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The European Securities Industry Under A Single Currency

Roy C Smith

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The European Securities Industry Under a Single Currency

by

Roy C. Smith
New York University

This paper examines the competitive dynamics of the securities industry in Europe and seeks to identify the major sources of competitive advantage for firms participating in the European industry in the future. It compares a variety of developments to date in the European market with those that have occurred in the United States over the past fifteen years to establish a benchmark position. It then attempts to assess what impact on the European securities industry the forthcoming adoption of a single European currency and Economic and Monetary Union (EMU) will have. It restricts its examination, however, to the wholesale finance sector, focusing only on matters that effect markets for debt and equity securities that are issued or traded within Europe or across its borders, and related advisory services of investment banks and securities firms. It does not address retail financial services, including brokerage in stocks, investment trusts or insurance, or retail banking services. Participants in the wholesale finance industry are broadly defined to include European universal banks and securities firms as well as all firms operating in Europe that are owned or controlled by non-Europeans. The aim is to create a composite picture of the European securities industry of the future and what will be required to succeed in it.[1]

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[1] I am grateful for useful comments on this paper from David Backus, Jean Dermine, Ingo Walter and Holger Wolf.

I. Introduction

In the thirty-five years since the first Eurobond issue, the global securities market has changed beyond recognition. But the first issue, a $15 million bond issued by Autostrade, the Italian state highway system, began an irreversible process of capital market development that has been of great importance to the growth and development of European (and non-European) public and private sector institutions. At the end of 1996, the total market capitalization of all European debt and equity securities exceeded $11,800 billion, or approximately 28% of the total global value of all outstanding securities. Approximately $7,600 billion of these outstanding securities were debt issues, and $4,200 billion were equities. See Exhibit 1.

This progress is also reflected in the increasing importance of debt securities issued in Euromarket transactions in several different categories. During 1996, new issues of Eurobonds exceeded $500 billion, an amount greater than the volume of new issues of corporate debt securities issued in the United States, a distinction the Euromarket also earned in three of the preceding four years. In addition to Eurobonds, $380 billion of Euro-medium-term notes (EMTNs) were also issued, as compared to $250 billion of such notes in the United States.[2] In 1996, the total volume of "international" capital market new issues (predominantly Euro-issues but including some foreign bond and stock issues) was nearly $1,000 billion, approximately three

[2] Similar to Eurobonds, medium-term notes are unsecured corporate obligations of from one to ten years in maturity which are usually sold off-the-shelf on a "tap" issue basis using standardized documentation by banks which underwrite their sale.

times the volume in 1990. See Exhibit 2. European governments and corporations accounted for approximately half of the volume of the new Euromarket debt issues, the largest regional sector of the market for such issues.[3] The Euromarkets were also extremely active in the issuance of Euro-commercial-paper (ECP) and in Eurocurrency syndicated bank loans and associated note-issuance facilities. At the end of 1966, ECP and EMTNs outstanding were approximately $840 billion, and Eurocurrency loans outstanding were estimated at $5,000 billion.[4]

Moreover, the European share of the world equity market capitalization had increased by 1996 to approximately 28%, up from 15% in 1980, reflecting a growth in the value of European shares outstanding of nearly 800%. The growth in secondary market trading activity in these shares was even greater. European equity new issues increased four-fold in the 1990s to $48 billion, the level of new issue activity reached in the United States in 1990. See Exhibits 1 and 2.

Also during 1996, European corporations completed a record number of mergers and acquisition transactions valued at approximately $266 billion, more than the value of all completed U.S. domestic deals in any year except 1989. The European deals accounted for 37% of the global volume of merger activity in 1996. This continues a trend begun in the late 1980s of aggressive European corporate restructuring through market transactions. See Exhibit 3.

And finally, European banks managing funds for institutional investors and

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[3] Bank for International Settlements, *66th Annual Report*, March 31, 1996. Table VIII.5

[4] Bank for International Settlements, *67th Annual Report*, March 31,1997. Table VII.1

government or multinational investment entities have also become extremely important in the global funds management business. This was estimated in 1995 to comprise assets of more than $22,000 billion—including $8,200 billion in pension fund assets, $6,400 billion in insurance companies, and about $5,300 billion in mutual funds. Of the world's 100 largest funds managers in 1992, 36 were European owned, and these accounted for approximately 31% of all global assets under management. See Exhibit 4. Institutional equity holdings under management represented 34% of the global total in 1995.[5]

Insert here:
Exhibit 1(Global Market Capitalization)
Exhibit 2(Capital Market Activity),
Exhibit 3 (Summary of Global M&A activity)
Exhibit 4(Total Assets Under Management)

These data defy some conventional perceptions of Europe as a capital markets backwater, only just beginning to stir itself to participate in global activity. On the contrary, Europe has made enormous progress in adapting to global capital market developments and opportunities. This is the direct result of widespread deregulation, reforms and improvements associated with the economic revival of the former European Economic Community (hereafter, the European Union, or "EU") that began during the 1980s. These developments were based on the idea that open markets and free competition would improve economic performance. Capital markets were significantly affected by banking deregulation, financial market reforms and massive privatization and corporate restructuring programs throughout Europe. An increasing

[5] Barry Riley, "Growth on a Grand Scale," *The Financial Times*, April 24, 1997, reporting studies by British Invisibles, plc., and Technimetrics, Inc.

Exhibit 1

Capitalization of Major Securities Markets

Nominal Value Outstanding
($US Billions at 12/31/96)

Country of Issuance	Bond Market		Equity Market	Total Market Capitalization
	Public Sector	Private Sector		
USA	6,366	3,217	8,484	18,067
Japan	2,246	1,410	3,089	6,745
Germany	839	1,464	671	2,974
Italy	998	276	258	1,532
France	732	312	591	1,635
UK	448	214	1,740	2,402
Canada	313	133	486	932
Netherlands	200	201	379	780
Other European	992	925	550	2,467
Other Non-European	200	50	3,911	4,161
Total	**13,334**	**8,202**	**20,159**	**41,695**
Total European	4,209	3,392	4,189	11,790
European %	32%	41%	21%	28%

Data: Salomon Brothers, 1996 Securities Industry Fact Book

Exhibit 2

Capital Market Activity: 1991-1996

($US Billions)

	1996	1995	1994	1993	1992	1991
US Domestic New Issues						
▪ US MTNs	255.9	404.9	282.8	260.3	169.4	142.3
▪ Investment Grade Debt	511.4	417.3	342.5	389.2	281.1	193.7
▪ Collateralized Securities	248.7	154.1	252.5	478.9	428.2	292.6
▪ Junk and Convertibles	129.4	30.2	36.4	69.5	53.7	20.9
▪ Municipal Debt	151.5	154.9	161.3	287.8	231.7	162.8
Total Debt	**1,296.9**	**1,161.4**	**1,075.5**	**1,485.7**	**1,164.1**	**812.3**
▪ Preferred Stock	40.5	16.3	15.5	22.4	20.9	20.2
▪ Common Stock	115.1	81.7	61.6	101.7	72.4	54.8
Total Equity	**155.6**	**98.0**	**77.0**	**124.1**	**93.3**	**75.0**
Total Domestic	**1,452.5**	**1,259.4**	**1,152.5**	**1,609.8**	**1,257.4**	**887.3**
International Issues						
▪ Euro MTNs	384.3	251.6	257.2	149.8	96.9	38.5
▪ Euro and Foreign Bonds	546.7	385.1	485.2	482.7	335.9	260.8
▪ International Equity	47.7	32.1	32.4	27.7	17.7	12.0
Total International	**978.7**	**668.8**	**774.8**	**660.2**	**450.6**	**311.4**
"World-Wide" Total	**2,431.2**	**1,928.2**	**1,927.3**	**2,270.0**	**1,708.0**	**1,198.6**
Global Syndicated Bank						
▪ Loan & NIFs	1,400.0	1,098.0	785.6	555.4	403.0	727.0

Data: Securities Data Corporation, Investment Dealer's Digest

Exhibit 3

Global Mergers and Acquisitions

(Volume of Transactions in $US Billions and Percentages)

	1996	1995	1994	1993	1992	1991	1990	1989	1988	1987	1986	1985
US Domestic	330.7	218.5	199.8	101.1	119.3	108.5	124.9	250.1	293.2	203.9	200.9	192.3
US Cross-Border	84.5	106.5	58.4	34.9	33.5	40.5	73.0	85.6	77.9	50.2	39.3	15.9
Intra-European	193.3	151.8	85.6	59.9	91.0	117.2	127.2	130.1	86.4	54.9	20.7	11.5
European Cross-Border	73.2	72.4	57.1	33.0	43.0	53.8	97.7	74.3	54.6	41.4	35.4	8.8
US-European Cross-Border	(52.9)	(43.5)	(39.0)	(27.4)	(13.3)	(22.8)	(36.6)	(46.3)	(38.2)	(28.3)	(17.4)	(5.9)
All Other	84.9	47.1	34.3	60.2	43.0	54.2	47.8	69.7	37.5	28.2	15.9	10.5
Global Total	**713.7**	**552.8**	**396.2**	**261.7**	**316.5**	**351.4**	**434.0**	**563.5**	**511.4**	**350.3**	**294.8**	**233.1**
US %	58.2%	58.8%	65.2%	52.0%	48.3%	42.4%	45.6%	59.6%	72.6%	72.5%	81.5%	89.3%
Europe %	37.3%	40.6%	36.0%	35.5%	42.3%	48.7%	51.8%	36.3%	27.6%	27.5%	19.0%	8.7%
US Domestic %	46.3%	39.5%	50.4%	38.6%	37.7%	30.9%	28.8%	44.4%	57.3%	58.2%	68.1%	82.5%

Exhibit 4

World's Largest 100 Fund Managers

Total Assets Under Management
($US Billions at 12/31/92)

Asset Managers	Amount Managed	No: of Managers
USA	4,641	39
Japan	3,874	22
UK	1,183	11
France	1,145	8
Switzerland	839	8
Germany	549	6
Netherlands	255	3
Canada	124	2
Australia	62	1
Total	**12,672**	**100**
Total European	3,971	36
European %	31%	36%

Data: P&I Watson Wyatt World 100 largest fund managers, Sept. 1996.

volume of funds has consequently flowed into the European markets from many sources. This flow was stimulated by the removal of foreign exchange controls, increasingly efficient markets, improved investment opportunities, the growth of new financial institutions such as pension and investment trusts (mutual funds), and by the continuing appeal of the world's least regulated, most innovative financial marketplace, the "Euromarket."

Euromarket Characteristics

The Euromarket began long before the current period of reforms. Technically, it is a market for offshore funds. Originally an interbank market for collecting and lending offshore deposits in dollars (and a few other currencies). The market does not officially exist, nor is it regulated by any country. Yet, it has operated effectively for more than three decades. The market allows money to flow untaxed between countries, and for securities to be owned in bearer form so ownership can be disguised. The market is operated by reputable and competent banking institutions and is very attractive to clients seeking financial safety, security and anonymity. The typical investor has been described as a "Belgian dentist," but more realistically the market serves tax-shy wealthy families and individuals, both shady and distinguished, from all over the world.[6]

The market has been tolerated by European governments because it did not involve the sale of unregistered securities to retail investors in individual countries, and

[6] Samuel L. Hayes and Philip H. Hubbard, *Investment Banking, a Tale of Three Cities*, Cambridge MA, Harvard Business School Press, 1990.

therefore was outside the jurisdiction of each. Sales could be made, however, to wholesale investors (i.e. large, sophisticated investors) as private placements. As a result securities issued in the Euromarket are not sold to retail investors *except* through the agency of a bank or other qualified representative. The retail market for corporate securities in Europe, however, was never very significant (except in the United Kingdom, which had a more active capital market). The distribution of large privatization issues of stocks in well-known companies has changed this situation somewhat. But for the most part, the securities market in Europe is comprised of institutional investors such as central banks and government agencies, commercial banks (acting for their own accounts and for customers), investment funds, insurance companies and similar fiduciaries. The Euromarket is the principal trading arena for such investors.

The boundaries of the Euromarket are indistinct. Issuers of securities come from North and South America, from Japan and other parts of Asia, as well as from all parts of Europe itself. They include supranationals, governments and agencies, corporations and banks. Their securities are sold within Europe, and in Asia, the Middle East and America under certain, private placement rules. Thus the Euromarket is substantially integrated with important financial markets outside Europe.

Euromarket participants are very sophisticated. They understand investment opportunities around the world, foreign exchange effects, derivative instruments such as warrants and options to purchase or sell securities, and with approximately 500 international banks and investment banks involved in the market, it is very competitive. There are no restrictions as to who can participate, and few rules and

regulations affect those who do. Innovation is prized but so is the ability to copy a competitor's idea in record time. All commissions and service fees are negotiable, and competition for new issue mandates is intense and sometimes rough: frequent issuers shop around for the lowest rates, banks will often deliberately take losses on deals in order to show their importance as an underwriter in published "league" tables, or stuff poorly priced deals into passive customer accounts to get rid of them. But many firms compete on the basis of innovation and bold initiative. As a result, the Euromarket saw the first significant use of the floating-rate note, the zero coupon bond, the warrant bond, the swapped foreign currency bond, Ecu denominated securities, and other new ideas. It also saw the first use of the "bought deal," or fully underwritten issue by one bank, the tap issue, and the note-issuance facility. It has also begun to accept some of the more complex and controversial products of the U.S. bond market, such as asset-backed issues, and recently, the first Euro-junk bonds.

Industry Deregulation and Reform

The Euromarket was well established by the middle 1980s when the current wave of EU economic and financial reforms began. These reforms, included not only the Bank for International Settlements' (BIS) minimum capital adequacy regulation for banks (1987), and the EU's Second Banking Directive under the Single Market Initiative (1987), but also the various internal market reforms such as "Big Bang" (U.K., 1986) and stock exchange market system upgrades that came to be widely adopted throughout Europe. These also included substantial re-regulation of the financial marketplace in most of the European countries along converged if not entirely common lines.

The reforms also included the now common practice of "privatization"—the public sale by governments of shares of state-owned enterprises—which has resulted in over $200 billion of new European equity securities being issued and traded in the market by individual and institutional investors, both European and non-European. Privatization programs were adopted by almost all European countries, and in aggregate these contributed enormously to the outstanding supply of securities, especially in countries with restricted public ownership of equities.

With such large volumes of debt and equity securities issuance has come a large supporting infrastructure for the financial services industry. Such infrastructure consists almost entirely of human talent and organizations. It includes not only underwriting, legal and accounting firms trained to accommodate new issues, but also market-makers and brokers and merger and acquisition specialists and firms specializing in securities research, bond ratings, clearance and settlement, information technology, and even recruitment. In the beginning of the Euromarket, this infrastructure was located in London, but since then most major firms have spread their significant operations to Frankfurt, Milan and Paris as well. Many of these firms came to Europe first to assist their own clients, but then to compete for market share with the European banks with long-standing ties to traditional clients. Their success has stirred the larger, long-established European banks to respond, and competition in all financial services sectors has become more intense as a result, much to the benefit of market users. Today, with no impediments to funds crossing borders, and cheap and efficient telecommunications systems that instantly transmit price information all over the globe, the market in Europe is closely linked with those in New York, Tokyo and elsewhere. Any price disparities are quickly removed by

arbitrage trading. Indeed, the wholesale finance market has become totally globalized and open to competition.

Redefining Wholesale Financial Markets

Wholesale financial markets are those in which the issuers and investors benefit, relative to the retail market, from significant volume discounts. Only those with large capacity and reputations for knowledgeable behavior need apply. Users of wholesale financial markets have had a choice in the past between bank loans and the issuance of securities. As in the United States, in recent years, entities that have full access to the European securities markets have found these markets cheaper than traditional bank financing. Full access generally requires that the issuer obtains investment-grade bond ratings from two rating agencies, but there are exceptions for better-known government and corporate issuers. The securities markets now provide short (ECP) and medium term borrowing (EMTNs) for full-access entities at significantly lower net interest cost than from banks. For such companies, banks mainly provide stand-by and bridging facilities and swaps that are later refunded in capital markets, but today banks also compete to underwrite and distribute the securities. Smaller, more regional or less well-known companies may have insufficient access to the markets to issue securities on the same basis. These companies usually rely on their commercial banking relationships for financing needs. Gradually, however, the wholesale market is reaching out to smaller companies and those with below investment-grade bond ratings.

As the world's largest securities market is in the United States, and with

market integration U.S. securities firms have been highly active in capital markets in Europe and Asia, the principal firms attracting the leading shares of market for *global* wholesale financial services have been U.S. firms. See Exhibit 5. In the United States, competitive capital market activity has been intense for at least 20 years. The success of U.S. firms is partly explained by the fact that a large portion of full-access issuers are U.S. entities. But they have also been effective in gaining business from an increasing number of government bodies and corporations from Europe, Japan and other areas outside the United States because of their technical skills and marketing abilities.

Exhibit 5 (Global Market Leadership Tables)

The U.S. Experience

The history of the modern securities industry in the United States begins on May 1, 1975 when major reforms were implemented by the New York Stock Exchange.[7] For some years previously, the large financial institutions had complained that the Exchange's fixed, or minimum, commission rates that applied regardless of transaction size were excessively expensive and in restraint of trade. Institutions could only buy shares of NYSE listed companies on the Exchange, but the institutions were not permitted to become members to obtain lower rates. The U.S. Department of Justice became interested in the issue and threatened anti-trust action unless the Exchange voluntarily agreed to negotiated commission rates, which (very reluctantly)

[7] A day called "Mayday" by journalists, signifying both the magnitude and the irony of the changes: Mayday was also an international radio call for distressed ships and aircraft, and the national day of the Russian communist party.

Exhibit 5

Global Wholesale Banking and Investment Banking, 1996

Full Credit to Book Running Manager Only

($ US Billions)

Firm	Global Debt & Equity Securities Underwriting & Placement [a]	Rank	Global M & A Advisory [b]	Rank	International Loans Arranged [c]	Rank	Medium Term Notes Lead Managed	Rank	Total [d]	Rank	% of Industry Total
Merrill Lynch	215.74	1	100.06	3	2.97	27	54.82	1	373.58	1	11.94%
Chase Manhattan Bank	31.53	15	17.37	18	249.12	1	2.99	24	301.00	2	9.62%
JP Morgan	104.34	7	77.95	4	90.43	2	19.77	6	292.49	3	9.35%
Goldman Sachs	146.71	2	116.50	2	2.70	28	24.02	4	289.92	4	9.26%
Morgan Stanley	125.47	4	116.72	1	-		28.52	3	270.72	5	8.65%
CS First Boston	107.33	6	60.88	5	39.44	6	17.06	7	224.71	6	7.18%
Salomon Brothers	119.06	5	47.94	7	-		41.46	2	208.46	7	6.66%
Lehman Brothers	125.61	3	47.41	8	-		19.89	5	192.91	8	6.16%
UBS	34.96	13	46.38	9	38.16	7	9.86	9	129.37	9	4.13%
Bear Stearns	57.75	8	18.58	17	-		13.39	8	89.73	10	2.87%
Citicorp	-		-		84.51	3	4.89	20	89.40	11	2.86%
Deutsche MG	36.87	11	13.51	22	27.85	10	7.40	13	85.64	12	2.74%
SBC Warburg	37.58	10	29.41	11	5.47	26	8.99	10	81.44	16	2.60%
DLJ	52.93	9	28.07	13	-		-		81.01	13	2.59%
NatWest	20.72	20	33.21	10	25.19	12	-		79.12	14	2.53%
Nations Bank	22.94	17	-		49.27	5	5.41	18	77.62	15	2.48%
ABN/Amro	23.64	16	13.11	23	30.90	8	7.63	12	75.28	17	2.41%
Smith Barney	36.02	12	28.36	12	-		5.20	19	69.58	18	2.22%
Bank of America	-		-		65.40	4	-		65.40	19	2.09%
Lazard Houses	-		51.95	6	-		-		51.95	20	1.66%
Total Top 20	1299.19		847.40		711.41		271.31		3129.31		
Total Industry	1769.86		684.62 *		1093.71		371.73		3919.92		-
Top 10 as % of Total	**61.73%**		**102.10%**		**64.33%**		**63.97%**		**55.89%**		**55.89%**
Top 20 as % of Total	**77.77%**		**134.31%**		**79.17%**		**80.48%**		**73.62%**		**73.62%**

Data: Securities Data Corporation

[a] Global rankings, top 25, completed deals only. Includes all U.S. private placements.

[b] By market value of completed global transactions, full credit to both advisors, top 25 advisors.

[c] Top arrangers of International Syndaicated credits by volume.

[d] Global MTNs, top 25 managers.

* As a result of "double accounting", the total for the top 25 firms is higher than the industry total.

it agreed to do. Lower commissions were the immediate result, and these greatly stimulated trading and increased competition. There were a number of failures and mergers in Wall Street as a result.

The Declining Role of Banks

Also developing around this time were the beginnings of the great banking and savings and loan crisis of 1980-95. During this episode banks, savings and loan corporations and other depository institutions suffered massive losses which ultimately involved taxpayer expense of about $200 billion, and their competitive positions plummeted. Much of the difficulty, beginning in 1978, was the result of sharply increasing U.S. interest rates which raised the costs of variable-rate, short-term borrowing that many institutions had relied upon to fund large long-term, fixed-rate positions in home mortgages and term loans. The resulting asset-liability mismatches produced enormous write-offs of bank capital. To alleviate the pressure on the S&Ls, Congress allowed them to undertake riskier investments to increase lending spreads, but many of these loans failed. More than a thousand savings and loan institutions (S&L's) were closed or taken over by the Federal Savings Loan Insurance Corporation as a result.

Also during this period, financial deterioration visited American commercial banks, many of which had been overly aggressive lenders during the 1970s to third world countries and ailing American corporations and failed. Others suffered forced

reorganization or severe lending constraints.[8] The banks' credit ratings were drastically lowered, opening the door to competition from capital markets and foreign lenders. Money market mutual funds, paying investors interest rates significantly higher than bank deposits, siphoned funds out of the banks and into commercial paper and other fixed income securities. Indeed, the assets of money market funds grew from $9.5 billion in 1978 to $327 billion in 1988. Meanwhile, the banks were also absorbed by the third-world debt crisis, which would cost billions and cause further management upheavals and heightened regulatory requirements.[9]

Partly, because of these difficulties, most banks experienced a loss of wholesale business to the capital markets where commercial paper, corporate bonds and new asset-backed securities could be put together at lower rates than the banks could provide. This disintermediation was countered by efforts on the part of banks to increase holdings of assets of lesser (below investment-grade) credits; however competition for these assets drove lending spreads downward to unsatisfactory levels.

U.S. banks were restricted by the Glass-Steagall provisions of the Banking Act of 1933 from entering the securities business, so they were unable to diversify away from the banking business when they might have wanted to do so. However, most banks were not sufficiently healthy to make much progress in the securities industry, even if they had been permitted to do so at the time.[10] During this period, however,

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[8] Over $150 billion of this expense was incurred by failed savings and loan institutions, the rest by the failure of banks with assets of $264 billion. (Federal Deposit Insurance Corp., 1996)

[9] Lawrence White, *The S&L Debacle*, New York, Oxford Univ. Press, 1991, pp.76-123.

[10] This period in American banking has been well documented by Anthony Saunders and Ingo Walter in *Universal Banking in the U.S.*, New York, Oxford University Press, 1996, and by the author in *Comeback, The Restoration of American Banking Power*, New York, Harvard Business School Press, 1993.

capital market activity increased sharply. In 1975, the value of shares traded on the NYSE was $127 billion; by 1985 it had grown to $970 billion and by 1996, $4,100 billion. Total corporate underwriting in 1975 was $47 billion and by 1985 it had reached nearly $140 billion, and by 1996, $1,452 billion.[11] The burst of capital market growth than began in the 1970s ignited an explosion of activity that continued for more than twenty years.

During the latter part of the 1980s new laws were passed that tightened banking regulation. Most banks went through a painful ordeal of loss recognition, downgrading and lowered stock prices. Management changes and downsizing were common throughout the industry. The banks were forced to focus on what they could do well, and substantially reduce operating costs and investments in non-core businesses. Many banks chose during this time to emphasize their consumer and small company lending businesses, and to take advantages of opportunities to expand their businesses into other states and regions. Most banks reduced their emphasis on wholesale financing, leaving this territory to investment banks. Some continued to act in the wholesale markets through regular and specialized lending activities supplemented by modest securities businesses. In 1989 The Federal Reserve and other bank regulators allowed banks to apply for securities underwriting powers, under Section 20 of the Glass Steagall provisions which permitted limited activities in prohibited areas. As of December 1996, fewer than 25 domestic U.S. commercial banks had applied for and obtained permission for securities businesses (along with

[11] New York Stock Exchange *1996 Fact Book*.

about the same number of non-U.S. banks), even though by this time the regulators had increased the size of permitted securities activities to 25% of the bank's assets and revenues.

The Rise of Trading

As the 1970s came to an end, the U.S. fiscal and trade deficits were at all time highs, but during the next decade, these would increase approximately four-fold, requiring the issuance and sale of trillions of dollars of U.S. government and agency securities. A significant portion of these securities would be placed with foreign central banks and other non-U.S. investors. At different periods, the Saudi Arabian Monetary Authority, the World Bank, Japanese financial institutions and investment companies, and the monetary authorities of Kuwait, Taiwan, South Korea, and Singapore have been extremely important investors in these securities.

U.S. commercial and investment banks in the business of trading and selling U.S. government securities (Glass Steagall did not restrict banks from the government or municipal bond businesses) found the sudden and huge increase in the volume, and the increasingly competitive and globally diverse markets for government bonds, to have profound effects on their businesses. In the space of only a few years, the capital requirements, position-risk exposures and the aggregate size and skills required of securities firms increased substantially. Government securities are the base against which all fixed-income securities activities are measured. Skills learned in trading government bonds could be used to trade other instruments, corporate bonds and bonds issued by foreign governments and corporations.

Increasing competition in fixed-income securities threatened to narrow the margins, but volatility, calculated risk taking, and innovation (especially in forms of proprietary, or technical trading) made it possible for some operators to earn very large profits. These were increased further by securitization, especially of mortgage-backed securities, and by the introduction in the early 1980s of interest rate derivatives, such as futures and options contracts and interest rate swaps. Firms soon recognized the profit potential of intensive trading activity, and began to look for new instruments to trade—such as foreign exchange, commodities, and other forms of corporate securities. For many of the larger U.S. investment banks, trading (in its various forms) would soon comprise more than fifty percent of the firm's non-interest revenues, and even more of its profits.

The emphasis on trading, however, changed the nature of the investment banking business. Increased competition and access to the clients of other banks placed a great premium on tight pricing and lower dealing spreads. As a result, banks often thought more about their dealing profits than whether their quotes best served their clients. For many clients, these developments encouraged shopping around for the best prices and ideas, at the expense of traditional, nearly exclusive banking relationships. The pendulum swung away from a business in which client relationships were the essence of the business, towards a position where the pricing of issues was more important.

Globalization and Market Integration

Early in the years of the Reagan administration, interest rates began a dramatic

decline. This was partly in response to inflation-checking monetary policy changes introduced by the Federal Reserve in October 1979, and partly as a result of the economic and foreign policies of the new administration. Although real interest rates remained high in light of the continuing fiscal deficit, the nominal rates declined as sharply as inflation did. As a result a bull market in bonds (and in stocks) began in 1982 that except for a few brief interruptions in 1987 and 1990, has continued until the present time, a factor which greatly underpinned the shift towards trading activities.

The improved U.S. economic performance, and confidence in the new president seemed to contribute too to the dollar's strengthening, from 202 yen per dollar in 1980 to 260 in 1985. During this period non-American investors found U.S. securities to be very desirable and advantageous. Some, such as Swiss banks investing client funds, bid for U.S. corporate Eurobonds at interest rates that could not be equaled in the United States. Because the unregulated Eurobond market was so flexible, a large bank seeking $100 million or so of new bonds for investment could contact a U.S. corporation directly, offer an extremely attractive interest rate with the deal to be agreed on the telephone. The transaction was not subject to underwriting, marketing, due diligence, documentation, or anything else. It had been agreed as a "bought deal" between the European bank and the issuer, something that was not at the time possible in the United States. Some issues at this time were made at interest rates *below* the U.S. Treasury bond rates, instead of at a premium of 0.50% to 1.00% or

so required in the U.S. market.[12] As a result, a wave of U.S. Eurobond issuance occurred, resulting in more investment-grade corporate bonds being sold outside the United States in 1982 and 1983 than domestically. This had never happened before.[13]

One consequence of the surge in overseas financing was an important change in the regulatory procedures governing new issues of securities in the United States. The change, Securities and Exchange Commission ("SEC") Rule 415 (1983) provided for "shelf-registration" of securities with the SEC. This in effect meant that the issuer could pre-register securities, and draw them "off the shelf" to be issued on demand. For those companies that qualified to use Rule 415, it meant that no longer would an issuer seeking access to financial markets have to file a registration statement with the SEC and then wait approximately 30 days for permission to proceed to the market. Rule 415 allowed firms to go to the market when they wanted to—without any appreciable wait. Firms that wanted to do so could engage in bought deals inside the United States, and they could shop around among competing underwriters for the lowest interest rate. Experienced by the competitive struggles in the Eurobond market, many U.S. firms decided to compete on European terms in their home market. Soon the whole of the corporate bond market had been brought to accept the Euromarket practices. No longer could a securities firm rely on a long-standing relationship with

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[12] U.S. Treasuries were not available free of withholding taxes and in bearer form, two important requirements of Swiss Bank money managers, so prime U.S. corporate bonds, which were became the benchmark for Eurobond pricing.

[13] Roy C. Smith, *The Global Bankers*, New York, E.P. Dutton, 1989, pp 151-190.

a client for assurance that when it needed financing the firm would arrange it. No longer could a firm assume that it's proposed interest rate would be accepted, or that another firm would not appear with a lower rate. This change alone profoundly affected the nature of the relationships between investment banks and their clients. Exclusive, traditional banking relationships, in which clients and banks showed great loyalty to one another and few banks bothered to call on the clients of others, became a thing of the past. Many stable investment banking products, like debt financing turned into commodities. Often, a "winning bid" would cause the firm a loss. Clients wanted winning bids and bankers became wary of them. Many decided there was more money to be made in simply trading with clients, rather than in providing services at uncompetitive rates.

This condition, in which the competitive elements of one market (Eurobonds) were transferred to another, less competitive market (the U.S. bond market), represented a form of involuntarily, imported deregulation. It was caused by disequilibrium of competitive conditions in markets that were otherwise closely linked. The disequilibrium was caused by regulation that existed in one market but not the other. When the regulation was changed (Rule 415) the disequilibrium disappeared, and American firms continued to do business with their American clients, but under European competitive conditions. The change was drastic for American banks, but it was also very sudden occurring less than three years after the revival of interest in the Euromarkets by U.S. companies.

There were several responses to these changed competitive conditions in the

United States. One was to strengthen firms' trading and distribution capabilities, especially by reaching out to the global investor pool to a greater extent. Another response was to become more innovative, and to introduce more customized securities tied to derivatives contracts of various types. Yet another was to withdraw from aggressive, money-losing underwriting activities to specialize in trading and non-commodity financings like equities, and new instruments like mortgage-backed securities. The result was a dispersion of competitive energy expended on the bond and related securities markets, creating more niches and areas of highly concentrated specialization. The result was a shift, as in the Euromarket, in the valued-added of investment banking from the financial intermediary to the issuers and investors.

Soon the U.S. market and the Eurobond market became very closely integrated. Issuers and investors compared interest rates and issuing costs in both markets. Currency and interest rate swaps permitting floating-rate contracts to be converted to fixed-rate contracts operated across borders and continents. Virtually full globalization of the debt securities markets soon resulted. Debt securities became subject to a global pricing matrix with rating and liquidity (bond quality) on one axis, and maturity (duration) on the other. Pricing aberrations were subject to arbitrage, and soon disappeared.

The U.S. market was subject to a further round of securities deregulation in 1990 with the adoption of the SEC of Rule 144a, which provided for the resale (i.e., trading) of securities that were exempt from registration by virtue of "private placement" provisions. The effect of this regulatory change was to permit

unregistered securities to be issued, sold and traded within a special community of several hundred "qualified institutional buyers," a community that was indistinguishable from the institutional bond market which accounted for more than 90% of the market for new issues of registered corporate bonds in the United States.

Provided with greatly enhanced liquidity, the private placement market began to offer rates much closer to the rates of fully tradable, registered bonds. One result of this regulatory change was to disengage the SEC from the task of protecting qualified investors from normal disclosure deficiencies, so the SEC could devote itself more appropriately to regulating financial transactions affecting the retail public. Another result was the opening of the U.S. debt and equity markets under Rule 144a to foreign issues unable or unwilling to go through the expense, difficulties and time required for a full SEC filing. Numerous Latin American issuers, for example, have made Rule 144a offerings. Thus, foreign issuers of unregistered securities totaling $38 billion in 1996 were able to access the U.S. institutional investor market, the world's largest by far, on a very low cost basis. Those issuers preferring to develop access to this market would forego using the Eurobond market, unless the interest rate or stock price offered was superior to that in the U.S.

Takeover Booms

During the 1980s the United States experienced its largest period of takeover activity ever. Beginning in the 1900s, there had already been three previous takeover booms, or waves of mergers and acquisitions, but the one in the 1980s was different in several respects. Although the largest in value terms (it was not the largest in terms

of the percent of GNP represented by the value of the transactions), its main identifiable characteristic was the extent to which hostile transactions and leveraged buyouts were included. Between 1985 and 1990, more than 8,500 mergers and corporate reorganizations valued at more than $1,250 billion took place in the United States, about 22% of which were initially resisted transactions. Much of this activity has since been attributed to the need to improve the competitive performance of industry in the United States, by challenging corporate control and instituting performance measures that would improve profits and shareholder returns from the relatively low levels to which these had sunk during the gloomy decade of the 1970s.

Much of this restructuring and reorientation to shareholder value has been effective, but the intensity of the effort was so great that it turned to excess, and the boom burned-out in 1989-1990. However, fundamental economic needs in the American economy for industry reorganization in banking and financial services, technology, defense and other sectors caused the boom to reappear in the early 1990s, and between 1991 and 1996 a further 15,000 transactions valued at more than $1,070 billion have occurred.

These developments affected investment banks in four significant ways:

They provided a bonanza of merger and refinancing fees, opened up the market for below investment-grade corporate bonds, and gave many firms the opportunity to invest their own money in LBO deals. This produced a considerable increase in profits for those investment banks and commercial banks participating in the activity.

They affected the banks' relations with their clients in significant ways.

Takeover targets, of course, disappeared as clients after the deal was completed. Sometimes buyers hired banks to help them launch raids against other clients. And sometimes when clients wished a firm to act for them, the firm was prevented from doing so by a conflict of interest. Clients were annoyed when their banks were not available to them, and also became suspicious of banks they thought might be seeking to "put them in play," or making them subject to an unwanted offer. The whole effect was to loosen the bands of trust between the firms and their, or anyone's clients.

They also affected the banks and investment banks because many of the acquisitions that occurred involved firms in their industry. Many leading investment banking firms were acquired by others in the industry since 1980 (some more than once), including such well known names as, Alex. Brown, Dillon Read, First Boston, Kidder Peabody, Lehman Brothers, Morgan Stanley, Oppenheimer, Robertson Stephens, Salomon Brothers, Smith Barney and Dean Witter. Also, top money-center banks were being merged into other banks, including Chase Manhattan, Continental Bank, Manufacturers Hanover, Irving Trust, Security Pacific, and First Interstate. Further, significant second or third tier U.S. securities firms have been acquired since 1996 by Canadian Imperial Bank of Commerce, SBC Warburg, Bankers Trust, Bank of America, and NationsBank. Mergers and acquisitions, many involuntary, have helped to reshape the commercial banking and investment banking businesses in the United States as much as any other single factor. The result was industry consolidation into a smaller number of powerful players—large, globally diversified firms with greater emphasis on output and profitability and on competitive performance.

Finally, the rising level of merger activity attracted the attention of European corporations, and Europe's first merger boom began involving many of the same globalizing industries that were being restructured in the United States. Motivated by concerns about competing in the new European single market, having access through the marketplace to control of some corporations, and helped by aggressive American merger know-how, the merger boom spread to Europe. In 1985, the total volume of mergers and acquisitions involving European companies was 8.7% of the world total, by 1996 this share had grown to 37.3%.[14] See Exhibit 3. American (and American associated) investment banks, establishing merger specialists in their European offices early in the period, became the market leaders in European cross-border transactions. These firms included four of the top five ranked advisors in 1996, and in aggregate accounted for more than half of the total volume of transactions involving the top fifteen ranked firms.[15]

Sources of Competitive Advantage

It is clear that the securities industry in the United States has existed in a condition of tumultuous change since the middle 1970s. Many firms failed to adapt to the competitive conditions that came to prevail, and have since disappeared. Many of those that have survived have merged with others, or otherwise increased their size, geographic reach and business mix several fold. Management problems have

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[14] Gayle DeLong, Roy C. Smith and Ingo Walter, *Global M&A Tables*, published by The Salomon Center, New York University, based on data supplied by Securities Data Corp.

[15] "Europe's Top Advisors," *Acquisitions Monthly*, February 1997, and "High Noon in Europe, Wall Street Banks Gallop In," *The New York Times*, July 13, 1997..

been continuous, and sometimes extremely painful as those at Salomon Brothers, Lehman Brothers, Kidder Peabody, and Bankers Trust (to name but a few) could testify. New leaders were appointed, mainly young, trading-oriented managers who replaced the older people whose rise had been associated with client relationships. Many different strategic ideas were tried. Some firms specialized in one or two key areas—Lazard Fréres and Dillon Read, for example, remain focused on mergers, corporate finance and money management. Others decided to move aggressively into new areas where they believed market leaders had become cautious, such as Kidder Peabody's briefly successful push into mortgaged-backed securities, a business developed by Salomon Brothers, or Bankers Trust's emergence as a leader in derivative securities. Many firms experienced difficulties with regulators and with the courts as the ground rules of acceptable behavior in modern finance were progressively made clear.[16] The leading American firms today, however, are mainly highly experienced, battle-hardened survivors. They have had to adapt continuously and often suddenly to changing industry trends, often doing so by ruthlessly laying off large numbers of employees, or by moving before they were ready into new areas of opportunity (such as emerging market securities) so as not to be left behind in case the new area turned into a bonanza. In the middle of this, these firms had to attract, train, compensate and retain top-quality professional employees, and supervise their work all over the world. Among their important achievements has been the development of new, highly flexible, non-hierarchical management systems and unique ad-hoc arrangements for dealing with

[16] Roy C. Smith and Ingo Walter, *Street Smarts*, Cambridge, MA, Harvard Business School Press, 1997, Chapter 1.

urgent matters. In aggregate these factors constitute a very important comparative advantage of the American firms, as compared to European or Japanese firms.

As compared to each other, the American firms would probably agree that their most important comparative advantages include the following:

- They are the right size to be global players, while still remaining flexible and responsive. The top 5 U.S. investment banks are much larger firms than they have ever been in terms of total assets, now averaging about $200 billion, but they are still comparatively small in comparison to the largest U.S., European and Japanese banks. Leaving out the large retail sales forces that Merrill Lynch and Dean Witter Morgan Stanley maintain, the wholesale business headcount is in the area of 8,000 to 10,000, which is much larger than the smaller, niche-oriented American firms but also larger than most of their European counterparts.

- They are specialized in several but not necessarily all areas of wholesale finance. They are focused on what they are able to do well, and demand expertise second to none. Bond traders are bond traders, not general managers on rotation through the bank. They will be bond traders for their entire careers, except for the small number pushed up to management positions. Their businesses have been mainly simplified to debt, equity and advisory services. They are market makers and trading counterparties to everyone in the market, and the importance of individual clients has diminished with the weakening loyalty of the clients to them. Being specialized means being able to trade at the best prices possible and to survive and prosper accordingly.

- They recognize that much of what they do has become commoditized, and the trading spreads, commissions and advisory fees have been cut to the bone. To overcome the economic effects of this erosion of margins the firms have increased the volume of trading positions (making themselves more dependent on trading than on anything else). They have also increased efforts to devise innovative new products (that will carry higher spreads at least for a while) and to enter into new markets (Latin America, Eastern Europe) in which opportunities to recreate the sort of businesses they have developed in the U.S. are just appearing.

- They are constantly experimenting with new strategic initiatives. The firms' business strategies are always under review (if not under attack) by management. There are few sacred cows. As a result widely different long-term business strategies have emerged among the top firms. Morgan Stanley and Dean Witter have merged to create a new competitor to Merrill Lynch. Previous Merrill challengers, Smith Barney and Lehman Brothers, have backed away from the effort to specialize in retail distribution and

fixed income, respectively. Goldman Sachs remains a partnership, devoted to global corporate finance and trading, but with increasing commitments to investing its own capital in private transactions. Salomon Brothers remains a fixed income specialist, though it has recently entered into an imaginative strategic equity securities distribution arrangement with the Fidelity Funds group. Chase Bank remains firmly in second place in the global wholesale rankings by sticking to syndicating bank loans while virtually ignoring the other investment banking activities. Different strategic approaches may constitute distinct comparative advantages in the future, but it is usually difficult to understand which strategy may be better than others while they are being implemented.

- The strategies, however, are mainly meant to be offensive and aggressive, to build market share and profit opportunities. Periodically there is concern that a firm may be overly dependent upon revenues streams from too limited a number of areas, and efforts are made to build another business area to protect the firm's overall profitability. An example of this may be the current rush to acquire money managers to supplement trading and corporate finance revenues streams. But the firms generally do not view their strategies as defensive—to protect their existing market positions and clients, or to enable greater cost reduction and economies of scale.

- Perhaps the one thing all of the firms would agree on is that none of their objectives can be achieved without the highest quality personnel that it is possible for them to attract. These are top graduates of the best business and law schools, highly competitive persons who have already excelled in the military services, athletics, politics or other businesses. They are team players to a point, but disdain unreasonable authority and are fearless in advancing their own viewpoints. These people have to be recruited, nurtured and developed as strong contributors. They must be paid extremely well, and allowed a great deal of freedom of action. They challenge everything and can be difficult to control and to work with, but they are capable of extraordinary results. They are not traditional organizational men and women: they do not resemble at all those who held high positions in commercial banks in the 1980s, and that occupy similar positions in Europe today. Mastering the difficult art of attracting, managing and retaining such people is certainly a comparative advantage in the securities industry. Much of the success of Goldman Sachs, Merrill Lynch, Morgan Stanley Dean Witter and J.P. Morgan is attributed by their competitors to this capability.

As of September 1997, the U.S. Congress was still considering, for the third time

in ten years, a substantial revision to the Banking Act of 1933 that would effectively eliminate all or much of the Glass-Steagall provisions separating banking from the securities and insurance businesses. On this occasion there is no substantial disagreement between the parties on allowing banks to recover powers to conduct securities operations, which *de-facto* the Federal Reserve and other regulators have already permitted under the Section 20 exemption. If the Congress does act to repeal all of the restrictions on activities of the banks, it will remove a comparative advantage that some have regarded as important to securities firms—they can participate in whatever businesses they like but the banks cannot. Would repeal mean a widespread movement towards universal banking in the United States? Professors Saunders and Walter have concluded that universal banking could be conducted safely in the United States, but the potential economies of scale and scope would be few and limited only to exceptionally large banks.[17] So far, evidence from the marketplace seems to suggest that most banks believe they would be better off avoiding the capital intensive, volatile and difficult-to-manage business. Shareholders investing in banks have indeed been willing on the whole to pay higher prices for banks that are predominately in retail and regional banking, not wholesale banking. Managers and boards of directors have taken this in, and restricted their securities activities accordingly. What acquisitions there have been between banking and securities firms have been of smaller, specialized firms, not large national firms, and even these have been very expensive in terms of price to book value. Further, bank managers and directors do not believe that investors want to

[17] Ingo Walter and Anthony Saunders, *Universal Banking in the United States*, New York, Oxford University Press, 1995.

see banks retain their stability by transferring profits from successful areas to unsuccessful ones—they would rather see the unsuccessful business improved or sold off. Clients also show little sign of being interested in European style "Hausbank" relationships, and seem committed to shopping around to gain the lowest financing costs whenever they have business to do.

III. Competitive Dynamics in Europe

The European securities industry has been affected by all of the forces that have changed the American securities industry. Most of the changes came to Europe after they had been tested in the United States—Europe had shared the same conditions that made the United States banking system ripe for change. Certainly for the past several years the European marketplace has been influenced by a gradually declining role of banks, an increasing usage of global capital markets by corporations and governments, by regulatory reform, by the application of new technology in trading markets, and even by Europe's first takeover boom. An increased volume of financial transactions and competition for them are the result of these changes.

Just as the beginning of events was marked in the United States by "Mayday" in 1975, it all began in Europe a decade later with the United Kingdom's "Big Bang," on October 27, 1986.[18] This event was the result of an out-of-court settlement between the Thatcher government and the London Stock Exchange on charges of restraint of trade by the exchange that were similar to those which the New York Stock Exchange was

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[18] "Big Bang" is the name given by British journalists to the day on which the City of London was to be blown sky-high, and a new financial "universe" was to be created.

forced to face. The result was that the London Stock Exchange agreed to open memberships and to allow commission rates to be negotiated. These concessions, however, changed everything, because they changed the economics of the system used by the City for over a hundred years. The reforms led to an enormous transformation, among them being the streamlining of markets, a sharp lowering of commissions and increases in volumes of securities traded, new investments in electronic market-making, and efforts to attract institutional investors in securities of other European countries to the more efficient London market. These reforms were thought to so advantage British markets that the other major European countries embarked upon Big Bang-like reforms of their own, and for the first time, serious competition between European securities marketplaces began to develop. The improving markets led to the ability to absorb the new, large privatization issues that appeared subsequently, as well as greater investment in European securities by U.S. and Japanese investors.

The Biggest Bang

Among the changes caused by Big Bang were major alterations in the competitive structure of the British market and its leading players. The U.K. market was very old and established, having been at the forefront of global finance all during the 19th Century, and earlier. Many brokers, jobbers, banks and merchant banks that could trace roots back to these early days were forced into mergers and alliances, because the firms feared that they could not survive in the securities business without becoming fully-capitalized, full-service firms like the Americans. Most of the major market participants in Britain in 1986 endeavored to do this, either by acquiring capacity they lacked or by building their own.

The results, however, were mixed. The earliest leaders to emerge were Barclays' merchant bank, called Barclays de Zoete Wedd or "BZW", and S.G. Warburg, both of which had acquired a leading broker and a leading jobber. NatWest Bank made a modest effort to gain prominence in the securities market, but the other British clearing banks (Lloyds Bank, Midland Bank and Standard Chartered Bank) after initial half-hearted attempts, withdrew. (In 1992, Midland Bank was acquired by Hong Kong & Shanghai Banking Corp., which had earlier acquired British broker James Capel). Many other U.K. brokers were acquired by foreign banks: Union Bank of Switzerland bought prominent broker Phillips & Drew, and Swiss Bank Corp. bought Savory Milln. Citibank and Chase Manhattan each acquired two brokers, and Security Pacific bank bought an interest in Hoare Govett, which was later sold to ABN Amro Bank.

Most of the other merchant banks were cautious—Morgan Grenfell entered the trading businesses briefly but withdrew after losing money; it was subsequently acquired in 1989 by Deutsche Bank for its corporate finance and investment management skills. Similarly, Kleinwort Benson acquired a broker but remained on the sidelines after some early unsuccessful attempts at trading, specializing in privatizations and investment management until it was bought in 1995 by Dresdner Bank. Hill Samuel was bought in 1988 by Trustee Savings Bank, after which it subsequently faded into obscurity. Hambros Bank, Robert Fleming, N.M. Rothschild, and Schroders, all family-controlled firms, have remained specialists in corporate finance and investment management. Lazard Brothers, similarly specialized, has strengthened its familial alliance with Lazard Fréres of Paris and New York. Rothschild's securities trading subsidiary, Smith

Newcourt, was sold to Merrill Lynch in 1995. Baring PLC, also a family controlled firm, was sold in 1995 to Internationale Nederlanden Groep (ING) after its spectacular failure at the hands of trading rogue Nick Leeson.

The star of the post-Big Bang period, S.G. Warburg, was seen by many to be the only British firm capable of global market leadership in investment banking. However, it stumbled in the difficult trading markets in 1994, and after an aborted effort to be acquired by Morgan Stanley, was sold to Swiss Bank Corp. Swiss Bank immediately integrated it into its investment banking unit that had been fortified by the acquisition of Chicago-based derivatives specialists, O'Connor & Co. Thus in 1997, the two surviving British-owned, full-service, investment banks were the subsidiaries of the country's two largest commercial banks, National Westminster, ranked 15th, and BZW Barclays ranked 21st, among the top global wholesale banking firms in 1996. The board of NatWest, however, facing declining profits and a sagging stock price, acted in early 1996 to undo some of its previous commitment to investment banking, by sacking the CEO of its NatWest Markets subsidiary and bringing control of many of its activities back into the banking parent.

Despite these events involving U.K. firms, an earlier hybrid British-led, Swiss-owned, and American-styled, Credit Suisse First Boston, which ranking 6th in 1996, experienced many years among the top five global finance firms. However, but its profitability has not always been satisfactory to its Swiss owners, and the firm has experienced several reorganizations and management changes though it continues to be a powerful player in the competitive rankings. Out of British origins, however, are now

rising three other hybrid market leaders, UBS with Philips & Drew (9th), Deutsche Morgan Grenfell and SBC Warburg (ranking 12th and 13th, respectively), and perhaps two other contenders, ABN Amro (17th) and Hong Kong & Shanghai Banking Corp. (22nd). It is possible to say that of the top twenty firms identified as market leaders in Exhibit 5, seven are firms that have British origins, though all are now owned by non-British banks.

Trading Markets

Bond markets in EU countries as of December 31, 1996 totaled approximately $7,600 billion of outstanding issues. Of this amount about $4,200 billion represented public sector issuers, of which $2,600 billion, or 62%, was issued by government bodies in Germany, Italy and France. Corporate bonds issued by EU countries (companies, banks and savings institutions) amounted to more than $2,300 billion sold in domestic markets, and $1,000 billion of international bonds. These bonds are sold within the country of issuance and to other investors in and out of the EU, but they were predominantly bought by institutional investors, both from EU countries and outside them. See Exhibit 6.

Exhibit 6 (European Bond Markets)

The bond market is facilitated by the volume of trading in the foreign exchange markets, which during 1995 averaged about $1,500 billion per day.[19] Trading is encouraged by arbitrage and proprietary programs undertaken by investors and large

[19] BIS, *Annual Report, 1967,* Table V5.

Exhibit 6

European Bond Market

(US $ Billions at 12/31/96)

Country	**Total Bonds Outstanding**	**Public Sector Debt**	**Corporate & Other Bonds**	**International Bonds**
Germany	2,303	839	1,161	304
Italy	1,274	998	188	88
France	1,044	732	153	160
UK	662	447	33	183
Netherlands	401	200	120	81
Belgium	387	223	127	38
Denmark	288	104	175	9
Sweden	253	118	131	4
Spain	234	185	34	15
(ECU)	130	66	-	64
Austria	133	59	61	2
Other EU	252	182	50	20
Total EU	**7,361**	**4,153**	**2,233**	**968**

market-makers and financial intermediaries all over the world. Such trading in government bonds is often highly leveraged as well. Further, the availability of currency swaps and other forms of derivative instruments, all of which have increased steadily since their introduction to the market in the middle 1980s, is helpful to traders who can accordingly manufacture "synthetic" securities by combining a bond and a swap contract, for example, to create a bond with a different financial exposure. Such synthetic securities permit arbitrage against authentic positions. As long as profit making opportunities exist, market operatives will take positions to benefit from them.

Trading in derivatives has grown substantially in Europe, in the over-the-counter markets (mainly for swaps) but also on futures exchanges London, Paris, Frankfurt and Zurich. See Exhibit 7. The availability of such extensive trading in derivatives has also assisted market-makers in taking positions in Ecu-denominated bonds, for which markets have existed since the early 1980s. It is likely that this market will be the forerunner of the coming market in bonds denominated in Euros. On February 1, 1997 the European Investment Bank issued Euro 1 billion ($1.18 billion) of bonds due in 2004. Payment for the bonds, and payments of interest and principal until January 1999 will be in Ecus, after which time all payments will be made in Euros. The issue, known in the market as the first "Euro Eurobond" was three times oversubscribed.[20]

Exhibit 7 (Swaps and Derivatives Outstanding)

Equity markets have also grown in importance and activity. The EU accounted for $2,200 billion in value of equity market trading, or 16% of all global equity trading

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[20] Richard Adams, "Boost for EMU at $1.18 billion Bond is Sold in Euros," *The Financial Times*, February 2, 1997

Exhibit 7

Financial Derivative Instruments

Notional Principal Outstanding

($US Billions)

	1996	1995	1994	1993	1992	1991	1990	1989
Exchange Traded Instruments	**9,884.60**	**9,188.20**	**8,862.5**	**7,771.1**	**4,634.4**	**3,519.3**	**2,290.2**	**1,766.7**
Interest rate futures	5931.1	5863.4	5,777.6	4,958.7	2,913.0	2,156.7	1,454.5	1,200.8
Interest rate options[1]	3277.8	2741.8	2,622.8	2,362.4	1,385.4	1,072.6	599.5	387.9
Currency futures	50.3	38.3	40.1	34.7	26.5	18.3	16.9	15.9
Currency options[1]	46.5	43.2	55.6	75.6	71.1	62.8	56.5	50.2
Stock market index futures	198.6	172.2	127.3	109.9	79.7	76.0	69.1	41.3
Stock market index options[1]	380.2	329.3	238.3	229.7	158.6	132.8	93.7	70.6
Over-the-counter instuments[2]	**24,292.00**	**17,712.60**	**11,303.2**	**8,474.5**	**5,345.7**	**4,449.5**	**3,450.3**	**1,951.7**
Interest rate swaps	na	12,810.70	10,800.0	6177.3	3,850.8	3,065.1	2,311.5	1,502.6
Currency swaps[3]	na	1,197.40	2,100.0	899.6	860.4	807.2	577.5	449.1
Other swap-related derivative[4]	na	3,704.50	1,500.0	1397.6	634.5	577.2	561.3	-

Source: BIS Annual Report, March 1997 (Table VII.5)

Data: Futures Industry Association, various futures and options exchanges, ISDA & BIS calculations

1. Calls and Puts
2. Data collected by the International Swaps and Derivatives Association (ISDA) only; the two sides of contracts between ISDA members are reported once only.
3. Adjusted for reporting of both currencies; including cross-currency interest rate swaps.
4. Caps, collars, floors and swaptions.

during 1996. (The United States accounted for 52% of the global equity trading total.)[21] However, because of the structure of European ownership of equity securities, the large portion of state owned enterprises still operating within EU countries and lower market valuations of many companies, the intensity of European equity market utilization lags well behind that of the United States and Japan. See Exhibit 8. It is likely that since the data in Exhibit 8 were complied (1993), the European markets have been much more active, and large privatization issues such as the $13 billion initial public offering of Deutsche Telekom have pushed European utilization higher. The expectation is that this utilization will continue to increase until in approximates the levels of the United States and Japan.

Insert Exhibit 8 (World Equity Market Utilization)

Trading opportunities, however, often depend on market volatility, and this volatility is affected not only by changing domestic market conditions, but also because of global market linkages and changing foreign exchange and interest rates. Many observers (but not all) believe that increasing trading volume in cash markets and derivatives contributes to a dampening of volatility. This may be evident in U.S. dollar bond and stock markets, and in many foreign exchange markets, since the early 1980s. Indeed, volatility of long-term U.S. government bonds, large U.S. company stocks, the French Franc-Dollar rate and the DM-Dollar rate, have fallen to levels about half what they were at their peak in the mid 1980s. Volatility in these instruments is as low in mid 1997 as it was at any time since 1979-1980, though factors others than increased trading

[21] Securities Industry Association, *1996 Securities Industry Fact Book*.

Exhibit 8

World Equity Market Utilization (1993)

($US Billions)

	No. of Domestic Listed Companies	Market Capitalization	GNP	Market Capitalization per GNP %
USA	7,246	5,136	6,388	80.4%
Japan	2,155	3,000	3,927	76.4%
E.U.	4,458	2,830	7,234	39.1%

Data: International Finance Corp.(1996)

volume are involved. See Exhibit 9.

Exhibit 9 (Volatility Charts)

Many market participants have discovered that trading in increasingly efficient markets is not an easy business. Indeed, much money was lost in Europe during 1994, a bear market year for bonds, by traders who had open positions instead of fully hedged ones. The traders discovered that the cost of hedging consumed all their expected profits, so they decided instead to bet on their "feel" for how the market would develop. Getting the feel wrong may have cost S.G. Warburg its independence.

The Emerging Power of Pension Funds

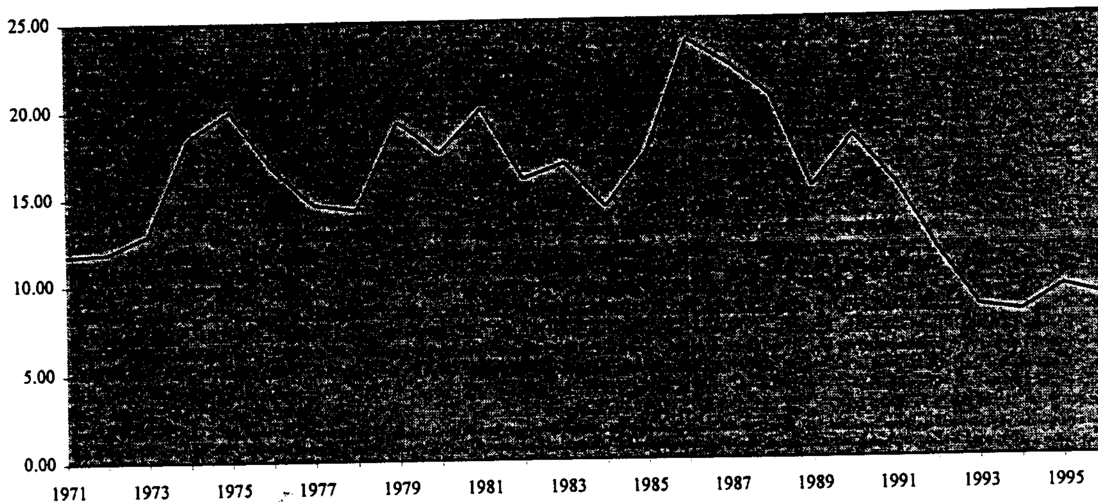
At December 1995, the world's funded pension assets amounted to $8,000 billion, of which $4,519 billion were in North America, $1,963 were in Europe, and $1,474 were in the Pacific Basin countries. The funded investments in Europe were substantially lodged in the United Kingdom ($900 billion), the Netherlands ($327 billion), Switzerland ($280 billion), and Germany ($140 billion). A leading American pension fund consultant, InterSec Research Corp., estimates European funded pension funds to grow about $3,000 billion by 2000, reflecting a growth rate of about 9% per annum.[22] This growth is in response to popular demand for greater amounts of pension security, which in most European countries is on a pay-as-you-go basis that has to be funded each year in the national budget. The $1,000 billion of growth in pension assets outstanding will provide substantial additional opportunities for money management firms and will add

[22] InterSec Research Corp., Client Memorandum, June 30, 1996.

Exhibit 9

Volatility of Large Company Stocks and Long-term Govt. Bonds

Annualized Monthly Standard Deviations (3 Yr Average)



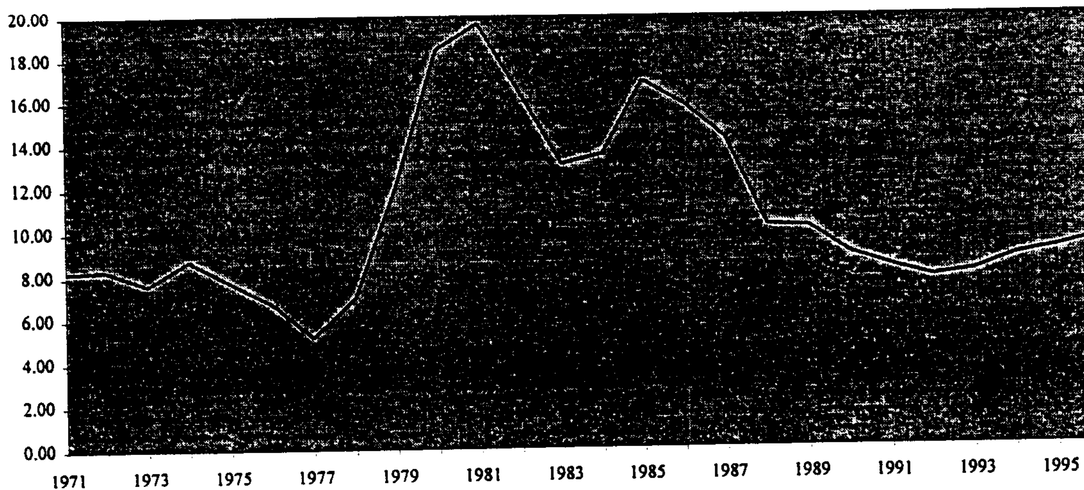
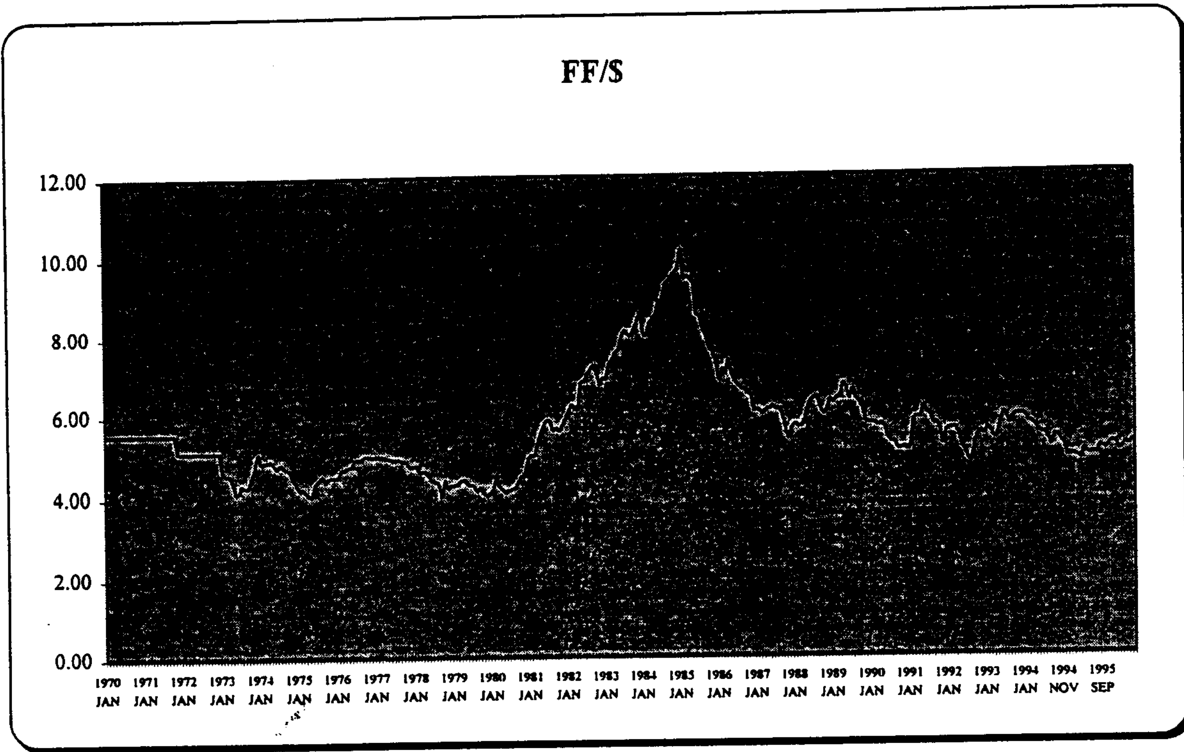
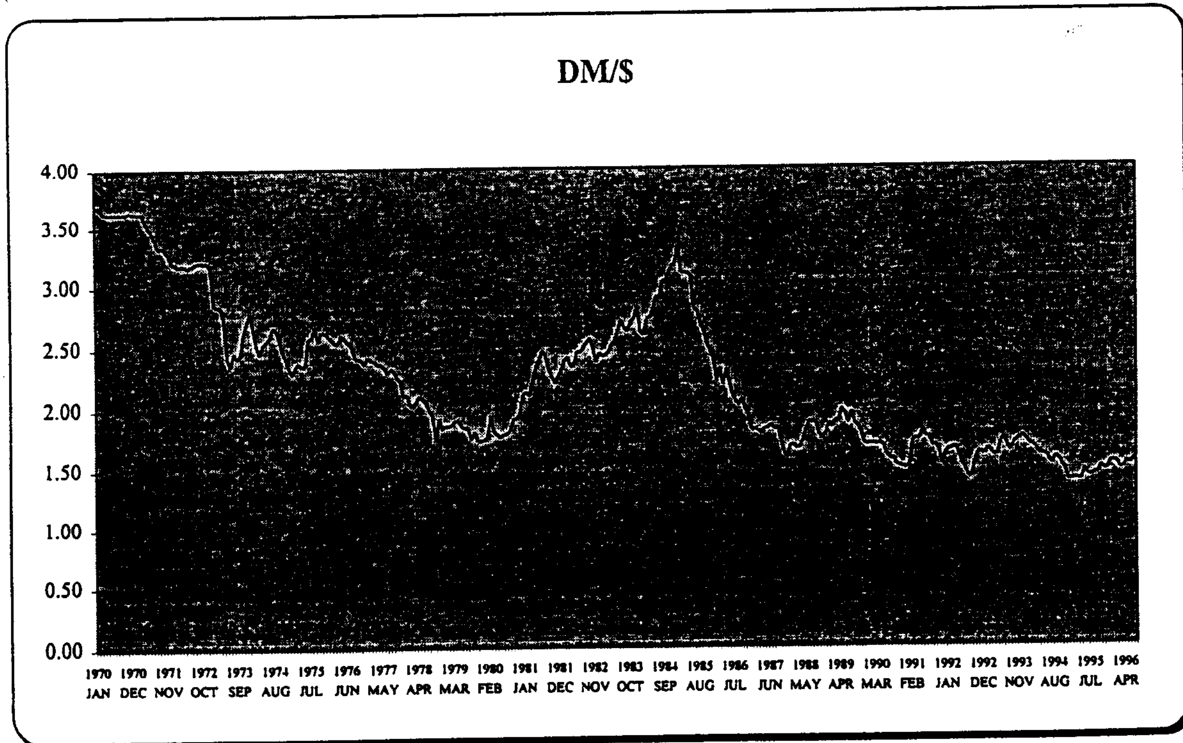


Exhibit 9 (contd.)

Volatility of Exchange Rates: FF/$ and DM/$

(3 Month Average)





considerably to the support of European equity markets. In the United States and the United Kingdom, between 30% and 50% of new pension fund money has been invested in equity securities.

European "Restructuring"

Europe of course has experienced other economic and regulatory changes that are unique to itself, the Single Market Act and the Maastricht Treaty perhaps being the most important of these. However, the intense merger and acquisition activity in Europe since 1985, valued at more than $900 billion in completed transactions, has also been important. This activity has been attributed to the need on the part of corporations to reposition themselves for both the Single Market and for the more closely linked global market for their products and services, and to improve performance and become more competitive.[23]

Today, the term "restructuring" is popular in Europe to describe efforts by major companies to improve profits, returns on investment and market values by shedding subsidiaries, trimming work forces and investing more in new technologies and overseas production.[24] A number of notable restructuring successes have been reported in Germany (Veba, Daimler Benz, and Hoechst), but the effort is generally thought to apply across the continent. A major Wall Street firm pointed to special, self-initiated restructuring success at Zurich Insurance, Unilever and the Rank Group during 1997.[25]

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[23] Ingo Walter and Roy C. Smith, *Investment Banking in Europe -- Restructuring for the 1990s*, London, Basil Blackwell, 1990. pp 5-21.

[24] Boom and Gloom in Germany," *The Economist*, April 5, 1997.

[25] Goldman, Sachs & Co., "Passing the Baton on Corporate Restructuring," April 9, 1997.

Some of the impetus for restructuring has come from aggressive domestic investor groups, partly as a result of observing comparable activity on the part of their U.S. and British fund manager counterparts. Some has come from determined, impatient European managers eager to make headway in the difficult job of remaking companies.

Several hostile transactions have been attempted to achieve restructuring, something not generally associated with European industry. The Krupp-Thyssen takeover effort in early 1997, for example, was resisted by Thyssen, but financed by Deutsche Bank and Dresdner Bank (it's "Hausbank"), and included Goldman Sachs as an advisor. The offer was called off in favor of direct negotiations between the companies after protests by the trade unions involved, but the net result was still the consolidation of the two steel works and a significant downsizing of the work force. A previous successful hostile transaction resulted in the combination of Krupp and Hoechst Steel in 1995.

Similar restructuring efforts have been occurring in Europe for several years, especially in the manufacturing, chemicals, banking and finance, and telecommunications industries. Unfriendly transactions continue to be rare in Europe where they have averaged 11% of all transactions since 1985 (as compared to an average of 18% in the United States, and 14% in the U.K.), but they have successfully been completed in all countries.[26] Even when an unsuccessful takeover attempt is made, there are usually concessions made by the target management that might not have occurred otherwise, so that there may be some restructuring value in even unsuccessful bids. Also, the perceived threat of an unfriendly takeover has shaken many companies out of their complacency and into some form of self-restructuring.

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[26] DeLong, et.al., *Global M&A Tables, Op Cit.*

Another development in Europe has been the increasing use of stock markets to affect initial public offerings of privately-owned, mid-sized, or "Mittlestand" companies as well as for privatization issues. Creating a public market for a company's stock means that it is subject to reporting requirements, performance measures and investor scrutiny which tend to contribute to an attitude on the part of management to run the company more profitably and productively. Exhibit 10 is a list of several mid-sized German companies that had recently gone public, or were scheduled to go public, in October 1996.

Exhibit 10 (German companies to go public)

Changing European Players and Strategies

Many of the changes affecting European banks during the past decade are the same ones that shaped important changes in American banking. Credit losses, disintermediation, regulatory changes, technology developments and increasing competition from foreigners and from nonbanking enterprises have put most European banks under the gun to rethink their long term strategies. Banks now have to think both offensively and defensively—to assure access to important new markets in the pan-European context and to protect their existing, mainly domestic, market positions. They have also had to address the changing nature of wholesale banking, which now depends on market activity, and of retail banking which depends more heavily than ever on improved technology and services. They know that, after centuries of serving mainly as safe places for depositors to put their money, they now have to be competitive as well or they will lose business to those who are. This is a difficult and stressful time for

Exhibit 10

German Companies Going Public

(as of October 1996)

Company	Business	Date of Issue
Binder Optik	Opticians	1996/1997
Dt. Oberflachenfechnik	Suface treatment plants	1996/1997
Deutsche Telekom	Telecommunications	Fall 1996
DIS	Employment Agency	Summer 1997
Dragoso Gerberding & Co,	Perfumes	1996/1997
Gardena	Garden equipment	1996/1997
Grapel	Mechannical enginerring	1996/1997
Grammer	Seating	Fall 1996
Eurobike	Motorcycle accesorries	Summer 1996
HLB Bau-Stahl Holding	Steel trading	1997
Homag AG	Mechanical enginerring	1998
Integrata Training A.G.	Training	1996
Klockner & Co.	Trading	After Jan. 1
Konsortium Stuttgart	Investment Company	June 1996
Pro Sleben	Television	Summer 1996
Leicht Kuchen A.G.	Kitchen Furniture	1997
Nordenia	Plactic packaging	1996/1997
Remmers	Building, Chemicals	1996
Rinol A.G.	Coating systems	1997
Sanacorp	Phamaceuticals	Fall 1996
Stella Musical	Music	1996/1997
Tank and Rast	Service	1997
Techem	Heating	1996/1997

Data: Financial Times, Oct. 1996

European banks (as the 1980s was for U.S. banks). Several trends have been observed that indicate how many banks are resolving these issues.

The first trend is towards increasing the size of banks, through mergers and consolidations, in order to present a more powerful defense of the domestic franchises. During the twelve years from 1985-1996, financial service acquisitions accounted for more than $2,500 billion, 44% of the global total. Of this amount, $1,158 billion or 46%, were transactions that occurred outside the United States. Further, non-US domestic and cross-border mergers and acquisitions of banks and other financial service firms during the period involved more than 7,000 transactions valued at $907 billion (74% of these were domestic transactions). The financial services industry comprising $284 billion in transactions for the twelve-year period under study, was the most active of all industries in Europe involved in mergers and acquisitions (as it was in the United States for the same period).[27] See Exhibit 11. Though many of the mergers were the result of failed lending policies during preceding years, they have nevertheless created new banks that are among the largest in Britain, France, Germany, Italy, the Netherlands, Sweden, Norway, Denmark, Belgium, Austria, Spain, and Portugal (as they have also in the United States and in Japan). In many such cases the mergers have resulted in increase competitiveness and the introduction of new products and services, such as insurance, especially at the retail level.

Insert Exhibit 11 (Financial Service Industry Acquisitions)

Approximately 87% of all global financial service industry combinations involved

[27] DeLong, et.al., *Global M&A Tables, Op Cit.*

Exhibit 11

Completed Global Financial Services M&A Transactions, 1985-96

($US Billions - thousands of transactions)

	1985				1996				12 Yrs 1985-96			
	$ Value	(%)	#	(%)	$ Value	(%)	#	(%)	$ Value	(%)	#	(%)
US Domestic												
All Industries	192.5	82.6%	0.8	72.7%	340.6	45.2%	6.9	43.7%	2,859.5	49.2%	50.9	42.0%
All Financial Services	47.9	82.3%	0.7	77.7%	114.5	39.8%	2.4	42.9%	1,172.7	46.6%	19.9	45.1%
US Cross-Border												
All Industries	15.7	6.7%	0.1	9.1%	93.4	12.4%	1.7	10.8%	679.0	11.7%	12.6	10.4%
All Financial Services	6.3	10.8%	0.1	8.6%	15.8	5.5%	0.3	5.4%	185.9	7.4%	2.8	7.4%
Non-US												
All Industries	24.8	10.6%	0.2	18.2%	319.2	42.4%	7.2	45.6%	2,271.4	39.1%	57.7	47.6%
All Financial Services	4.0	6.9%	0.1	8.6%	157.4	54.7%	2.9	51.8%	1,158.2	46.0%	21.7	47.5%
Total												
All Industries	233.0	100%	1.1	100%	753.2	100%	15.8	100%	5,809.9	100%	121.2	100%
All Financial Services	58.2	100%	0.9	100%	287.7	100%	5.6	100%	2,516.8	100%	44.4	100%

Data: Securities Data Company

intra-sectoral transactions (i.e., banks and banks, insurance companies and insurance companies). Few cross-border bank-to-bank acquisitions have occurred, however, through Deutsche Bank's acquisition of Banca d'America e d'Italia (from Bank of America) in 1986, Crédit Lyonnais' acquisition of Bank fuer Gemeinwirtshaft in 1986 and Hong Kong Shanghai Bank's acquisition of Midland Bank in 1992 are significant exceptions. Also, a few significant inter-sectoral transactions have occurred, such as Swiss Bank Corporation's acquisition of S.G. Warburg & Co. and Dillon Read & Co., ING's acquisition of Barings PLC., and Dresdner Bank's acquisition of Kleinwort Benson. The industry's early interest in "strategic alliances" among banks in different countries has appeared to have faded. Acquisitions of minority interests in financial service companies accounted for only 15% of global transactions, mainly in emerging market countries.[28]

Another trend is related to the role of mergers in bringing about changes in corporate control. Corporate governance matters are now the subject of acute interest in Europe, and in the light of the dominant role played by banks in many countries, governance issues related to banks have attracted much attention. The most celebrated case was the unsuccessful effort during 1995-1996 by Martin Ebner to win control of Union Bank of Switzerland. Ebner, a minority investor in the bank, in essence attempted a proxy fight for control of Switzerland's most prominent financial institution, and lost—but not without gaining months of sympathetic press attention and a number of

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[28] Roy C. Smith and Ingo Walter, "Global Patterns of Merger and Acquisition Activity in the Financial Services Industry," Paper presented at the conference on Financial Institutions Mergers, NYU Salomon Center, Oct. 11, 1996. Revised February 1997.

concessions by management. In the United Kingdom, the board structure and governance procedures of Barclays Bank was much in the press.

Also in France, Germany and Sweden issues have been raised as to the best way for the great power of large universal banking institutions to be governed. In particular, this attention has focused on the industrial holding of banks, and the role of the banks in governing these so-call "Hausbank" companies, especially in the light of very poor results of a number of important (and closely watched) clients of Deutsche Bank, Crédit Lyonnais and Banque Indosuez. In many cases, it is now expected that these and other large universal banks will begin to shed some of their industrial holdings, as they are no longer as important as they were, tie up capital unproductively, and create major headaches for management. Indeed, even Deutsche Bank, through is head of corporate finance Ronaldo Schmitz, has said it had decided that reducing its 28% shareholding in Daimler Benz was appropriate as Germany stood on the brink of "the most significant industrial reconstruction since the second world war."[29]

A final major trend has been the internal combination within universal banks of their corporate banking operations and their investment banking or securities arms. Originally this was done by Barclays and National Westminster banks in the U.K., but later some of the major Swiss, German, Scandinavian and Dutch banks (and U.S. banks such as J.P. Morgan and Bankers Trust) followed suit. This has resulted in a major change in the organizational structure of the European universal bank, from a monolithic, hierarchical, one-board-decides-all structure that emphasized safety and depended on

[29] David Waller, "Deutsche Bank Re-thinks Stake in Daimler Benz," *The Financial Times*, March 18, 1993.

captive clients, to a more streamlined approach that permits autonomy of decision making within separate sectors of the bank.[30]

The new structure assumes that clients will not remain loyal unless they receive the best rates and executions in wholesale finance and to deliver these the banks have to become more specialized and focused, and free from high-level interference in their competitive activities. These changes have not come without considerable problems, however. The problems mainly concern how much control over overseas activities the head office is to retain, knowing that to be competitive the banks have to delegate considerable autonomy to market specialists—and how much to retain and by whom. Many disputes have arisen between traditional commercial bankers involved with domestic and overseas lending and the new securities people. These disputes cover compensation, and matters of "turf," or who is to be responsible for particular clients and territories. But they also embrace some new areas. Swiss Bank Corp., for example, promoted several of the young, very smart and aggressive American executives from O'Connor to high executive positions in Zurich and London, much to the chagrin of the traditional Swiss officers of the bank who were displaced. Few Swiss were prepared for a system in which they would have to report to a profit-driven American several years younger who was sitting right there at headquarters. Deutsche Bank has struggled with issues of control at Morgan Grenfell, especially after an undisciplined Oxford-educated portfolio manager there cost the bank about $700 million, and Dresdner has recently let go the popular CEO of its Kleinwort Benson subsidiary over policy disputes about who

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[30] Ingo Walter, "Universal Banking: A Shareholder Value Perspective," Universal Banking Conference, Basel, Nov. 1996, forthcoming, *European Management Journal*.

would control the increasing activities of Dresdner Kleinwort Benson that were not located in London.[31] These cultural and management problems must seem endless to many of the European banks trying to reposition themselves.

Non-European Players in Europe

American firms operating in Europe have, with few exceptions, built their own organizations by hiring talented Europeans and mixing them with American colleagues in on-the-job training. For reasons mentioned earlier, American firms have had certain comparative advantages (including the huge size of their domestic market) that have assisted them in securing leadership in the global market. Nine of the top ten, and 15 of the top twenty firms in Exhibit 5 are American or have American origins. However, even among American banks and investment banks, only a relatively small number (fewer than 20) continue to compete for global wholesale leadership. Citibank has deliberately given up market share, preferring to concentrate on consumer financial services and services in emerging markets. NationsBank and Bank of America, ranking 16th and 19th, respectively, generate most of their origination volumes from U.S. domestic business. Bankers Trust failed to make the top 30 wholesale banking firms in 1966 although it has been among the top 20 several times in the past. Nonetheless, J.P. Morgan, now widely recognized as a highly competitive investment bank (no longer a commercial bank) has earned high ranking.

Other Europeans possibly attempting to find places among the top twenty are

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[31] Andrew Fisher, "Dresdner to Run Investment Arm from Twin Cities," *The Financial Times*, April 14, 1997.

Schroders and Paribas. Virtually all others (including the Japanese, who a few years before were seen as extremely strong competitors) have decided not to compete for leadership positions in the global wholesale finance market, preferring to concentrate on domestic opportunities of various types. Today these include various other financial services from credit cards, to insurance and funds management.

IV. The Securities Markets After the Euro

At this point, one thing should be clear: the securities industry in Europe has been and is continuing to undergo major changes in its structure and organization regardless of what happens with the EMU and the Euro. These ongoing changes may be of greater importance to the industry than those related to the change in the European monetary system. However, without doubt, the anticipated changes in the EMU will affect the marketplace in which the securities firms operate. To the extent that they increase the overall trading volume in securities, and the premium placed on innovation, trading skills and distribution capacity, and global reach they may also affect the size of firms and their apparent need for consolidation into even larger entities. To the extent that this occurs, the impact of the Euro on the securities industry could be very important indeed.

Of course there remain many uncertainties. These include the efficiency with which the exchange rates are set for those entering the system on January 1, 1999, which countries will be included in the original group[32], and which will be outside the

[32] As of mid 1997, the countries appear to be divided into a "hard core eight" (Belgium, Germany, Finland, France, Ireland, Luxembourg, the Netherlands, and Austria) which should go join from the outset, and an "outer seven" (Denmark, Greece, Italy, Portugal, Spain, Sweden and the U.K.), which won't. The main consideration is whether countries representing a critical mass of securities

system. There are also the questions of whether the benefits of establishing the new system will exceed the costs, as is now widely predicted by public officials, and what will happen in 2001 when the opt-out countries are expected to come into the EMU. These factors will determine how quickly the Euro-effect will take hold in the markets.

Those seeking financing in the markets will continue, as they do now, to compete for money, as, for example, when different European governments consider issuing Eurodollar bonds. For the next few years, including probably the period between 1999 and 2001, competition will continue to rely mainly on credit ratings, innovation, tapping particular maturities, and other devises used to achieve lower rates. But in the longer run, it is intended and expected that the effectiveness and transparency of the EMU should lead to a further convergence of fiscal policies so no one country within the EU has a significant advantage over other countries. To the extent that this means a movement towards freer and more open markets and away from European mixed-economy social policies and political attitudes, then it may mean a rise in productivity for the entire EU region, but there is no certainty that this will occur.[33] Nor is there certainty to the proposition, posed by the EU itself[34] and many Euro advocates, that the changes will increase market integration, lower overall costs of capital, or result in more efficient bond auctions by governments.

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outstanding in the market, especially Germany, France, and Italy enter at the outset.

[33] See also Andrew Fisher, "European Bourses May Get Lift on Back of EMU," The Financial Times, April 15, 1997. This article refers also to an interesting study by Alexander Schraeder, of Bayerische Vereinsbank.

[34] European Commission, *Green Paper on the Practical Arrangements for the Introduction of the Single Currency*, Brussels, May 31, 1995. pp.10-15.

But the changes will invariably affect the markets in a number of ways, and indeed have already begun to do so. The BIS has reported that implied exchange rates calculated out to ten years forward, based on yields on interest rate swaps, indicate that the currencies of a number of European countries are expected to be stable against the DM. It also reported that the volatility of many intra-European exchange rates declined significantly during 1996—the implied volatility in the French Franc/DM averaged 2% in 1996, compared with 7% in April 1995—and foreign exchange volume diminished somewhat as a result. These factors suggested to the BIS that approximately 10% of the foreign exchange market (based on its 1995 survey of foreign exchange trading in 26 countries) could disappear with the advent of the Euro.[35]

A market shrinkage of this proportion could have several effects on market participants. First, foreign exchange trading opportunities, already being squeezed by reduced volatility and electronic trading, would be reduced further, driving some traders and market-makers into new markets in neighboring countries, thereby perhaps significantly increasing competition to be faced by smaller market players in individual countries (like Belgium) which had the local market largely to themselves before the introduction of the Euro. Second, dealers may be driven to expand their business in riskier or higher margin areas, such as trading derivatives, or the Euro against emerging market currencies. This trend too could be disadvantageous to smaller, national players without experience or an international infrastructure. The BIS estimates that such

[35] BIS, *1997 Annual Report*, pp 80-81.

business may represent over one-third of the volume of the intra-European trading that may disappear with the Euro.[36]

Money Markets

Intra-European trading volume in individual instruments will be replaced, it is assumed, by greater extra-European trading in Euro-denominated instruments and in instruments denominated in the currencies of the opt-out countries. Assuming membership of the countries currently expected to join, the market in Euros that will emerge will be larger and more liquid than any single European currency market that it will replace, thus generating perhaps a greater interest by non-Europeans in holding Euros. Several portfolio shifts might be expected:

First, non-participating European and non-European central banks will invest a portion of their reserves in Euro-denominated investments. Second, major European institutional fund managers will adjust their portfolios to reflect the investment outlook that the Euro-denominated instruments present to them. There is already some concern that the Euro may be significantly less inflation-proof than the departing DM, and that such a concern may generate higher rates, on one hand, or greater demand for Swiss Franc investments, on the other. Many economists, however, believe that the Euro may emerge as a better long-term reserve asset than either the Deutsche Mark or the French Franc. Accordingly, many investors, including non-European investors (especially from the United States and the Far East) will take up Euro positions as a part of their overall

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[36] *Ibid*, pp 81-83.

portfolio diversification efforts. To them, a larger, more liquid market in Euro-denominated securities than the fragmented markets they replace should be welcome. The latter two portfolio shifts will also be affected by increasing investment in European and Asian pension funds over the next several years which will direct a substantial flow of new money looking for a variety of liquid and creditworthy investments into the markets.

Also, the new European Central Bank will presumably absorb all of the reserves of the EMU participating countries (for all EU members, reserves excluding gold totaled $370 billion at Dec. 1996, far more than those of Japan or the United States). Even after netting EMU member countries' holding of other member's currencies, this development could lead to a condition of substantial excess reserves. What will be done with the surplus?[37] Unless they can be returned to the countries in the form of a cash distribution, the expectation is that the conservative German-influenced European Central Bank will hang on to the surplus to provide a fund to stabilize the Euro against the dollar and the yen. Might this mean a much more active intervention policy on the part of the new central bank, which would push Euro rates below their equilibrium level? Such rate levels might become very attractive to issuers of securities. A surge of Euro new issues might result, at least for a while. Any interventionist activity would, however, also be of great interest to international foreign exchange speculators who are inclined to take the opposite side of the market from government operators.

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[37] "The Euro and the Dollar," *The Economist*, October 19, 1997.

Bond Markets

Despite the many uncertainties associated with the EMU, there are some things that nevertheless appear to be fairly predictable:

When the conversion process is complete, it will formalize the existence of the world's second largest bond market after the United States. Initially, about two-thirds of the $7,600 billion European bond market, and approximately half of the nearly $4,200 billion government bond market, will be denominated in Euros as the amounts of bonds outstanding in the opt-out countries (except for Italy) are relatively small compared to the whole. The new bond market will be segmented into at least three parts:

> (1) the *Euro-Eurobond* sector for issues by international institutions such as agencies of the EU and the World Bank, and perhaps some major multinational corporations whose currency composition is European or global (e.g. Nestle, Unilever, Shell). These will be issued free of withholding taxes and in bearer form as previous Eurobonds were.
>
> (2) the *Euro-sovereign* sector for issues by the in-governments and major national private corporations. These bonds will replace domestic bonds in the participating countries, and presumably will be issued to retire outstanding domestic-currency denominated bonds.
>
> (3) issues in *non-Euro* currencies, including new bonds issued by the opt-out countries and old bonds still outstanding in non-Euro currencies, including Eurodollar bonds, presently the market's largest component.

The first segment of Euro denominated bonds (which is not expected to be a large one because of the limited supply of such supra-national issuers) will trade in the market on the basis of the creditworthiness of the issuer and liquidity alone. As there is no benchmark reference for direct EU obligations denominated in Euros, the market will have to establish a pricing regime for such issues, perhaps by comparing the offering

yields to U.S. Treasury securities on a swapped-in basis.

The second segment, which is expected to be by far the largest, will discriminate between EMU countries and trade at prices reflecting creditworthiness, liquidity and sovereign economic factors. This means the market (like the U.S. municipal bond market) will impose a risk-premium relative to a base-rate (agencies of the EU itself or possibly German or French sovereign issues) for Euro issues of different sovereign and most corporate credits. The premium will reflect the market's valuation of national fiscal policies and economic results, and the liquidity available in bonds from such issuers. Under such conditions there is as much potential for spread differentials and volatility between issuers as there is in today's market.[38] Indeed, the market makes such distinctions today in choosing between EU member country debt issues (which range in credit ratings from Aaa to Baa1) by applying a yield differential. See Exhibit 12. Sophisticated U.S and Japanese investors may not see much difference in the new system (for either bonds or stocks) from that in which they invested prior to conversion, although the rate differentials will most likely be somewhat different. Also, prior to the Euro they could invest in European securities on either a currency-hedged or unhedged basis. Subsequent to the Euro, this will still be true but the difference in unhedged returns associated with particular currencies will appear partly in terms of the Euro exposure and partly as a result of the intra-EMU sovereign yield differential.

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[38] Mark Fox, "The Shape of the Future Euro Market," Lehman Brothers, August 15, 1996. The author acknowledges that the U.S. municipal market is frequently referred to as a good model for the Euro market. But he notes that the U.S. municipal market is different because the issuers are within a single sovereign state and have operated as a single currency area for a long time and therefore the Euro market may operate somewhat differently. Also, most U.S. municipal issues are sold free-of U.S. tax liability on income, which means that most investors are individuals not institutions.

Exhibit 12 (Sovereign Debt Ratings)

Equity Markets

The Euro denominated stock markets will become the world's third largest, and Europe's largest in terms of market capitalization and trading volume. The market, however, will still be disbursed over a minimum of eight to ten different stock markets that with few exceptions will continue to have a high national concentration. Investors seeking unhedged (against currency risk) investments in different European companies will, as will bond investors, have to accept Euro denominated securities instead, though the prices of the individual stocks should reflect companies' differing exposure to particular national economies. Investors seeking hedged investments may find it easier and less expensive to cover Euro risk than the other, preceding currencies, but the substantial majority of investors in European stocks have been willing takers of currency risk. Initially there may be little difference in valuation of stocks from the different countries.

However, as investors become more familiar with the Euro, there may be created a fungibility between stocks from different countries that has not yet fully developed. There has been an increase in the correlation in stock market returns between the different European countries in recent years, caused by increasing European cross-border trade, investment and acquisitions, and this correlation may increase further as a result the market integrating effects of the EMU. See Exhibit 13. The increasing correlation may be seen by some investors seeking diversification under the protocols

Exhibit 12

Sovereign Debt Ratings for EU Countries and Debt Pricing Spreads

(March 10, 1997)

Country	Standard & Poors		Moody's		Debt Pricing (bp)	
	Local Currency	Foreign Currency	Local Currency	Foreign Currency	Local Currency (relative to U.S. Treas.	Foreign Currency
Austria	AAA	AAA	NR	Aaa	-18	-8
France	AAA	AAA	Aaa	Aaa	20	-17
Germany	AAA	AAA	Aaa	Aaa	22	-4
Netherlands	AAA	AAA	Aaa	Aaa	-22	NA
Luxembourg	AAA	AAA	NR	Aaa	NA	NA
Britain	AAA	AAA	Aaa	Aaa	-6	-11
Belgium	AAA	AAA	NR	Aa1	-9	-10
Denmark	AAA	AA+	Aa1	Aa1	-17	-12
Sweden	AAA	AA+	NR	Aa3	10	-12
Italy	AAA	AA	Aa1	Aa3	100	55
Greece	AAA	BBB-	NR	Baa1	-6	5
Spain	NR	AA	Aa2	Aa2	-5	-4
Portugal	AAA	AA-	Aa2	Aa3	NA	NA
Finland	AAA	AA	Aaa	Aa1	-27	-1
Ireland	AAA	AA	Aaa	Aa1	-8	NA

Data: Deutsche Bank Research, "EMU Watch", No. 28, Table 4, March 10, 1997.

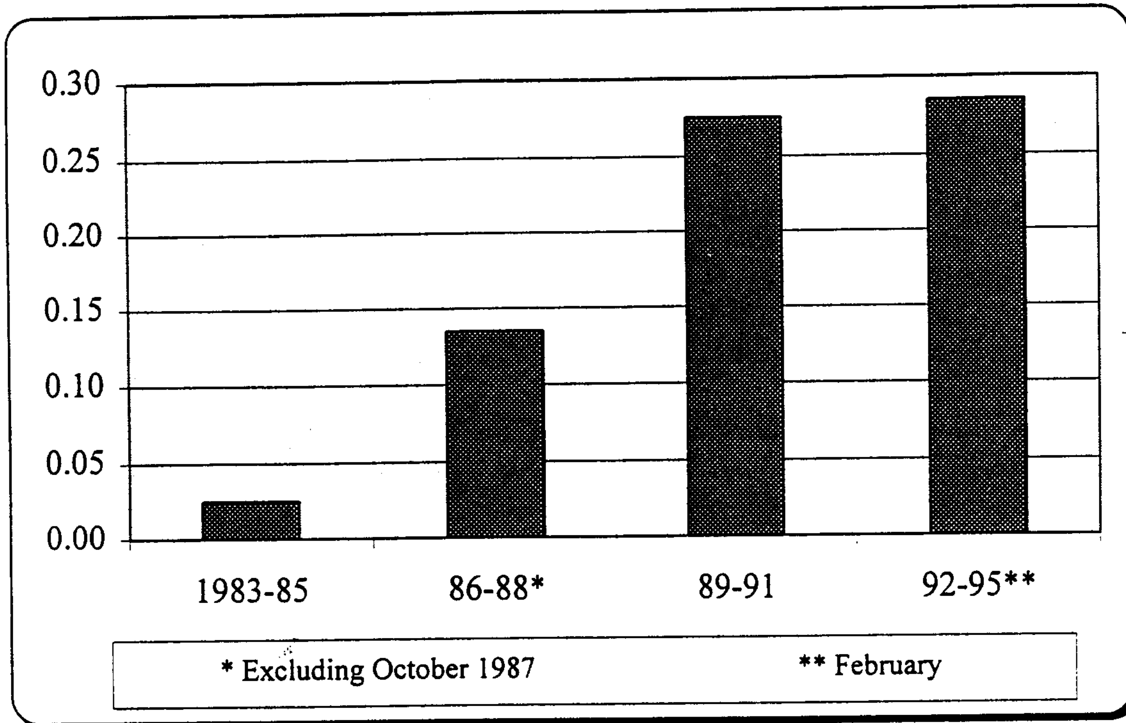
of modern portfolio theory as a negative development which would reduce investment activity. On the other hand, to the extent that market liquidity increases as a result of increasing fungibility; institutional activity on the part of large EMU institutions, especially pension funds, also increases and the markets begin to cohere as if under a single trading and regulatory regime as in the United States. Then there may be substantial advantages to investors in the European market that are absent today. Among these could be substantial increases in block-trading activity, investor services and discounts, shareholder activism that promotes improved corporate governance, and anti-fraud enforcement. Such advantages should contribute significantly to improved operating and competitive conditions of the stock markets.

Insert Exhibit 13 (Correlation of European Equity Returns)

Equally important, however, will be the continuation of (a) privatization programs in Europe (estimated by one analyst at $300 billion over the next ten years) that create new supplies of stock to be traded, (b) growing investor activity and sophistication on the part of stock-investing institutions such as pension funds, (c) continued corporate restructuring through mergers and acquisitions, and (d) increased use of capital markets by corporate issuers previously dependent on banks for financing, and on the part of issuers from Eastern Europe and the former Soviet Union. These dynamic factors make big changes in the market environment of the securities industry.

Exhibit 13

Average Correlation of EU Stock Markets with Germany's



IV. After The Euro

The totality of the changes anticipated with the introduction of the single currency and the EMU are considerable, especially after 2001 when current membership issues will finally be resolved. The prospect of achieving the many goals of European economic and monetary union are exciting to those who are able to look forward to a strengthened, unified and productive European single market, the largest in the world. There are many, however, who are less confident that the benefits of EMU will actually exceed the costs of achieving it. The Deutsche Bank estimated that it alone would spend DM400 million on conversion of its banking and financial systems to accommodate the Euro. Similar costs extended throughout the entire European banking community might well threatened to exceed saving in foreign exchange hedging costs on the sale of goods and services within Europe. Indeed, it is very likely to may take several years to recover the initial investments required of the financial services sector in Europe.

On the other hand, the EMU contemplates a variety of benefits to appear that are not directly related to trading patterns. Among these might be included improved capital market activity, lower financing costs for industry, increased corporate restructuring, more sophisticated pension investment practices, greater global awareness of market opportunities and, in general, a more vigorous and enterprising financial marketplace. It is perhaps unlikely that a single currency and monetary system could have induced such powerful developments in the old European capital marketplace of ten or fifteen years ago. But because of the flood of major changes and competitive pressures that have developed since that time, the markets are now ready to make the most of the next

wave of changes. Such changes have the potential to make Europe a contender for world financial leadership in the next century.

But without the first wave of changes—the major reforms and responses to market pressures to compete that have passed over Europe, in many cases after beginning in the United States—it is unlikely that the great potential could be realized. Indeed, the first wave has not nearly been completed, and much more needs to be done to bring the major European financial houses up to American standards of market awareness, global reach, competitiveness, profitability, and shareholder value.

In the meantime, over the next few years, we can expect to see the following:

- Market forces, fueled by the free flow of funds and increasing institutional interest in global diversification, and by the fierce competitive activities of successful American and other firms, will continue to make European capital markets more efficient and attractive to those seeking to raise, or invest, large amounts of funds. These forces will also compel more restructuring of European corporations and institutions, through privatizations, takeover activity, and greater efforts by shareholders to assert their will on entrenched management.

- These forces, including the need to improve the returns to shareholders provided by European banks, will also bring to Europe much of the separation of wholesale and retail financial services that has occurred in the United States. The separation will require that separate, autonomous units be allowed to conduct the business of each, so that each can be as specialized and close to its market as possible. This development will put a lot of pressure on traditional European universal banks, to restructure themselves, or eliminate certain businesses altogether with which they have been associated over the years.

- Equally, the banks will not be able to function as permanent cross-subsidizers of unprofitable or inefficient activities to maintain prestige or the appearance of importance. Industrial holdings, branch office structures, and manning levels will all have to justify themselves if the banks are to be competitively effective. Even government-owned banks must adhere to these new conditions: their fiscal restrictions are such that they can no longer afford the sorts of mishaps experienced by Cr¾dit Lyonnais. Indeed,

every opportunity to privatize a business will have to be taken. Once privatized, the banks become fully subject to all of the disciplines of the marketplace.

- Banks will also have to consider their basic business strategies in functional and geographic terms. Do they wish to stay in both retail and wholesale businesses? Or should they attempt to remain as national players only, or to become regional (trans-European) or global. Do they have the size or capabilities needed to remain independent, or are they better off selling out to another organization before competition erodes their market shares further.

- European banks seeking to remain as important wholesale market players will undertake (further) major management reforms to bring about an streamlined organization and decision making system that is highly flexible, risk-oriented, less hierarchical, adaptive to sudden changes and capable of competing directly with the best of the American firms.

- U.S. firms will continue to Europeanize themselves by hiring high placed and well-educated local nationals, and to compete for business from the inside as well as by offering attractive rates and ideas.

European banks must cope with these important developments while at the same time realizing that all of their future opportunities may not be contained in the EU. Indeed, the possibilities in Asia, Eastern Europe, Latin America, and the United States do not diminish because of the coming of the common currency. A potentially great danger to European firms in the near term may be to take their eyes off the rest of the world while waiting for things to happen in the EU. Altogether, meeting these various challenges require formidable management capabilities, and a fair amount of time and capital to spend to getting it all right. Doing this will not be something all banks can expect to achieve, increasing the possibilities that the banking community in Europe in ten or twenty years time will consist of a much small group of highly competitive, indeed, Americanized firms. It will be a very interesting time.