) pan-European specialized banks, and (3) large national universal banks. For competitive reasons discussed above, it is unlikely that many banks in the one category that is excluded, namely, the smaller national specialized banks, will survive.

There is room for only a handful of pan-European universal banks offering all services to most client segments in nearly all EEC-12 countries. Succesful players in this group will need to develop numerous skills that center around the management of complex banking institutions. In part, success will be determined by those institutions that innovate and perfect a product or client business system within any given national market (and not just from the home market) and quickly tailor and transfer the approach to each of the other national markets. In other words, innovation should be encouraged from any given market and in turn this entails a "de-layering" of managerial control downwards from the head office. Naturally, also needed are other key skills as multi-country strategic cost accounting (for product/client profitability analyses), multi-currency funding and asset-and-liability management, and human resource management across many cultures with increased cross-country mobility of professional staffing, among others.

The pan-European specialized banks could be those that take either a product group focus or a client segment focus. While their managerial task is made somewhat easier by the fact that they are not burdened with a complex matrix of products, clients, and countries, they also have less ability to rely on profits of one business area to support another during any lean years. Nevertheless, their very focus is also their competitive advantage giving them flexibility in reacting to changes in demands of their end clients. Additionally, a European field of operations will enable them to build scale and diversify their business risk. The skills necessary for this segment will include all of the above cited for the first group, but in addition, they will need the strategic skill of choosing the right segment and defining its characteristics and parameters. Moreover, they will need to fight the natural tendency of most specialized institutions to start diversification in response to competition instead of further improving operational efficiencies.

Large national universal banks will find life in the 1990s extremely uncomfortable: pan-European universal and specialised banks will be utilizing their respective competitive advantages to capture local market shares. And for many large national banks, their size is due to traditional

monopolies of client or product segments that are already falling with national de-regulation (even before EEC reforms are considered). Their potential strength, in any case, is their typical vast branch networks and a somewhat traditionally "loyal" clientele. Capitalising on these advantages will require a separation of the strategies that need to be developed for the retail and wholesale client sector. On the retail side, new essential skills will include managing individual branch profitability through micro-marketing techniques (which the other two groups may not afford to undertake) and managing product offering that captures cross-selling opportunities without excessively increasing fixed costs. On the wholesale side (corporate and institutional clients), large national banks may find it advantageous to collaborate with players from the first two groups by focusing on certain parts of the business system (as funding and marketing instead of new product development or off-loading of paper in the secondary markets).

(2) a. **Retail consumers will be faced with a panoply of products/services provided by local and European intermediaries through numerous market channels, many of which should be non-traditional.**

b. **Although retail consumers as a group should benefit greatly from the formation of a single financial market, the financially sophisticated sub-group of retail consumers among them should benefit proportionately more.**

c. **However, capitalising on these opportunities even for this sub-group will necessitate the development of new borrower and investor skills which were unimportant in the past.**

One of the major outcomes of EEC legislative reforms should be the proliferation of new products and services across Europe offered not just by local banks and securities brokers but by other European institutions. The ability to offer services throughout the EEC with only one license will increasingly result in European financial institutions trying non-traditional marketing channels, often based in their home country. Coupled

with this, the freedom of capital movements will permit retail consumers to have mobility in their borrowing and investing practices.

If European financial integration is achieved on schedule, the following should be an altogether realistic scenario in the retail banking in the 1990s: an Italian office worker in Milan uses a local national bank for his current account needs, takes a low interest rate Deutschmark mortgage loan from a U.K. building society marketing out of Madrid which also sells him an exchange rate coverage, places his savings in ECUs with a German universal bank based in Luxembourg, and purchases Lira-denominated variable life insurance from a Dutch company, by mail, from its Rome office.

It may be highly improbable that this will be the scenario for the average individual. Therefore, although we observed in our discussion on potential price reductions in financial services that consumers stand to gain on average in terms of lower borrowing costs and higher investment returns, this remark needs to be qualified. Hence our hypothesis that European financial integration should disproportionately benefit the financially sophisticated individual who can see the checker-board pattern of individual product cost-differentials across Europe and selectively "shop around" for the best price-value mix.

There are many pitfalls involved in pan-European shopping, requiring the development of new skills. National consumer protection legislation may diminish as home country supervision becomes the guiding rule. While accounting standards may become more standardised, foreign intermediaries may publish financial statements in limited number of languages hence making risk assessment more difficult for some. The first five years of post integration may turn into a somewhat volatile period as financial intermediaries go in (and out) of new businesses and markets. This will make client commitment to, and reliance on, any one institution difficult to sustain.

And considering that progress towards unified monetary and fiscal policies may take us well into the next century, European retail equity and bond investors will have to contend with evaluating various currency risks,

general economic risks and industry-specific market risks before embarking on a pan-European investment strategy, which for other reasons (as we will discuss below) should become easier.

(3) a. **Corporate financing should increasingly take on a European perspective as the range of financing options expands from traditional bank borrowing to include more active tapping of national and European securities markets.**

b. **Within corporations as a group, the "new" beneficiaries should be small and middle market companies rather than large multinationals who in many aspects are already operating on a pan-European basis.**

c. **Serving these corporate finance needs requires the acquisition of new skills and systems on the part of financial intermediaries as well a different organisational structures that correspond to the needs of the client segments they plan to serve.**

We discussed in our section on European securities markets that European companies are beginning to explore non-bank sources of funding. We observed that this was due to numerous inter-linked factors. Domestic bond and equity markets are becoming vibrant and national and international de-regulatory tendencies are jolting both national exchanges (who fear foreign and OTC market competition) and domestic brokers into modernizing their infrastructures and operating practices in order to build more efficient markets. Encouraging this process are the various EEC legislative reforms which will allow intermediaries to operate freely across all EEC markets. These developments have opened to corporate managers a rich gamut of financing options which was unavailable in the past for all but a few large corporations.

While currently the government sector dominates most national bond markets, and tapping the Eurobond markets is still the prerogative of large and well-known companies, we cited various reasons that point to more lively

domestic corporate bond markets, including, the future ability of banks to underwrite and trade corporte bonds (as universal banks), the trend towards increased merger and acquisition activities in general, and LBO activities more specifically, (partially from anticipated increased corporate restructuring activity) and a potential greater demand from Europe's growing institutional funds for higher return corporate bond paper over domestic government paper.

Likewise, various factors are expected to push the use of European equity financing, including privatisation programs, off-loading of universal banks' equity holdings in light of possible EEC requirements, the future ability of brokers to trade for their own account, and the growing awareness of equity risk and consequent demand for equity paper among retail and institutional investors.

European equity exchanges, especially in the major financial centers, are rapidly modernizing their infrastructure and self-liberalising in order to be viewed as being operationally efficient by corporations and investors alike. We observed how rules/practices on exchange membership, transaction commissions, and clearing and settlement systems are being streamlined and slowly standardised at a Europe-wide level.

While even the large European companies will gain from these improvements in the functioning of securities markets, it is especially the small and middle market companies who will reap the most benefits. We saw earlier how this sector was traditionally neglected by the banks. In addition, they had little hope of being nurtured by the securities houses who, in most European countries are (until 1992) prohibited from holding and trading securities for their own account. Faced with reluctance of investors to hold small corporate paper, these securities houses felt no reason to place much effort on this sector.

This situation should change for several reasons. In addition to those improvements in securities market conditions that we discussed above, one has to include the changing nature of competition for corporate business. With universal banking after 1992, well-capitalised commercial banks will

start competing with brokers on the upper-end of corporate market, to underwrite and make secondary markets in their shares either on or off the exchanges. Most of this action will be among a handful of players and is expected to gravitate towards the key financial centers of Europe, with London predominating. The vast majority of European banks and brokers should then begin to focus their attention on understanding the credit and equity risk of middle size companies, propose tailored financing packages that should include a open market securities portion, and literally "grow" the relationship.

Success in serving these non-traditional corporate finance needs will not be easy for most banks or brokers. Needed are new skills, sophisticated integrated systems, and a highly flexible yet linked organisational framework. For instance, pan-European intermediaries wishing to tap small and middle size companies need to build credible research capabilities either through acquisition, internal development or through strategic alliances with research houses in multiple European countries. In addition, intermediaries have to integrate their operating system and tailor their organisational and business system approach in accordance with the client segments they are targeting. For a universal financial intermediary, an integrated one (from origination to distribution) may be advantageous for the middle market but will be extremely costly for the upper end of companies. On the other hand, focused intermediaries (as brokers) specializing across Europe in certain industry categories may find it cost-effective to serve across the business system, across the size spectrum, and across countries, provided that operating scale and synergies are achieved.

(4) a. **European institutional investors should play an increasingly important role in national and European securities markets.**

b. **This enhanced role will be aided by national and EEC reforms which should encourage the diversification of institutional portfolios away from a heavy reliance on local investment vehicles toward a more pan-European investment approach.**

c. **Financial intermediaries that wish to serve the growing investment needs of these institutional investors will need to develop specific skills on a pan-European basis and decide what aspects (if not all) of the business system they intend to focus on.**

The primary impetus to the growing importance of European institutional investors is derived from the continued development of mutual and pension funds. The European mutual funds market today is estimated at over 420 billion ECUs and further growth can be expected from both the retail and institutional side seeking higher returns without foregoing too much liquidity [61]. European pension funds are rapidly shifting from a redistribution system to a capitalisation system. In the former, contributions made by individuals currently working are immediately redistributed to current pensioners, whereas in the latter, funds collected from individuals are invested for future distribution according to certain investment criteria. The effect of this trend will be to increase the current size of funded pensions [62].

As these funds grow in size, the institutions that "manage" them will increasingly play a greater role in the actual dynamics of securities markets. Typically, institutional market participants transact in vast quantities of securities. Hence, they will have larger effects on price movements in any individual securities market especially those with limited "depth" (i.e., liquidity). In turn, this implies that these institutional investors will tend to gravitate their transactions towards those financial centers where they can take "active" approach to managing their large portfolios than in those where they are forced to take a "buy and hold" attitude. In addition to the importance of liquidity, these institutional investors will naturally favor those financial centers where trading information is readily accessible, where intermediaries are cost effective and where settlement and clearing processes are efficient.

While these funds grow in size, their "composition" can also be expected to be enriched by national and EEC reforms. For example, EEC directives enabling free movement of capital and European-wide offering of

financial services will make it extremely difficult, and in some ways practically impossible, for governments to dictate the composition of pension funds (as insisting that certain percentages be kept in government paper). In addition, the managers of these funds should be increasingly pressured to produce superior results by their end-investors. This may force many institutional fund managers to enhance the risk-return profile by taking more sophisticated and research-intensive portfolio management strategies and increasingly these may be viewed on a European basis.

Several factors will aid this "pan-Europeanization" tendency. We saw in our discussion on diversification potential accross European equity and bond markets that these oportunities exist and that while European integration may reduce these diversification benefits, they should be offset by improvements in informational and operation efficiencies. Moreover, the sheer sizes of these institutional funds will lead them to quickly "outgrow" their traditional home markets which no longer can provide the rich portfolio mixes that would be possible on a pan-European basis (see earlier discussion).

As European institutional investors grow and become more sophisticated in their investment strategies, it goes without saying that financial intermediaries will need to rapidly develop strategies that meet the needs of these investors. As institutional investors trade in enormous blocks they will favor intermediaries who can serve as "dealers" (those with an ability to position securities for their own book) over simple "brokers" (those that trade only on behalf of customer orders). This in turn has significant implications for capitalization of European brokers. While EEC reforms will enable them to position for their own account, they also set guidelines for capital requirements for various types of instruments. Currently, in many countries, brokers are thinly capitalized. We hence may witness increased levels of acquisitions of such brokers by major well-capitalised banks wanting to develop their capital markets business.

We stressed the importance that institutional investors will place on excellent research and market information and increasingly so on a European-wide basis. In other words, successful intermediaries will be extensively

called upon for their "informational" capability (i.e., their knowledge of who the buyers and sellers are) in addition to their execution capability. This implies that purely "national" brokers/dealers may either need to develop or acquire these capabilities in other EEC countries or that they develop strategic alliance with other players in the form of a clearly defined consortium. Pan-European universal banks may opt to offer services across the institutional investment business system (from in-house research in each country to active secondary market-making in all major EEC markets). Others may choose to specialize in one aspect of the business system but on a European basis (as research capabilities in each of the 12 countries tightly integrated by sophisticated tele-communications networks).

(5) a. **National and EEC de-regulation trends should diminish the role and relative power of European governments in the financial markets.**

b. **As governments begin to lose direct and indirect control over their respective financial markets and compete more or less on equal grounds with other participants, the need for better understanding the parameters of other borrowers and ultimate investors should become critical.**

We observed in our various discussions above of the past importance of the government sector in European financial markets. Government ownership of banks is still high in many European countries. Primary domestic bond markets are primarily dominated by the state and quasi-state sectors. Many governments still impose investment criteria on insurance or pension funds that emphasize the holdings of government securities. Governments, in most European states, used to control the criteria by which intermediaries (especially foreign) could enter and participate in domestic capital markets. And last but not least, many governments tightly imposed controls on private capital movements.

In both the banking and securities market sections we reviewed numerous reasons why the past situation summarized above is rapidly changing. Privatization programs are increasing in popularity as deficit-ridden

governments successfully tap the relatively bouyant equity markets. Although the government role in domestic bond markets will continue to be paramount, we discussed the potential increased share of the corporate sector in the primary market, especially arising from an increase in bond issuance from corporate restructuring. In addition, we observed that EEC reforms concerning freedom of capital movements and the freedom of establishment and offering of products/services should greatly diminish the last three examples of state importance in financial markets mentioned in the above paragraph.

As the relative role of European governments in national financial markets continues to wane over the next decade, governments may have to increasingly view themselves as competitors for capital with other borrowers. In addition, European financial integration implies a more "holistic" view of national monetary management, one that is indeed more "European" in perspective.

Without the "captive" investors discussed above, and without the ability to impose capital controls, the credit worthiness of governments will increasingly be judged by national investors similar to the way local corporations are evaluated. Governments are used to this level of scrutiny and investment evaluation at the international level of fund raising (e.g., in the London syndicated loan market). But most are barely prepared for local investors to start to regard them as "one of many investment options". In turn, governments will need to understand the "buying criteria" of retail and institutional investors and begin to tailor their instruments to these preferences. For many governments this may mean a radical change of mentality from the days when whatever they chose to issue in whatever period of the year was simply absorbed by investors who had limited alternative investment opportunities.

In a financially integrated Europe, monetary management becomes increasingly exposed to external factors frequently beyond the control of the national government. For certain countries with excessive deficit financing, interest rates may have to rise as the capital markets "equilibrate" themselves in terms of capital allocation with a European

perspective. And in the post-1992 era the significant players in national markets may often be non-local with no particular vested interest in buying x or y amounts of government paper in order to be on "good terms" with the respective authorities.

Relatedly, as European financial markets integrate, national governments will systematically need to consider "Europe" as the national market in terms of evaluating the impacts of "regional" macro-economic policies on their region's financial system. In other words, national debt financing can no longer be viewed from a local perspective: movements in, say, Italian money supply should trickle through the various European capital markets more rapidly than in the past and have repercussions in, say, Danish and Belgian government financing patterns. National governments, then, will find that what was once a locally manageable concern becomes far more intertwined with the actions and reactions of other EEC states. In turn, this implies the need for greater skills at European level negotiation and coordination of monetary and fiscal policies.

(6) a. **As European markets in financial services integrate, we may witness the development of a two-tiered market structure: one, more centralised market, revolving around the largest corporate and institutional clients and the other, more decentralised market, focusing on smaller national corporations and retail clients.**

b. **This double-tiered structure, however, will differ in its characteristics when comparing the banking sector with the securities sector. Moreover, these two "levels" should be increasingly efficiently linked, both in terms of telecommunications and in terms of market dynamics.**

c. **The strategies that financial intermediaries choose and nurture for the next decade should take these future market structure characteristics into account in order to build realistic and viable positions in an integrated European financial market.**

In many of our discussions above, we have implied that the structure of European financial markets is evolving into what can be characterised as a two-tiered market. Under this structure, few key financial cities, will serve as "hub" centers attracting major corporate and institutional clients from across Europe, while other major cities will serve as "satellite" centers of differing importance that focus on serving smaller national companies and retail clients. Nevertheless, an interesting and important distinction needs to be made when speaking about the implications of this market tiering for the banking sector or the securities sector.

We observed in our analysis of the securities market that London, for numerous reasons, was consolidating its position as "the" key center for the Eurobond and Euroequities markets, with cities as Frankfurt, Paris, and Amsterdam all vying to build strong positions in the home market (to keep the upper-end of the market from drifting to London) and to increasingly attract some of London's business through the promotion of their nascent bond and equity-related derivative markets.

London's developing role as the European "link" in the global equity market stems from (1) its vast market size and concentration of activity, (2) the existence of cross-links to other major capital markets as bank debt syndication, and foreign exchange, (3) the enormous investments the "City" has made in data processing and tele-communications equipment that enhance its operational efficiency, (4) the combination of these other factors which enables London to provide liquidity for block-trading and derivative markets.

In banking however, a different from of two-tiering should occur. London may still be predominant, but only for certain banking products/services (as activities related to key capital markets products as Eurobonds, major private placements, more sophisticated and esoteric parts of the swaps market, and foreign exchange). Indeed London-based banks (especially the American) will try and penetrate continental markets for mergers and acquisitions, investment management, and the like, but increased alertness and rapid innovation on the part of major continental banks should make this far from being an automatic prospect.

Instead, we should be seeing each major country consolidating its banking activity in one center which should serve as the "hub" for all the other minor commercial centers. In other words, European financial integration should not mean the increased concentration of all banking activity in one or two centers as is likely to be the case in the securities markets which tend to have a "wholesale" characteristic. Increased use of technology in banking should diminish the need for numerous regional banking centers. Moreover, the tele-communications aspect of technology should gradually "bind" these national hub centers together (this will be a prerequisite for the growth of pan-European universal banks we discussed earlier).

These structural developments have important implications for financial intermediaries. Building viable positions will require them to start with a assessment of where they stand now and what their short term capabilities and competitive advantages can allow them to reach within the next decade. For instance, for a regional intermediary, it may turn out to be wiser to pursue a strategy of direct alliance in the form of a cooperative agreement with a "hub" center bank in its own country than trying to jump this step and embark on an acquisition strategy abroad.

Likewise, it may be more prudent for major national banks to develop better ties with smaller companies than try desperately to attract the debt-and-equity-new-issuance business of their major corporate clients whose needs in this particular area may be better met by London-based intermediaries. Similarly, brokers/dealers in London with excellent secondary market capabilities may be better off allying themselves with continental research firms for local advice and with continental brokers for local trades than trying to create "mini home offices" to duplicate their secondary market skills in less liquid continental markets. How well European financial intermediaries undertake this assessment of their capabilities in light of this evolving market structure will determine the winners from the losers in the integrated European financial markets of the 1990s and beyond.

NOTES

1. Note in this respect that the various European Free Trade Area (EFTA) countries are increasingly concerned about being excluded from the large EEC market on the basis of having different regulations and standards; their self-induced "aligning process" should result, over the next five to ten years, in similar structures and systems in the financial sector.

2. For further analysis on the historical origins of the EEC see Steinherr and Gilibert (1989) and Commission of the European Communities (1988).

3. A good review of the obstacles to European financial integration is presented in Fair and de Boissieu (1988).

4. Trade among EEC members far surpasses trade with third countries (see IMF 1989); the 1992 directives should increase the absolute volume of these trade flows.

5. See Hawawini and Jacquillat (1989). Also, as Lewellyn (1988) rightly points out: "if the regulatory environment in other countries has the effect of confering a competitive advantage on foreign institutions, pressure develops to adopt a similar regulatory arrangement. To the extent that technology has the effect of integrating financial systems, it also contributes to a trend towards developing similar regulatory arrangement between countries"; p. 252 in Fair and de Boissieu (1988).

6. See Fair and de Boissieu (1988), p. 251-252.

7. The driving philosophy behind this was the Commission's view that "perfect harmonization of prudential measures would not necessarily have to precede the complete liberalisation of capital movements and the freedom of cross-border supply of financial services, but would be a development somehow forced on member governments by the gradual movement towards an integrated market for financial services." Steinherr and Gilibert (1989), p. 7.

8. See Rolf H. Hasse (1988) in Fair and de Boissieu (1988) pp. 291-308.

9. The notion here is that an integrated Europe will be able to go from being a small entity with a passive role in influencing interest rates to a large entity with substantial weight in international capital flows and interest rates; Fair and de Boissieu (1988) p. 301.

10. For instance, what is considered a "representative" sample of financial products will vary among countries; it is difficult to ensure price comparability for any given product; it is almost impossible to clearly identify the factors for price reductions (say between the influence of EEC actions and the increasing processes of global de-regulation).

11. These estimations are based on individual central bank reports and OECD publications (1988, 1987a).

12. These 162 EEC banks are the top banks represented in a survey by The Banker (1988) of the world's top 500 banks.

13. For a discussion on the EEC proposals for capital requirements of the European banking sector, see Bernd Rudolph (1989) which touches upon this topic in discussing the capital requirements of German banks.

14. See Moniteur du Commerce International (1988), p. 33. The fact that Spain has a high branch density despite a low GDP per capita has been explained by inefficiency in the Spanish retail banking sector where higher operating costs were passed on to borrowers.

15. See OECD (1988a).

16. For further analysis of economies of scale and scope in banking, see Clark (1988) Revell (1989), Dermine, editor (1989), Steinherr and Gilibert (1989), Federal Reserve Bank of Atlanta (1982) and Benston (1965).

17. See Revell (1989), p. 185 and Steinherr and Gilibert (1989), p. 53.

18. Nevertheless, without further empirical evidence to prove the contrary, it is altogether possible that significant economies of scale or scope may exist in those non-traditional banking activities that efficiently leverage any inherent technology potential.

19. Note in this regard the difficulty faced by most banks in managing proliferating product lines at a time when product complexity is also increasing.

20. See Steinherr and Gilibert (1989), p. 55. Since we do not know the statistical significance of these correlation coefficients (i.e., are they statistically different from zero at, say, the 5 percent significance level), we should interpret these numbers with some measure of caution.

21. Op. cit., p. 53.

22. See Hawawini and Swary (1985).

23. See Revell (1989), p. 186.

24. See OECD (1987b), p. 58-59.

25. Op. cit., p. 60.

26. See Steinherr and Gilibert (1989), p. 34.

27. Note in this regard the U.K.'s constant reference to the strong opposition from U.S. banks that have threatened to reciprocate against any EEC action that would hamper their European activities, especially in London; similarly, Luxembourg has not been enthusiastic about measures for harmonizing withholding tax differences among member states (by agreeing to a fixed withholding level of, say, 15 percent) as it would diminish its attractiveness as a tax haven.

28. Before the 1988 amendment, the Commission had identified four different categories of capital movements with greater discretion for national

authorities in deciding the type of restrictions to place on two of these categories which were not directly related to trade flows, listed securities flows or direct investment flows (e.g., money market transactions). In addition, countries were free to use a "safeguard clause" (under Articles 73, 108 and 109 of the Treaty of Rome) of placing certain capital flows restrictions to protect one country's external position.

29. In this respect, the succesful enforcement of the capital movements directive should be greatly aided by some agreement of the directive for a Europe-wide withholding tax on interest income. At that point, investment funds will flow not where there are tax advantages, but where the investing infrastructures are optimal (e.g., efficient intermediaries, sophisticated settlement systems, and better overall risk-adjusted returns, etc..). Nevertheless, unless there is an EEC-wide harmonization of taxation schedules for personal income, or unless all EEC banks agree to report interest income to the respective home country tax authorities (which is not the option favored by the EEC), it is likely that income tax-distorted capital flows among the 12 states will continue to exist even if the withholding taxes are harmonized.

30. For a synthesis of the structure and dynamics of the Eurobond market, see Walter and Smith (1989).

31. See Salomon Brothers (1987a); the German financial institutions utilize their bond funding for on-lending to, or to purchasing shares in, German corporations.

32. See Corrigan (1989).

33. See Chapter on European investment banking by I. Walter and R. Smith in Dermine, editor (1987).

34. Note in this respect that current efforts of the EEC in harmonzing value-added taxes and interest income withholding taxes where notions of tax "liberalization" has tended to push the final Europe-wide rates towards the lower end of any "average" measure that is utilized.

35. Interestingly, this competitive situation has been apparent in the U.S. over the past decade and in part has been offered as an explanation of the high U.S. interest rates.

36. See Walter and Smith (1989).

37. Op. cit.

38. See Salomon Brothers (1988b), 1987a, 1987b) and Banca D'Italia (1988) p. 6.

39. See Salomon Brothers (1987b and 1988c).

40. See Salomon Brothers (1987b), p. 10; (1988c), p. 7; (1987a), p. 10; Banca D'Italia (1988), p. 11.

41. See Op. cit. (1987b), p. 10.

42. See Walter and Smith (1989).

43. See Banca D'Italia (1988) p. 11.

44. See Salomon Brothers (1987b), p. 33; (1988c); (1987a).

45. See Hawawini and Jacquillat (1989).

46. Op. cit.

47. See Walter and Smith (1989).

48. While there has been no massive shift from bank deposits into the individual purchase of shares and bonds, there is a definite trend towards the purchase of mutual funds which in turn invest in shares and bonds; see OECD (1988, 1987a).

49. For instance, approximately 25 percent of the capitalization of the most active French shares are traded in London as opposed to in Paris (Hawawini and Jacquillat (1989). In addition, this development seems to hold true in the case of large block trading of other Continental shares (Hawawini (1984), p. 155.

50. As we saw in the discussion of European bond markets, recent reforms in France now permit foreigners to purchase shareholdings in local brokerage houses; similar reforms are in process in Belgium and Spain.

51. See Hawawini and Jacquillat (1989).

52. Ibid.

53. Ibid.

54. Ibid.

55. See Hawawini (1984).

56. See Hawawini and Jacquillat, op. cit.

57. Ibid.

58. See Jorion (1987).

59. See Hawawini and Jacquillat, op. cit.

60. Ibid.

61. Spicer & Oppenheimer (1989), p. 1.

62. See Hawawini and Jacquillat (1989).

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TABLE 1

ESTIMATED PRICE REDUCTION IN FINANCIAL PRODUCTS
RESULTING FROM COMPLETE EUROPEAN FINANCIAL INTEGRATION

COUNTRY	Bel.	Ger.	Spa.	Fra.	Ita.	Lux.	Neth.	UK
1. Percentage difference in prices of financial products compared with the average of t four lowest observations								
Banking								
Consumer credit	-41	136	39	105	*	-26	31	121
Credit cards	79	60	26	-30	89	-12	43	16
Mortgages	31	57	118	78	-4	*	-6	-20
Letters of credit	22	-10	59	- 7	9	27	17	8
Foreign exchange	6	31	196	56	23	33	-46	16
Travellers cheques	35	- 7	30	39	22	- 7	33	- 7
Commercial loans	- 5	6	19	- 7	9	6	43	46
Insurance								
Life	78	5	37	33	83	66	- 9	-30
Home	-16	3	- 4	39	81	57	17	90
Motor	30	15	100	9	148	77	- 7	-17
Commercial fire, theft	- 9	43	24	153	245	-15	- 1	27
Public liability	13	47	60	117	77	9	-16	- 7
Securities								
Private equity	36	7	65	-13	- 3	7	114	123
Private gilts	14	90	217	21	-63	27	161	36
Institutional equity	26	69	153	- 5	47	68	26	-47
Institutional gilts	284	- 4	60	57	92	-36	21	*
2. Theoretical potential price reductions**								
Banking	15	33	34	25	18	16	10	18
Insurance	31	10	32	24	51	37	1	4
Securities	52	11	44	23	33	9	18	12
Total	23	25	34	24	29	17	9	13
3. Indicative price reductions***								
All financial services								
Range	6-16	5-15	16-26	7-17	9-19	3-13	0-9	2-12
Centre of range	11	10	21	12	14	8	4	7

* Observations for consumer credit in Italy and mortgages in Luxembourg were not obtained, and have been represented by mechanical estimates in the calculations of the larger aggregates. The data for institutional gilts transactions in the U.K. were not available on a comparable basis, and so the figures for institutional equity transactions were used in the calculations.

** The figures in part I of the table show the extent to which financial product prices, in each country, are above a low reference level. Each of these price differences implies a theoretical potential price fall from existing price levels to the low reference level. Part 2 sets down the weighted averages of the theoretical potential falls for each sub-sector.

*** Indicative price falls are based upon a scaling down of the theoretical potential price reductions. Taking into account roughly the extent to which perfectly competitive and integrated conditions will not be attained plus other information for each financial services sub-sector, such as gross margins and administrative costs as a proportion of total costs.

Source : Commission of the European Communities, no.36 (1988), p. 91, based on a study undertaken by Price Waterhouse.

TABLE 2

NUMBER AND TYPE OF BANKING INSTITUTIONS
IN THE EEC-12 COUNTRIES, 1988

Country	Commercial Banks	Savings Banks	Specialized Banks*	Total
Belgium	88	34	53	175
Denmark	79	147	18	244
France	386	422	1272	2080
Germany	311	596	3636	4543
Greece	35	0	9	44
Ireland	39	3	18	60
Italy	268	90	813	1171
Luxembourg	115	1	86	202
Netherlands	85	65	26	176
Portugal	19	1	3	23
Spain	138	80	381	599
U.K.	588	0	162	750
Total	**2151**	**1439**	**6477**	**10067**

* Includes cooperative banks, special purpose banks, quasi-banks as licensed deposit-taking companies, finance and lending companies, etc.; does not include direct banking activities (e.g. non-licensed subsidiaries) of retailers or industrial companies.

Source : Own compilation based on direct contacts with OECD, individual central banks' research departments, and general literature review

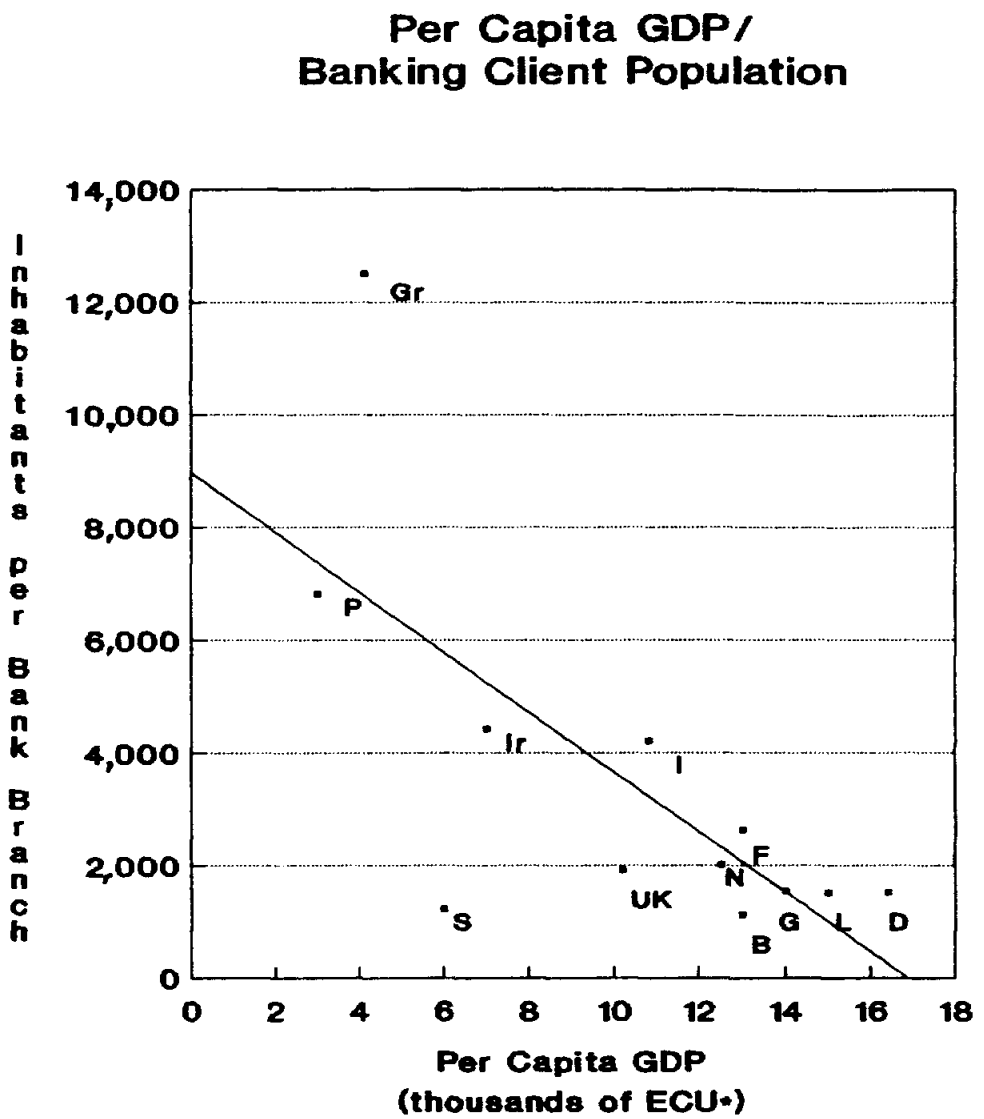
TABLE 3

DISTRIBUTION OF TOTAL NUMBER OF BANKS AND TOTAL BANKING ASSETS BY COUNTRY - 1987

Country	Number of Banks	Total Assets (ECU billion)	Percentage of EEC-12
Germany	4543	1,811.0	26.2
France	2080	1,343.8	19.4
Italy	1171	753,9	10.8
U.K.	750	1,515.7	21.8
	8544	5,424.4	78.2
Netherlands	176	398.8	5.8
Spain	599	369.7	5.2
Belgium	175	315.2	4.6
	950	1,083.7	15.7
Denmark	244	99.2	1.4
Luxembourg	202	173.6	2.5
Greece	44	59.9	0.8
Portugal	23	48.7	0.7
Ireland	60	27.5	0.4
	573	408.9	6.1
Total EEC-12	**10067**	**6,917.0**	**100**
U.S.A.	34249	5,558.9	-
Japan	5561	6,270.3	-

Source: Compiled from various data sources based on own literature search; OECD, Financial Accounts of OECD Countries (1988, 1987).

FIGURE 1



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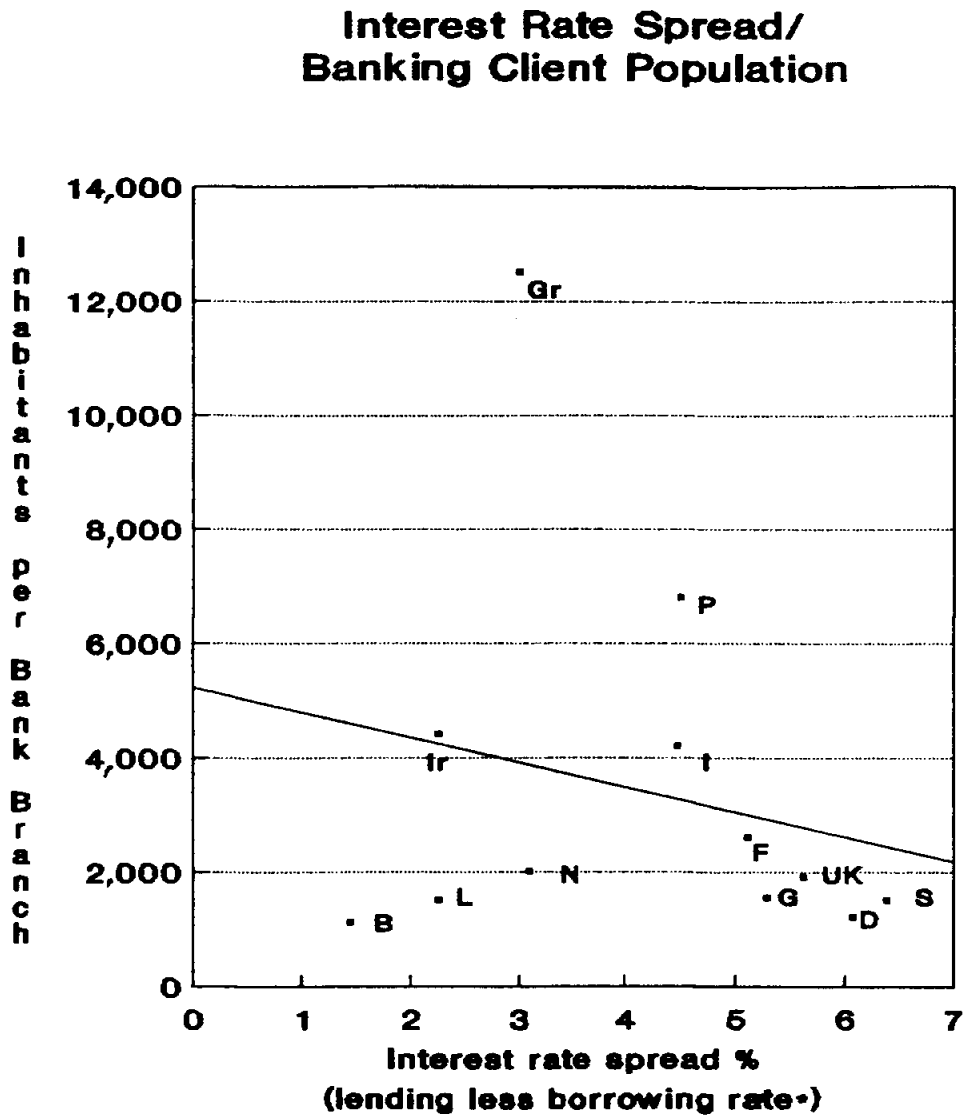
* Data consist of averages for 1985-1987 converted at mid-1988 exchange rates. B= Belgium; D= Denmark; F= France; G= Germany; Gr= Greece; IR= Ireland; I= Italy; L= Luxemburg; N= Netherlands; P=Portugal; S= Spain; UK= United Kingdom.

Sources: European Investment Bank, EIB Papers No.7, (December 1988).

FIGURE 2



* Data as of April 1988. Prime or base lending rates less interest rates paid on savings deposits or on small denomination savings certificates having a maturity of one year; minimum lending rates on overdrafts and bank advances, respectively, for the UK and the Netherlands.
B= Belgium; D= Denmark; F= France; G= Germany; Gr= Greece; IR= Ireland; I= Italy; L= Luxemburg; N= Netherlands; P=Portugal; S= Spain; UK= United Kingdom.

Sources: European Investment Bank, EIB Papers No.7, (December 1988).

TABLE 4

OWNERSHIP OF THE LARGEST EEC-12 BANKS*

Sector	Number of Banks	Mean Assets (ECU bill.)	Pre-tax ROA (%)	Pre-tax ROE (%)	Capital/assets ratio (%)
Public (central & local government)	67	26.9	0.61	14.30	3.70
Private	69	32.6	0.77	16.36	4.81
Co-operatives	14	35.9	0.89	17.31	5.16
Mutuals	12	9.0	0.81	14.78	6.14
Total	162				

* Data based on 162 EEC-12 banks in the "Top 500" survey undertaken by The Banker, July 1988: all figures are arithmetic means; sample data should be viewed as indicative due to the uncertainty of their statistical significance.

The cpuntry split for these 162 top EEC banks is as follows: Germany -44, Italy-33, France -20, U.K. -15, Spain -13, Belgium -9, Denmark -8, Luxembourg -6, Netherlands -5, Portugal -4, Greece -3, and Ireland -2.

Source : The Banker, January 1989, p. 39.

TABLE 5

MEASUREMENTS OF BANK PROFITABILITY IN EEC-12 COUNTRIES*

	Rate of return on equity (before tax)	Rate of return on assets (before tax)	Average rate of inflation
Belgium	14.25	0.39	4.87
Denmark	10.83	1.07	5.20
France	12.93	0.33	5.83
Germany	19.06	0.72	2.27
Geece	14.61	0.40	19.60
Ireland	12.84	1.08	6.27
Italy	19.27	1.09	9.53
Luxembourg	9.06	0.32	6.10
Netherlands	17.12	0.67	1.60
Portugal	5.06	0.33	21.67
Spain	9.95	0.83	10.60
United Kingdom	22.78	1.15	4.70

(*) Figures in percentages. Averages for the period 1984-1986. The inflation rate has been approximated with the GDP deflator at market prices.

Source : OECD, Financial Statements of Banks 1982-86.

TABLE 6

MARKET CONCENTRATION IN THE EEC BANKING INDUSTRY*
Assets in ECU billion

Category of Banks (1)	Total Assets of Category (2)	As % of total Assets of EEC-12 Banking Sector (3)	Equivalent of (3) for the U.S. Market
Top 3	566	8	7
Top 5	899	13	10
Top 10	1561	22	15
Top 20	2430	35	21
Total EEC-12	6917	100	

* Assumes an "integrated" view of the European banking sector

Source : The Banker, July 1988; OECD Financial Accounts of OECD countries (1988, 1987); own calculations.

TABLE 7

MARKET CONCENTRATION AND CAPITALIZATION
OF TOP 3 AND TOP 5 BANKS IN EEC-12 COUNTRIES

Assets and capital in ECU billion

	Top 3 Banks			Top 5 Banks		
	Assets	% Total	Capital	Assets	% Total	Capital
Belgium	132.6	42.1	2.6	199.3	63.3	4.4
Denmark	49.5	50.0	3.2	78.8	79.4	4.4
France	489.9	36.5	16.5	721.5	53.7	22.9
Germany*	347.1	19.2	12.4	512.4	28.3	16.6
Greece	37.4	62.4	0.8	N.A.	N.A.	N.A.
Ireland	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Italy	205.1	27.2	8.6	310.7	41.2	12.4
Luxembourg	34.0	19.6	1.4	48.9	28.2	1.8
Netherlands	214.6	53.8	9.4	280.6	70.4	11.6
Portugal	25.0	51.0	0.9	33.2	68.1	1.2
Spain	116.0	31.4	6.4	165.9	44.9	9.8
U.K.	362.1	23.9	23.1	483.2	31.9	28.2

* Source : The Banker, July 1988; OECD Financial Statistics (1988, 1987); own calculations

TABLE 8

SIZE AND PROFITABILITY COMPARISONS FOR BANKS IN EEC COUNTRIES

	Profitability ranked by asset size*															Spearman correlation index
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	
Belgium	4	9	5	3	8	7	1	6	2							-0.0546
Denmark	1	7	6	4	3	8	2	5								0.0151
France	8	7	3	6	2	10	5	4	13	11	1	14	15	12	8	0.0340
Germany	1	3	3	10	5	6	2	9	10	12	8	7				0.0478
Greece	3	2	1													-1.0000
Ireland	2	4	3	1												-0.3205
Italy	12	6	4	11	13	14	2	15	9	1	8	10	5	7	3	-0.0284
Luxembourg	1	5	3	4	2	6										0.0962
Netherlands	3	1	4	5	2											0.1667
Portugal	1	4	2	3												0.4006
Spain	3	4	13	7	5	12	11	1	9	8	2	6	10			0.0036
U.K.	7	5	10	8	9	3	1	2	6	4						-0.0823

* Profitability (inside figures) is measured by pre-tax profit on total assets; size (top layer of figures) is measured by total assets (total deposits for Italy); data is as of 12/31/87. For example, in the case of Greece (with only 3 banks in the sample) the bank with the highest size (rank 1) has the lowest profitability (rank 3) ; the bank with the second highest size (rank 2) ranks second in profitability (rank 2) and the bank with the smallest size (rank 3) has the highest profitability (rank 1).

Source : Centre For European Policy Studies, Research Report No 1, January 1989, Tables 5a and 5b.

TABLE 8

SIZE AND PROFITABILITY COMPARISONS FOR BANKS IN EEC COUNTRIES

	Profitability ranked by asset size*															Spearman correlation index
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	
Belgium	4	9	5	3	8	7	1	6	2							-0.0546
Denmark	1	7	6	4	3	8	2	5								0.0151
France	8	7	3	6	2	10	5	4	13	11	1	14	15	12	8	0.0340
Germany	1	3	3	10	5	6	2	9	10	12	8	7				0.0478
Greece	3	2	1													-1.0000
Ireland	2	4	3	1												-0.3205
Italy	12	6	4	11	13	14	2	15	9	1	8	10	5	7	3	-0.0284
Luxembourg	1	5	3	4	2	6										0.0962
Netherlands	3	1	4	5	2											0.1667
Portugal	1	4	2	3												0.4006
Spain	3	4	13	7	5	12	11	1	9	8	2	6	10			0.0036
U.K.	7	5	10	8	9	3	1	2	6	4						-0.0823

* Profitability (inside figures) is measured by pre-tax profit on total assets; size (top layer of figures) is measured by total assets (total deposits for Italy); data is as of 12/31/87. For example, in the case of Greece (with only 3 banks in the sample) the bank with the highest size (rank 1) has the lowest profitability (rank 3) ; the bank with the second highest size (rank 2) ranks second in profitability (rank 2) and the bank with the smallest size (rank 3) has the highest profitability (rank 1).

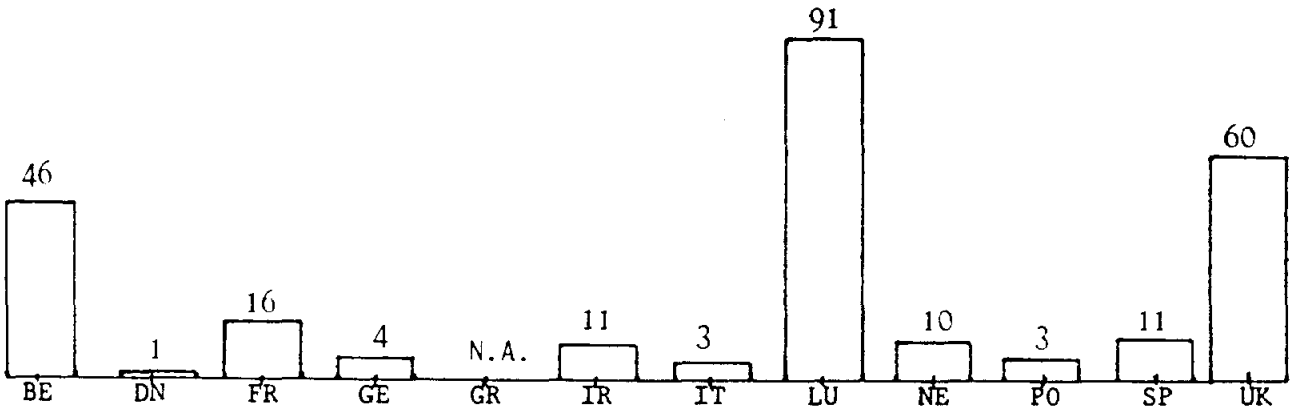
Source : Centre For European Policy Studies, Research Report No 1, January 1989, Tables 5a and 5b.

TABLE 9

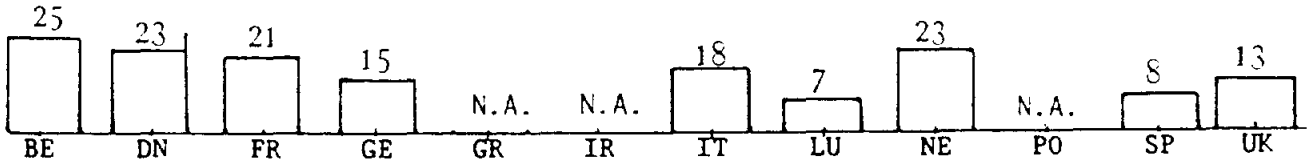
ESTIMATIONS OF THE DEGREE INTERNATIONALIZATION
OF EEC-12 COUNTRIES' BANKING SECTOR

End of 1987, figures in % of total banking assets

Measure 1



Measure 2



* Percent of total banking assets held by foreign financial institutions; end 1986 for Ireland

** International business of domestic banks as a percent of total banking assets "international business" = foreign and domestic currency claims on non-residents and foreign currency claims on residents); end 1986 for Belgium for total assets figure.

Sources : Centre for European Policy Studies, Research Report No.1, January 1989; OECD, Financial Accounts at the OECD Countries; (1988, 1987); own calculations.

EXHIBIT 1

EUROPEAN BANKING INDUSTRY-KEY DIRECTIVES

Name/Subject	Aim	Status/Comments
Directive on capital movements (1988; an extension of a related 1986 directive; this directive repeals an earlier series of directives that started in 1960 and culminated in 1986).	Removes exchange controls and allows the free movement of capital throughout the EEC, with safeguards to prevent short-term instability.	Adopted by Council in June 1988; Greece and Portugal have until 1995 to comply; at the time only the U.K. and Germany had abolished all exchange controls.
First Banking Directive (1977)	First attempt to achieve minimum standards for regulating banks and other "credit" institutions that take deposits and lend money.	Adopted by Council in December 1977; was the foundation for the Second Banking Directive.
Directive on consolidated supervision of banks (1983)	Assures that credit institutions are supervised on a consolidated basis.	Adopted by Council in June 1983.
Directive on bank accounts (1986)	Attempt to harmonize accounting rules (annual and consolidated) for credit institutions.	Adopted by Council in December 1986; this directive sets new standards, including reporting banks' securities portfolios at current value and historic cost.
Directive on bank branch accounts (1986)	Lays down reporting standards for branches whose head offices are	Proposed; to be enforced on Dec.31, 1990; reduces public scrutiny of branch operations; foreign banks likely to convert more subsidiaries to branches.
Second Banking Directive (1987)	Brings further harmonization of laws so that credit institutions can offer services freely across the EEC (see text for further discussion of this directive)	Proposed; still under debate on contentious issues as bank's equity participation in non-financial institutions and reciprocity vis-a-vis non-EEC countries; most likely to be adopted in some form and enforced by 12/31/92.

Exhibit 1 (ctd)

Directive on bank's own equity capital (originally proposed 1986, amended in 1988)	Harmonizes definition of bank capital (compatible with Basel Committee and Group of Ten capital adequacy standards).	Proposed; enforcement date undecided; this directive goes in tandem with the Second Banking Directive.
Directive on bank solvency ratios (1988)	Harmonizes solvency ratios for credit institutions; sets the risk asset weightings for on/off balance sheet items.	Proposed; enforcement date undecided; this directive goes in tandem with the Second Banking Directive.
Directive on bank bankruptcy (1985)	Harmonizes laws for winding up or restructuring insolvent credit institutions; home country rules will apply for branches in other EEC countries whose home bank is insolvent.	Proposed; unlikely to go through quickly as some countries feel the directive is unwarranted.
Directive on mortgage credit (1984; amended 1987)	Allows mortgage lenders to lend and raise funds in other countries without having to be authorized locally.	Proposed; could disappear completely into the Second Banking Directive as in some ways this was the "dry run" for that directive.

TABLE 10

MAJOR EUROPE BOND MARKETS : SIZE AND TYPE OF ISSUER
Year-end 1987

Bond Market	Total Publicly Issued[1] in ECU billions	Govt. sector issues[2] as % of total issues	Govt. sector issues[2] as % of GNP	Corporate and other Domestic[3] Public Issues as % of total issues	Int'l Bonds[4] as % of total issues	Private Placemen in ECU billions
Deutschemark	703.2	30.8	22.2	56.4	12.8	284.
Italian Lira	468.0	81.5	58.5	17.9	0.6	-
French Franc	292.9	77.8	29.9	18.6	3.6	-
U.K. Sterling	288.3	77.8	38.4	5.8	16.4	-
Belgian Franc	170.5	80.0	111.0	17.6	2.4	-
Danish Krone	148.4	29.1	51.2	68.9	2.0	-
Dutch Guilder	111.3	63.2	38.0	23.2	13.6	79.9
Total major European Markets	2182.6					
U.S.A.	3609.8	73.6	67.9	16.2	10.2	316.
Japan	1837.1	68.1	60.6	26.9	5.0	300.

(1) Nominal value outstanding

(2) Government sector includes GNP figures for 1987

(3) Corporate bonds include convertibles

(4) International bonds include both foreign bonds and Eurobonds (straight, convertible and floating rate debt)

(5) Private placements are unclassified issues; in addition there exists an unspecifiable amount of unreported paper in the private market

Source: Salomon Brothers, "Bond Market Research", May 20, 1988, p.1; GNP data from IMF (1989 March); own calculations.

TABLE 11

BOND MARKET FINANCING BY ALL EUROPEAN COMPANIES

1985-1987

(in ECU millions*)	Total debt issues			
	Eurobonds	Foreign bonds	Domestic bonds	Total bonds
1985				
Number of issues	340	93		
Volume	29,106	3,014	95,695	127,815
Avg. issues size	99	37		
1986				
Number of issues	449	95		
Volume	42,864	3,970	123,491	170,325
Avg. issue size	110	48		
1987				
Number of issues	337	165		
Volume	25,337	5,602	143,713	174,652
Avg. issue size	87	39		

* Converted from U.S.$ at year-end 1987 exchange rate.

Source: Adapted from European Banking Strategies for the 1990s, J. Dermine (1989), editor

TABLE 12

EUROPEAN EQUITY MARKETS : SIZE AND ACTIVITY
DECEMBER 1988/1987

	MARKET CAP. 12/31/88 local mils.	MARKET CAP. 12/31/88 ECU blns	MKT CAP. /GNP 1987	LISTED STOCKS 12/88	FOREIGN STOCKS 12/88	TRANSACT. VOLUME 1988 ECU blns	TURNOVER RATIO 12/88	NUMBER OF SECTIONS 12/87
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
BELGIUM	2,195,365	50	30 %	337	151	9	0.18	OM,SM,OTC
DENMARK	184,761	23	20 %	267	7	4	0.17	OM,SM,OTC
FRANCE	1,350,506	189	20 %	676	217	59	0.31	OM,SM,OTC
GERMANY	446,619	213	20 %	1083	474	346	1.62	OM,SM,OTC TM
ITALY	176,827,000	115	16 %	211	0	26	0.23	OM,SM,TM
LUXEMBOURG	691,174	13	3 %	594	172	0.3	0.02	OM,OTC
NETHERLANDS	207,236	88	48 %	460	228	26	0.30	OM,SM,TM
U.K.	393,190	602	92 %	2580	587	305	0.51	OM,SM,OTC TM
PORTUGAL	1,183,000	7	-	143	0	-	NA	OM,OTC
SPAIN	10,313,057	77	24 %	369	0	17	0.22	OM,OTC

1 : Amounts are in billions of local currency, figures are for domestic market capitalization only; Portugal-1987 data.
2 : Translation in U.S. dollars are based on year-end exchange rate given by The Federation Internationale des Bourses de Valeurs (F.I.B.V.).
3 : 1987 Market capitalisation divided by gross national product; Source : FIBV, 1988 REPORT; GNP figures-1987 data.
4 : Total number of listed stocks (domestic and foreign).
5 : Number of foreign listed stocks.
6 : Annual volume of transaction in billions of ECU.
7 : Annual volume of transactions (6) divided by total market capitalization (2).
8 : Markets are : official market (OM) ; second market (SM) ; third market (TM) ; over the counter market (OTC) ; and electronic screen trading.

SOURCE : Federation Internationale des Bourses de Valeurs ; SPICER & OPPENHEIM ; Société des Bourses Françaises ; OECD.

TABLE 13

EQUITY MARKET FINANCING BY ALL EUROPEAN COMPANIES

1985-1987

(In ECU millions*)	Total Equity Issues			
	Euro Equities	Foreign Equities	Domestic Equities	Total Equities
1985				
Number of issues	45	6		
Volume	2,819	135	25,332	28,286
Avg. issues size	72	26		
1986				
Number of issues	107	17		
Volume	12,082	1,990	49,887	63,959
Avg. issue size	130	135		
1987				
Number of issues	109	26		
Volume	10,337	2,926	64,389	77,647
Avg. issue size	109	130		

* Converted from U.S.$ at year-end 1987 exchange rate.

Source: Adapted from European Banking Strategies for the 1990s, J. Dermine (1989), editor.

TABLE 14

EUROPEAN EQUITY MARKETS: BASIC OPERATION PROFILE
December 1988

	Number of Exchanges[1] 12/87	Commission Structure	Number of Brokers[2] 12/87	Trading vehicles[3]	Access to Foreign Firms
Belgian	1	Fixed	314	A,B,C,D,E	No
Denmark	1	Negotiable	46	A,B,C,D,F	No
France	7 (Paris)	Fixed and negotiable	61	A,B,C,D,E,F	Yes
Germany	8 (Frankfurt)	Negotiable	680	A,B,C,D	No
Italy	10 (Milan)	Fixed	230	A,B	No
Luxembourg	1	Fixed and negotiable	74	A,B,C	No
Netherlands	1	Fixed	150	A,B	Yes
Portugal	2 (Lisbon)	Fixed and negotiable	12	A,B	No
Spain	4 (Madrid)	Fixed	87	A	No
U.K.	1	Negotiable	329	A,B,C,D,E	Yes

(1) Location of the principal exchange is given in parentheses.

(2) Three countries have a "numerus clausus" regulation that limits the number of authorized brokers : France, Italy and Spain. This regulation will be removed in July 1989 in Spain and in January 1992 in France.

(3) A=floor trading; B=off-floor trading; C= OTC market; D=continuous market; E=screen trading; F=margin trading.

Source: Fédération Internationale des Bourses de Valeurs; Spicer & Oppenheim; Société des Bourses Françaises, OECD.

EXHIBIT 2

EUROPEAN SECURITIES INDUSTRY - KEY DIRECTIVES

Name/Subject	Aim	Status/Comments
Directive on admissions to EEC stock exchanges (1979, amended 1982)	Set a policy of mutual recognition and minimum standards for company on stock exchanges with the goal of making it easier for companies to raise capital on a pan-European basis.	In-force except in Belgium, Portugal & Spain. Countries cannot refuse a listing on the grounds that the company has not been listed or another exchange first but they can turn it down for investor "protection" reasons.
Directive on listing particulars for equity issuance on exchanges (1980, amended 1982, 1987)	Sets basic standards for information that companies are required to furnish the exchanges for obtaining a listing.	In-force in seven countries.
Directive on interim reports (1982)	Sets minimum standards for interim reports of listed companies; establishes that interim reports must be published within four months of end of six-month period.	In-force except in Belgium and Spain. Reports must be comparable to same period in the previous year. Excludes UCITS.
Directive on UCITS (1985, amended 1988)	Coordinates laws & rules for UCITS (collective investments in transferable securities); principle is that a unit trust approved in one state and meeting basic standards set by directive, can be sold anywhere in the EEC without further approval.	To be in-force by 01/10/89, except for Greece and Portugal which have until 01/04/92.
Directive on securities transaction tax (1976)	Aims to abolish indirect taxes (stamp duties) on securities transaction does not apply to VAT on commissions	Proposal stage; anticipated enforcement by 01/10/89. This directive is part of the overall tax program of the EEC.
Directive on prospectus scrutiny, and distribution of prospectuses (1980, amended 1987).	Aims to harmonize rules for publishing, usage for public offers; this applies to unlisted securities	Proposal stage; no enforcement date established. Various exemptions included in the proposal.

Exhibit 2 (ctd)

Directive on large shareholdings disclosure (1985, amended 1987)	Ensures that investors/-regulators are aware of major changes in ownership; shareholder must inform company and/or regulator within seven days when holding goes above or below 10%, 20%; 33,3%, 50%, or 66,6%	Proposal stage; anticipated enforcement by 01/01/91. Main problem should prove to be enforcement; for example, the U.K. has a system where shares are registered by a company, while France & Germany have bearer securities cleared electronically through SICOVAM and Kassenverein.
Directive on insider trading (1987)	Aims to harmonize diverse rules on insider trading; defines "insider" broadly to include "tippee", i.e. people that information is passed to and without any connection to the company; defines "information" as that which is unpublished, specific, relate to one or more issuers of securities, and be likely to have a material effect on the price of the security.	Proposal stage; anticipated enforcement by 31/12/90. Distinguishes between "primary" and "secondary" insiders.
Directive on investment services (in draft form)	Similar to the Second Banking Directive, it allows firms to carry out specified investment services (including selling securities) throughout the EEC if they are authorization by home country, and may provide a list on conduct of business rules that could be applied by the host state; expected to be simpler a model than U.K. self-regulating system.	"Embryo" stage; anticipated enforcement by 31/12/92.

Source: Compiled from various sources, including The Banker, 1988 and the European Commission Directorate-General 15.

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