Les Entretiens de la Maison Dorée

THE EUROPEAN FINANCIAL SERVICES MARKET
WHERE ARE WE NOW?

Minutes from the meeting on October 4, 2007

INTRODUCTION BY MR. DU MOULIN DE LABARTHETE:

Mr. Arnauld du Moulin de Labarthète is in charge of Entretiens de la Maison Dorée

Mr. du Moulin de Labarthète was delighted to welcome Mr. Jacques de Larosière, Adviser to the President, who was also previously Director General of the IMF, Governor of the Bank of France and President of the EBRD.

Mr. Jacques de Larosière began his speech with a brief presentation, before answering a number of questions.

PRESENTATION BY MR. JACQUES DE LAROSIÈRE:

Mr. Jacques de Larosière is Adviser to the Chairman and Honorary Governor of the Bank of France

Today, Mr. Jacques de Larosière looked at the issue of the single financial services market in Europe.

HOW IMPORTANT IS THE EUROPEAN FINANCIAL MARKET? HOW DOES IT COMPARE WITH THE OTHER MAJOR MARKETS AROUND THE WORLD, AND MORE SPECIFICALLY THE UNITED STATES?

1. Gross new bond issues in euros have increased significantly since the euro was created. Since 1999, they represent a combined total 14.9 billion euros, compared with 25.7 billion euros for new bond issues in dollars.

However, since banks structurally play a much more important role in terms of financing the economy in Europe than in the United States, it is more meaningful to look at the respective international role of bonds in euros and dollars.

The calculation for issues by “non-resident” companies, foreign governments and multilateral institutions on foreign markets shows that bond issues with maturities of over two years represent a combined total of 5 billion euros since 1999, compared with 5.5 billion euros for issues in dollars. However, if we include short-term bond issues and money market issues, we can see than total net issues in euros accounted for over 54.9% of the global market in 2005, compared with only 26.4% for the dollar.

In this way, the euro market has grown considerably since the start of this decade, and represents a significantly larger source of funds than the dollar. While the dollar is still the predominant currency for international reserves, the bond market has become bipolar.

2. Equities markets:

In 2005, the eurozone accounted for 16.8% of the global stock market capitalisation, while the United States represented 41.6% and Japan 11.1%. If we look at the market capitalisation to GDP ratio for the countries and regions considered, we can see that the eurozone represented 55% in 2005, compared with 42.7% in 2003, while the US market capitalisation represented 105.24% and Japan 84.9%. We can therefore see a significant lag in terms of the European stock market capitalisation.

Equities markets in the United States have recently become less appealing. While in the 1990s, they attracted around 50% of all new public stock market listings, this percentage had fallen to 6% in 2005, a real black year for the American stock market. This fall reflects the regulatory constraints associated with Sarbanes-Oxley, the growing importance of private equity markets, the high cost of listing on the New York Stock Exchange, and the fears of US-listed foreign firms (or businesses looking to list there) of being definitively blocked there by regulatory obstacles, which, even recently, were making delisting difficult.

3. Financial services:

Since 2001, Europe has continued to catch up on the United States in terms of funds under management, investment banking revenues, equities transactions and hedge funds. On insurance (life and non-life), European firms have achieved higher levels of premium income than US companies since 2003, with 1,300 billion dollars in premium income for European firms in 2005, compared with 1,100 billion dollars for US firms.

On average, the revenues generated by the European client of a European investment bank represent 71% of the revenues generated by the American client of an American bank. The assets of European commercial banks represent close to four times the assets of their American counterparts. At the end of 2005, the stock of international loans granted by European banks totalled 14,000 billion dollars, compared with only 1,900 billion for American banks. Even factoring in intra-European loans, the international business of European banks is still three times higher than the US.

The global importance of European financial services markets is a fact, and the competitive nature of the various European players is a reality.

INSUFFICIENT INTEGRATION FOR EUROPEAN FINANCIAL MARKETS AND THE WAYS FORWARD

European money markets, wholesale activities and bond markets are relatively well integrated. However, the same cannot be said for retail activities, which are subject to highly diverse national consumer protection regulations. Europe is characterised by the fragmentation of market infrastructures, in terms of both the stock markets and the clearing and settlement systems. Post-trading costs are four to 10 times higher in Europe than the US. Europe is subject to still highly fragmented supervisory systems and regulations. Although the Lamfalussy process has sought to bring more coordination and homogeneity for the national transposition of directives and the application of supervision, there are still very significant national differences.

To tackle this phenomenon, it is necessary to adopt and combine two types of approach. Harmonisation represents a classic approach. However, it touches on sensitive subjects, including consumer protection, the diversity of habits in terms of means of payment, and the harmonisation of bankruptcy laws. Rather than putting forward a new range of directives, the European Commission has tended to focus on other priorities, notably the creation of a single European payments area (SEPA), or the introduction of a code of good conduct for post-market structure activities. These measures are useful, but fall short of what is required, and must be combined with another approach.

This second approach aims to strengthen the main European players in order to enable them to develop on a global scale. To build the financial Europe, regulations and supervision enabling cross-border groups to expand their activities under the aegis of a lead regulator should be promoted. Since such a system is likely to generate inconsistencies with the application of directives, it would inevitably need to be accompanied by an arbitrational body making it possible to identify and deal with these inconsistencies immediately. In addition, the banking systems of new European members are owned to a great extent by foreign groups. It is therefore politically indispensable to give host country regulators a right to review the regulation and supervision of their banking systems.

In the event of a systemic crisis, it is important to know who will foot the bill: will it be the regulator or the ministry of finance from the lead regulator's country, or from the host country?

QUESTIONS

What is your opinion about the expected development of the regulatory framework for derivative transactions on commodities? On this exponential market, what is at stake in your opinion?

This question is focused exclusively on commodities, which represent the smallest category of derivatives (6.9 trillion euros, out of a total of 415 trillion). However, commodities also represent the fastest growing derivatives, growing from only 1.4 trillion at the end of 2004.

The industry is not in favour of regulations for the derivatives market. However, it would be inaccurate to say that there are no regulations in this area, since the banks offering derivatives transactions have an obligation to verify the quality of their counterparties, and issue margin calls when counterparties deteriorate. However, derivatives are also available from non-banking players (financial, industrial or commercial). The question is whether these unregulated players should be subject to regulations.

In reality, what elements make a market unified and homogenous? Conversely, what structural factors make it still fragmented and heterogeneous? On the whole, are we closer to one or the other today? Or does the situation call for a specific analysis for each business?

A unified and homogenous market is characterised by the cohesion of prudential, consumer and investor protection rules. Without necessarily being identical, these rules must be consistent. An institution should be able to offer its products in another country without being obliged to set up branches or subsidiaries there.

Several factors are blocking the unification and homogenisation of the market. These notably concern differences with the transposition of directives at national level, differences in terms of the rules applied, and the fragmentation of supervision and infrastructures.

The current market is still midway between unification and fragmentation, homogeneity and heterogeneity. This situation therefore calls for a specific analysis for each business. The market is highly unified in terms of bond issues and wholesale banking, but not so for retail.

Can the European market legitimately rival other markets, and more specifically the US market (factoring in the euro, a relatively strong currency)?

The answer to this question is clearly yes. Europe has major strengths faced with international competition, including its commercial bank system, the adoption of Basle II, and its internal financial stability.

Do we need a European financial authority to supervise the financial market? Is the harmonisation of the European market not linked to the creation of common regulatory or supervisory authorities?

Although the term "authority" is open to debate, it is necessary to homogenise and harmonise regulations and supervision for groups in order to achieve economies of scale, improve the market's efficiency and make the system more fluid.

The methods under the Lamfalussy process will not make it possible to put this harmonisation in place, since the players are focused on national interests. In connection with their work within the Delors Committee, the participants saw their mission as contributing to the creation of the best European Central Bank possible, and not defending purely national considerations. It is therefore possible and indeed necessary to focus the mandates of the various Lamfalussy Committees on taking European interests into account more effectively. This will represent one of the key issues for the French presidency of the European Union.

Does the SEPA represent a key or secondary issue in view of changes in financial services? What are the key aspects at stake?

A fully integrated payment system represents only one of the many elements that make up a single market. It is not a priority issue. The widespread deployment of electronic means of payment would represent a step forwards, but such a change cannot be decreed. It hinges on a gradual change of habits and customs.

The SEPA offers a unified system for transfers and cards. Caution must be shown with such an initiative, since its economy is fragile. Submitting the card system to a single model could make it unprofitable and unstable. Adopting measures too quickly, notably on interchanges, could force banks to adopt an American Express-type solution, which is certainly not desirable for Europe.

What are the different conceptions faced at European level concerning the development of the financial markets? What conception is the BNP Paribas Group arguing in favour of? Who are our European allies and opponents in this area, if any?

The Chairman of BNP Paribas has taken up very clear positions: he is in favour of an integrated market. He has always recommended harmonising consumer protection systems, the absence of which is preventing the retail sector from becoming genuinely European. As far as allies and opponents are concerned for this conception, certain modern banks would like to expand abroad, while others would gladly withdraw into a nationally compartmentalised system.

Could the narrowing of the gap between banking services and insurance products result in a merger of their businesses in time?

The borders between banking services and insurance products have become blurred, and bankinsurance is a reality. However, a complete merger of these businesses is unlikely, since there are fundamental differences, notably in terms of how they are financed.

What consequences may the subprime crisis have on mortgage lenders in Europe?

Subprime only exists in the US, where it has represented a formidable social vehicle, allowing modest people to buy a home. However, over the last three years, cases of abuse in light of the American real estate bubble and excess securitisation have led US brokers and banks to let their guard down. The scoring of borrowers has become increasingly lax, down payments have virtually disappeared and the two-year grace period has encouraged borrowers to borrow unreasonable amounts. This behaviour by US banks is primarily down to securitisation: these banks were not keeping these assets, but spreading them around the world as financial assets. Such phenomena highlight how the various markets are interconnected. In this way, bad practices at certain US banks have been able to spread worldwide.

In spring 2007, when subprime defaults (delinquency rates) rose sharply, rating agencies starting downgrading these products, triggering a phenomenon of panic and contagion. Investors have fled from the markets for asset-backed securities, turning to more conventional products, resulting in a liquidity crisis. It is therefore important to move out of this crisis and restore investor confidence. It is naturally not necessary to put an end to securitisation. However, for very risky products, transparency rules are essential. Players offering such products must highlight the high level of risk for investors and the absence of any guarantees.

Can we expect to see the European political authorities having a certain level of control over the ECB in the near future?

Any such control is forbidden by the Maastricht Treaty, an international treaty that therefore applies to all. The ECB has curbed inflationary trends very effectively, and its interest rates are the lowest among the world's main industrialised countries. Since the euro was created, 13 million jobs have also been created, including over 2 million in France. The ECB’s monetary management has never represented a cause of economic weakening. In fact, quite the opposite. The way in which the Chairman of the ECB has managed the liquidity crisis has been exemplary. There is therefore every reason to be pleased to be part of a monetary union that is managed and led so effectively.