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INTERNATIONAL SECURITIES MARKET ASSOCIATION

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EU debt markets must embrace change for EMU survival: new ISMA report

(LONDON, UK) THE LAUNCH of European economic and monetary union (EMU) on January 1, 1999 has had a profound impact on financial markets within the EU. In response, a number of firms need to look more critically at their fixed income trading activity in order to ensure their long-term survival in the new single currency environment, according to an independent report published today by the International Securities Market Association (ISMA).

The Impact of the Euro on the European Fixed Income Market: A Post-Launch Appraisal and Outlook - commissioned by ISMA from the London-based European Economics and Financial Centre (EEFC) - embraces the findings of a global survey of some 1,100 financial institutions, comprising ISMA member firms as well as institutional investors, central banks, regulators and other organisations supporting the fixed income markets.

The report, compiled by the EEFC's Professor Hannah M. Scobie and a dedicated team of nine researchers, presents the key market developments that have unfolded since the launch of the new currency and suggests how market participants should be ready to adapt and revise their future strategies following its introduction.

Principal developments since the launch of the euro

A key observation made in the study notes that the introduction of the euro has led to substantial growth in the volume of new issuance, the size of each issue and the size of the tickets negotiated between traders. The report also indicates a number of further areas in which a manifest change has taken place since the new currency was launched, including:

- increased liquidity in certain segments of the market, e.g. bunds, at the expense of securities issued by the smaller euro-zone countries;
- increased consolidation and competition, particularly within the fund management industry;
- dramatic changes in placement and distribution, and clear signs of an end to relationships between local firms;
- substantial changes in primary dealership;
- a growth in credit analysis and credit trading; and
- a diminishing future for government debt.

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(i) Liquidity

Whilst liquidity overall is broadly unchanged as a result of the single currency, 50% of market participants taking part in the survey regarded the higher liquidity in certain segments of the fixed income market as one of the key elements affecting the industry following the launch of the euro. The market structure has become, on the whole, more fragmented and liquidity has migrated from the fixed income markets of smaller countries to those of the larger EMU members. For example, the German 10-year and the French 5-year bonds demonstrate greater liquidity, while the government bonds of countries such as Portugal, Finland and Ireland are traded less frequently.

(ii) Consolidation and competition

The introduction of the euro has prompted a wave of competition and consolidation across the financial services industry within the EU, one of the results being that the international ranking and position of banks is constantly changing. This, for a number of market participants, has proved unsettling.

A particularly striking finding of the survey is that many continental European banks have been laying-off staff in London and have either been closing down certain activities in the UK capital - in favour of centralisation in their home country - or have been shrinking the number of employees based in the City. The EEFC's findings show that London staff, including those employed by medium and small firms, are under considerably greater pressure to perform than their counterparts elsewhere in Europe.

The report also notes that the extent and speed of consolidation within the fund management industry has been particularly phenomenal, despite its finding that full liberalisation of funds and deregulation post-EMU has yet to materialise. The rationalisation of the asset management industry has been primarily in the direction of large organisations taking over smaller ones, rather than horizontal integration of the industry whereby smaller firms may merge with one another. Across Europe, insurance companies have been the leaders in taking over smaller portfolio management firms.

(iii) Placement and distribution - an end to local ties?

Participants in the study were asked to comment on whether the volume of business given by local firms to local players had changed since the introduction of the new currency. For 50% of respondents - a clear simple majority - EMU has had an adverse impact in this sense, with many respondents suggesting that larger banks have superior distribution capacity to smaller, local firms.

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For institutional investors across Europe, loyalty towards local brokers and investment banks has decreased dramatically since the launch of the euro, to the extent that many investors are even actively seeking out non-local relationships.

The penetration of US firms into Europe is a particular fear in the minds of many financial institutions in continental Europe. Indeed, before the launch of the single currency, many industry commentators predicted that American banks - experienced in the techniques of disintermediation - would immediately be best placed to take advantage of the new single currency environment, at the expense of indigenous continental firms whose profits, pre-EMU, depended heavily on domestic lending activities. However, the EEFC observed that most of the major US investment banks active in Europe chose to adopt a non-aggressive stance during the first year of EMU, preferring instead to follow a 'wait and see' approach. This reflects their initial caution over entering what - without the distribution capabilities that their continental European rivals enjoyed in their home territories - they believed to be an unprofitable market. Nevertheless, as the industry league tables cited in the report bear out, this attitude began to change as EMU became more firmly entrenched.

(iv) Primary dealership

In the context of primary dealership, the survey reveals that the strongest impact of EMU has been greater competition, to the extent that the traditionally strong pre-EMU links between governments and local primary dealers have broken down. 60% of survey respondents are acutely aware of this pressure and have experienced an increase in the number of primary dealers used by governments as well as the introduction of dealer groups by non-government issuers such as the European Investment Bank (EIB). For some 20% of market participants, once-parochial markets such as Italy, Spain, Portugal and Austria have begun to open up to non-domestic banks - primarily to those from other parts of the euro-zone, such as Germany.

Moreover, governments are increasingly prepared to opt for syndication instead of the auction system. Despite the higher fees involved, this route is preferred in order to enhance liquidity in their securities and to ensure a wider, more diversified distribution.

(v) The growth of credit analysis and credit trading

The removal of currency risk and interest rate divergence since the introduction of the single currency has, by default and by necessity, generated an increasing interest in the field of credit analysis and a corresponding move away from research into sovereign debt.

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According to the survey, the research capabilities of many securities firms have been restructured completely as a result of EMU. Some firms have simply retained their existing staff but refocused their activities by increasing their credit analysis activities. Others, however, have shifted from country-by-country analysis and have focused on analysis of the euro area as a single block. Close to 60% of financial institutions now have a pan-European approach in certain types of sector, whereas only 8% of firms cover all sectors in all countries of the euro-zone. Consequently, some have reduced the number of researchers they employ.

The improvement in analysis capabilities demonstrated by many firms means, in the EEFC's view, that investors are making up for the poor yields offered by Europe's low interest rate environment as an explosion in demand for and supply of non-sovereign, euro-denominated debt products - particularly in the high yield triple B sector - has taken hold. Going forward, towards the development of a deeper and broader European credit market, close to 45% of players believe that a far more sophisticated analysis of credit will enable fund managers to purchase lower credits - possibly down to double B as opposed to a previously-held requirement of a minimum average of single A.

For a number of the major investment banks, however, the introduction of the euro has meant more than a restructuring of their research capabilities. Some, believing that research is becoming defunct and not cost effective, have chosen instead to concentrate their resources on advisory work, particularly in the area of risk management.

(vi) Government debt - a diminishing future

The report observes that the government bond sector in Europe will be susceptible to considerable contraction in future, driven in particular by the requirements of the Maastricht Treaty, which have prompted the European Commission and different euro-zone governments to work together in bringing down government deficits to a level acceptable under the terms of the Treaty. However, most market participants taking part in the survey appeared unaware of the extent of the reductions in debt and deficit required under the Maastricht agreement and many expressed the view that a shortening in supply would bring about more ambiguity in government bond trading and substantially undermine liquidity.

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Future prospects

The report notes that, since the launch of the euro, the fixed income market as a whole has offered a relatively poor return on investment. However, the EEFC notes, the market continues to offer two principal features which remain attractive for investors:

- the inherent safety it affords; and
- the ability it offers to investors to diversify across asset classes.

Going forward, the survey findings indicate that the fixed income market is expected to undergo development particularly in the following directions:

- Price transparency will further improve. One of the immediate consequences of EMU was increased price transparency following the re-denomination of a number of products into euros (particularly government debt), which, in turn, has removed many of the price distortions that hitherto prevailed across Europe.
- Following the completion of the phased introduction of the euro, transaction costs are likely to continue to decrease.
- Market efficiency is likely to improve.
- Competition within the financial markets will increase even further, inevitably leading to more consolidation of the European capital markets.
- There will be an expansion in the single A and triple B credit categories of fixed income product.
- Credit trading in Europe is likely to be the most dominant issue for the fixed income market in the next decade.
- The issues coming into the market will be increasingly larger and the paper is likely to be better distributed along the credit spectrum.

In encouraging market participants to take better advantage of the single currency, the EEFC advises banks and securities houses to develop capabilities and awareness in the following areas. Firms should:

- develop their capabilities for electronic trading;
- allow for larger risk limits;
- provide faster answer time for clients;
- provide better pricing - both cheaper and more transparent;
- develop structured products; and
- generally widen their horizons across the euro-zone by stepping outside their own geographical borders.

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Of those, in the EEFC's view, the most crucial area in respect of which market participants need to take decisive action in developing their forward strategies focuses on the increasing trend towards electronic trading. Inevitably, the report observes, the 'e-revolution' will affect every aspect of business within financial institutions. The EEFC recommends that the way forward for firms is to embed electronic trading and the internet deep into the core of their various lines of business in order to offer their end-users - both wholesale and retail - complete flexibility. According to the EEFC, the rewards for those who succeed will be huge. Equally, there will be costs for those who fail to take advantage of the new environment brought by the single currency.

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Notes for editors

1 ISMA

The International Securities Market Association (ISMA) is the self-regulatory organisation and trade association for the international securities market. For almost 650 member firms in 51 countries world wide, ISMA oversees the efficient functioning of the market through the implementation and enforcement of a self-regulatory code covering trading, settlement and good market practice. The Association also provides its member firms - and other users - with a range of services, products and support. Via a UK holding company, ISMA is the majority shareholder in COREDEAL, the pan-European electronic exchange for international debt-related securities.

2 EEFC

The European Economics and Financial Centre (EEFC) is engaged in research and advisory work in the areas of economics and finance. It works closely with the financial community at large including many European central banks, ministries of finance/economy, as well as the European Commission and other international organisations. At any given time the EEFC has active many research projects on a cross-section of topics ranging from issues related to European integration, the single currency and behaviour of exchange rates to different aspects of financial markets, including the derivatives market, as well as dealing practices and regulatory environments of the global financial industry.

The Impact of the Euro on the European Fixed Income Market: A Post-Launch Appraisal and Outlook follows the highly acclaimed EEFC report published in 1997: *The Cost and Timescale for the Switchover to the European Single Currency for the International Securities Market*. Based on the findings of a survey of ISMA members, the report served to highlight the practical issues and costs faced by participants in the international securities market ahead of the conversion to the single currency. Now that the switchover has occurred, it has transpired that every single prediction made by the EEFC in this report has proved correct.

3 To obtain copies

Copies of *The Impact of the Euro on the European Fixed Income Market: A Post-Launch Appraisal and Outlook* may be purchased at a cost of GBP 20.00 for UK customers or CHF 40.00 for those based outside the UK (plus delivery charge). Further details are available from the Sales Department at ISMA Limited, London on telephone (44-20) 7538 5656.

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Review copies for media representatives are available free of charge. Please contact Tim Dickenson or Peter Ratcliffe as listed below.

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