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E1: Financial markets and financial intermediaries and
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QUARTERLY NOTE ON THE EURO-DENOMINATED BOND MARKETS

N° 55: APRIL – JUNE 2003

HIGHLIGHTS

- ***In line with global developments, euro-denominated government bond yields fell to historically low levels in mid-June and the euro yield curve shifted progressively downward over Q2/2003. The yield on the 10-year benchmark bund fell to 3.5%, while rates at the shorter end also fell in anticipation of the 50 basis-point cut in the ECB's refinancing rate on 5 June. The two-year/ten-year yield spread fluctuated in a narrow range around 165 basis points over the quarter. By the end of June 2003, the euro yield curve was significantly lower and steeper than at the corresponding time in 2001 and 2002.***

- ***Total gross issuance of euro-denominated bonds reached €484bn in Q2/2003. This is a decline compared to the record quarterly issuance volume of €515bn in Q1/2003 – although still much more than in previous years – and in line with the usual seasonal pattern. The main sources of issuance were central government and financial institutions, but corporate issuance has clearly rebounded since the beginning of 2003.***

- ***The composition of issuance in Q2/2003 reflected a slightly below average share of central government (45.2%), while the share of financials (21.3%) and pfandbriefe/covered bonds (13.3%) was above average. The share of corporate bonds (8.7%) has recovered notably but remains well below levels recorded in previous years. The share of smaller public borrowers (7.8%) also rose in Q2/2003 and asset-backed securities (ABS) accounted for the remaining share (3.7%) of total issuance.***

- ***The special feature in this quarterly note is a reproduction of the executive summary of the second report of the Giovannini Group on EU cross-border clearing and settlement arrangements.***

This series of notes, and a statistical annex, are available from the European Commission website at:

http://europa.eu.int/comm/economy_finance/publications/bondmarkets_en.htm

DEVELOPMENTS IN EURO-DENOMINATED BOND ISSUANCE
(APRIL – JUNE 2003)

1. EVOLUTION OF GOVERNMENT BOND YIELDS AND SPREADS

In spite of a recovery in global equity markets, investor demand for government bonds remained strong in Q2/2003. This development was a departure from the experience of recent years, when movements in equity prices and the prices of government bonds were inversely related. A direct correlation between prices in the two markets is by no means unusual in a longer-term perspective, but there has been growing unease among analysts about a possible inconsistency in investor expectations underlying the respective price trends. Current equity valuations would imply expectations of a near-term recovery in the global economy, while historically low government bond yields would imply expectations of low inflation rates associated with persistent weakness in economic activity. While the recovery in equity prices since the end of the Iraq war could be interpreted as merely the correction of a pre-war sell-off – making the co-movement of bond and equity prices more understandable – the apparent inconsistency in investor expectations raises doubt about the sustainability of the rally in one or other of the two markets. To some extent, these doubts were reflected in a mini-correction in government bond yields in mid- June.

In line with global developments, euro-denominated government bond yields fell to historically low levels in mid-June and the euro yield curve shifted progressively downward over Q2/2003. The yield on the 10-year benchmark bund fell to 3.5%, while rates at the shorter end also fell in anticipation of the 50 basis-point cut in the ECB's refinancing rate on 5 June. The two-year/ten-year yield spread fluctuated in a narrow range around 165 basis points over the quarter**.** By the end of June 2003, the euro yield curve was significantly lower and steeper than at the corresponding time in 2001 and 2002. ***(See Charts 1- 3.)***

CHART 1 – EVOLUTION OF EURO YIELDS SINCE 1999
(YIELDS OF EURO BENCHMARK BONDS IN %)

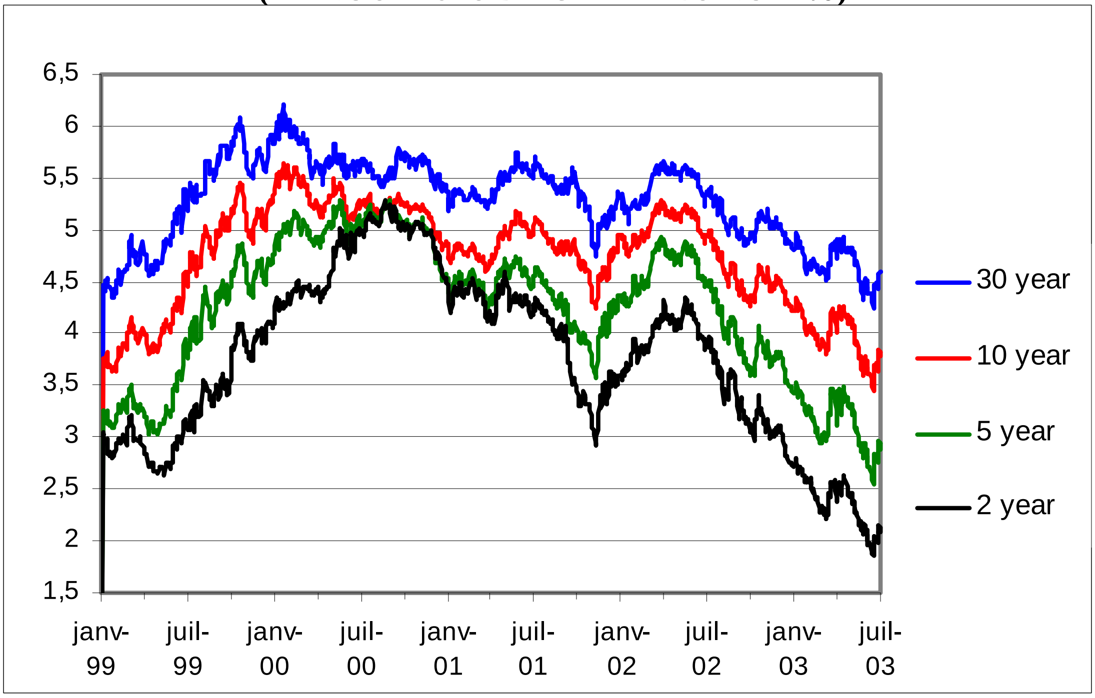


CHART 2 – EURO YIELD CURVE [1]

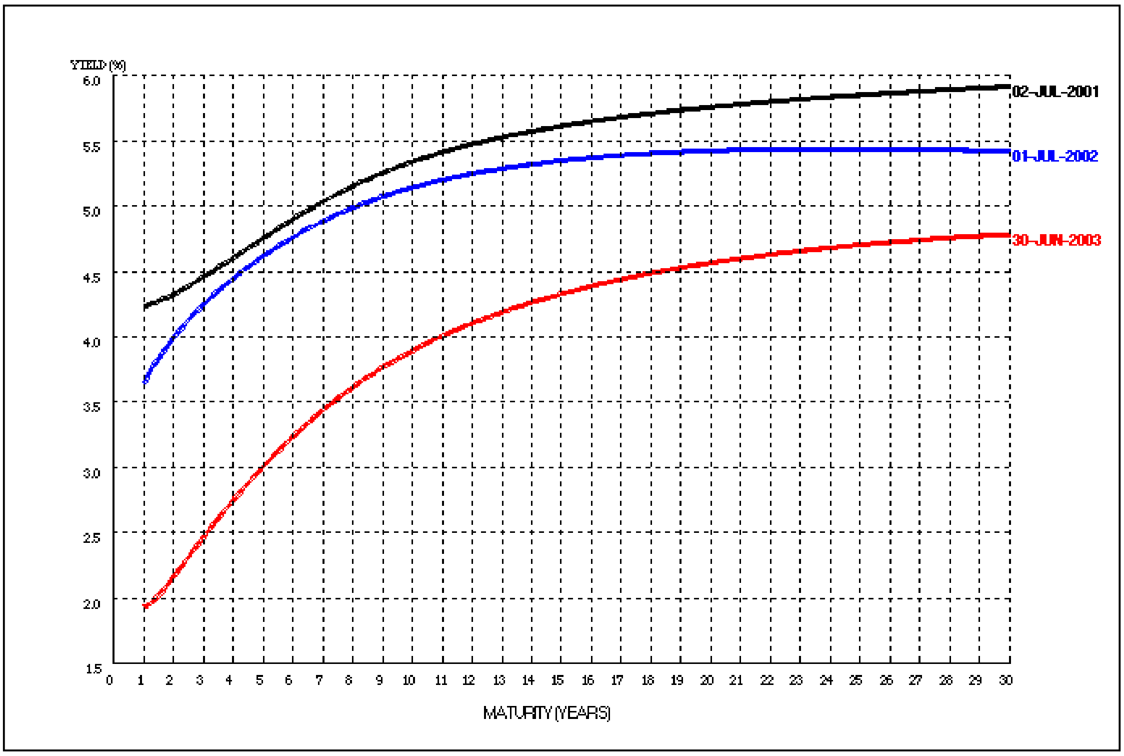
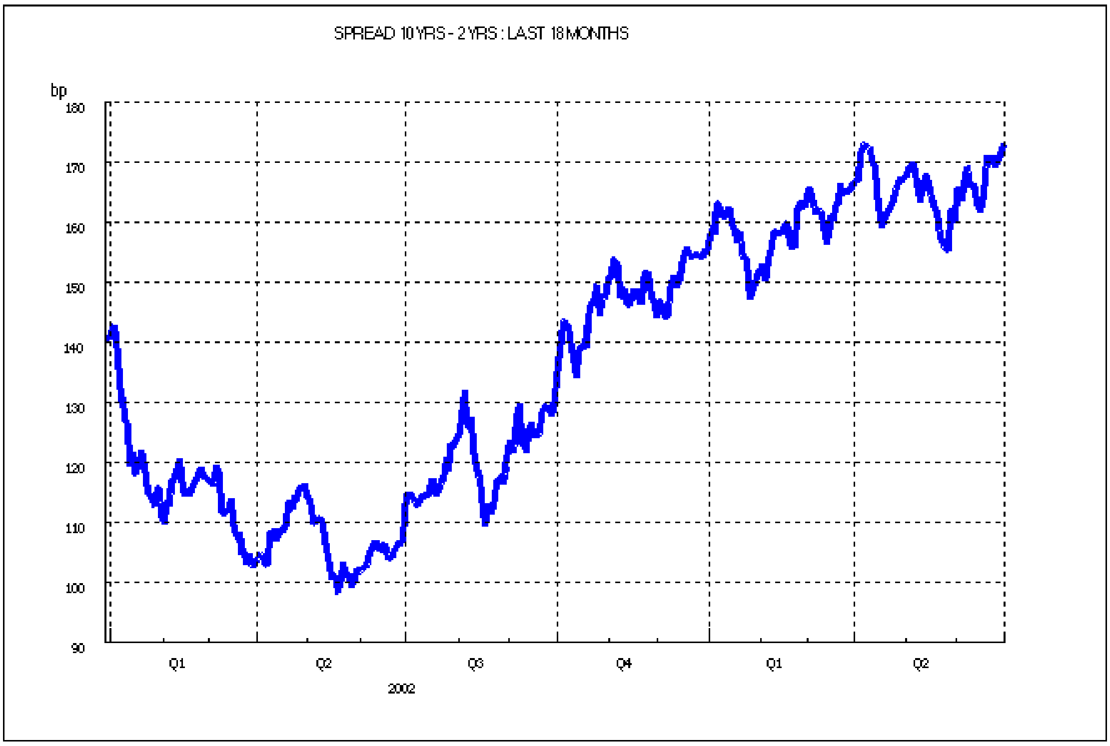


CHART 3 – EURO YIELD CURVE: SPREAD OF 10-YEAR OVER 2-YEAR YIELDS



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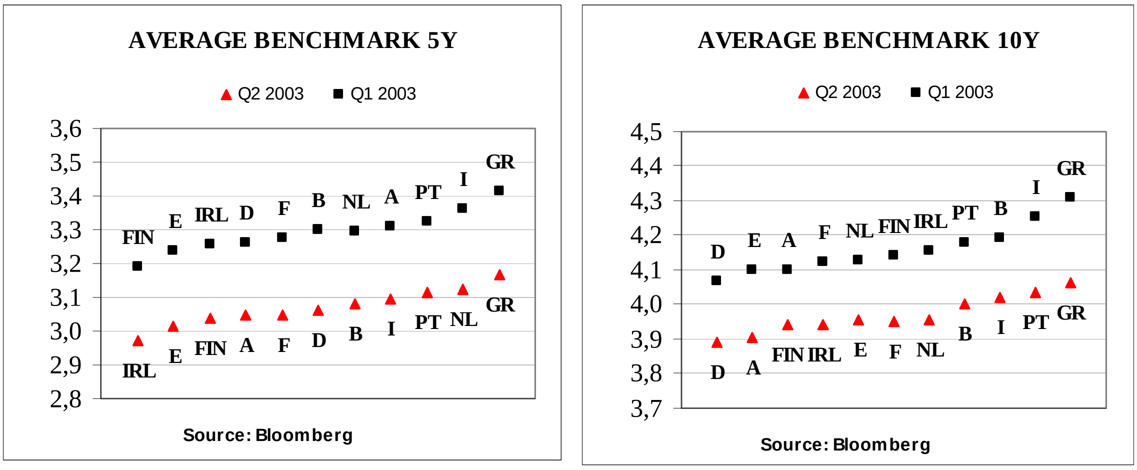
1 *Source:* Eurostat. A daily update of the euro yield curve can be found on the Eurostat internet site – see http://europa.eu.int/comm/eurostat

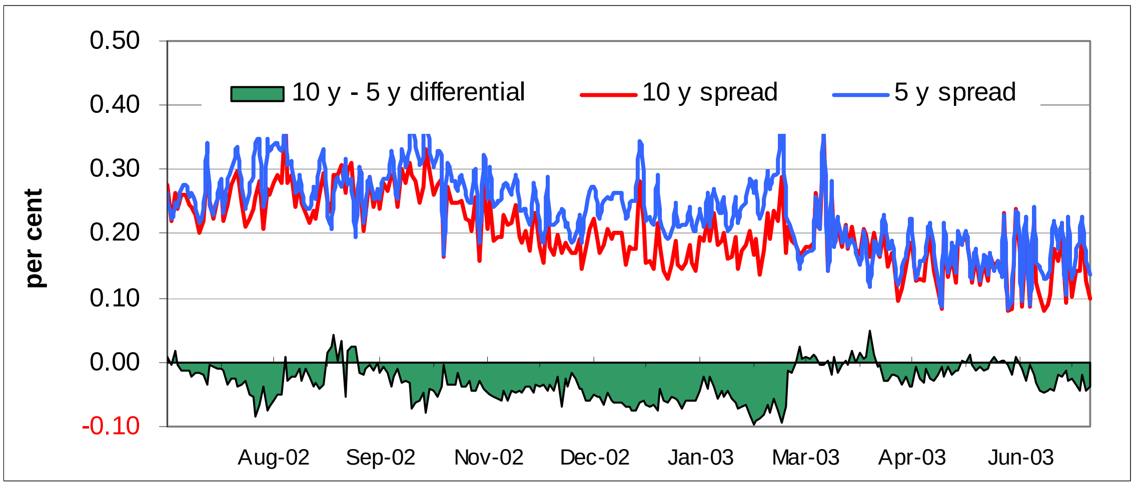
The further decline in average benchmark yields in Q2/2003 relative to Q1/2003 amounted to broadly 20 basis points for both the 5-year and the 10-year segment. ***(See Chart 4.)*** Within the euro area, the effects of increased supply and some concern about the longer-term budgetary situation – but also the search of investors for additional yield – were responsible for some further deterioration in the relative pricing of German benchmark bonds especially in the 5-year, but also in the 10-year segment. (See annex 1 for further discussion of euro-area yields)

CHART 4 – AVERAGE YIELDS AND SPREADS ACROSS GOVERNMENT DEBT ISSUERS IN Q4/2002 AND Q1/2003[2]



The spread between 10-year and 5-year euro swap rates was again mostly negative over Q2/2003, with especially Germany continuing to use swap transactions to restructure its portfolio risk and reduce borrowing costs. *(See Chart 5.)* Indeed, the German finance agency has announced an expansion in its activity in the swap market, raising the ceiling for the use of swaps in 2003 from an initial €30bn to €40bn in mid-April; this implies a doubling in the ceiling applied in 2002.

CHART 5 – SWAP YIELD SPREADS AND DIFFERENTIAL 10-YEAR OVER 5-YEAR

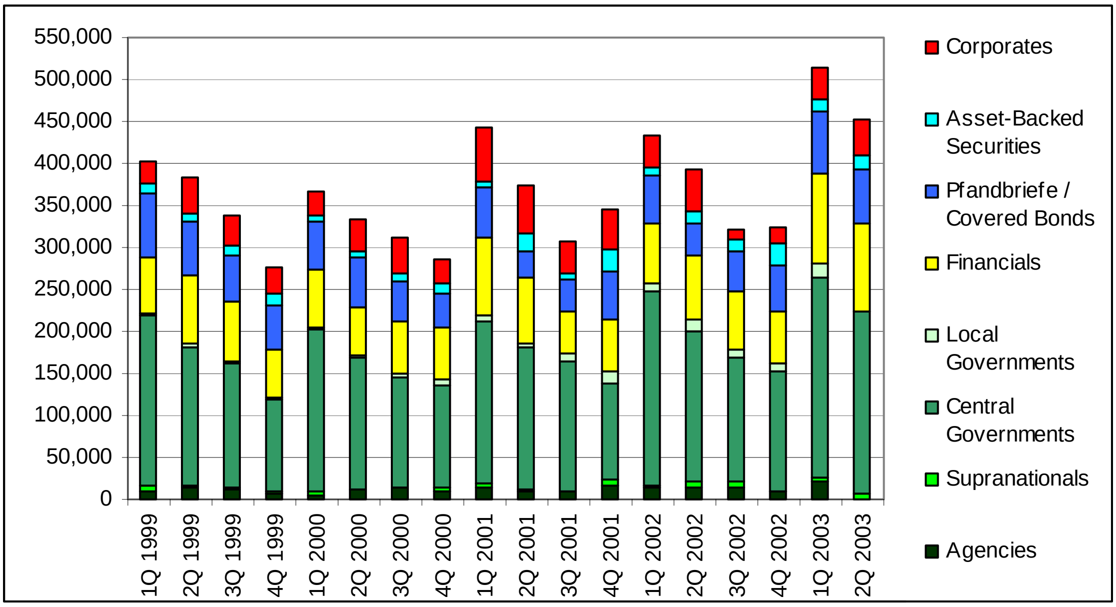


2. DOMESTIC AND INTERNATIONAL BOND ISSUANCE IN EURO [3]

2.1 Total issuance and composition of bond issuance in euro

Total gross issuance of euro-denominated bonds reached €484bn in Q2/2003, well up on the corresponding quarter in previous years but lower than the record quarterly issuance of €515bn in Q1/2003. This overall trend was reflected in most of the market segments, with issuance by central government and financial institutions particularly up on previous years but lower than in Q1/2003. A notable exception was the corporate segment, where issuance volumes continued to recover in Q2/2003 relative to Q1/2003 but remained well below the levels recorded in 2001. Nevertheless, the positive evolution in corporate issuance over the last two quarters represents a significant rebound from the subdued levels recorded in the period following the terrorist attacks in the United States and the emergence of the Enron scandal in late 2001. ***(See Chart 6A, Table 1, Table 2 and Table 3.)***

CHART 6A - ISSUING ACTIVITY IN EURO SINCE 2000 (VOLUMES IN € MILLION)



The composition of issuance in Q2/2003 reflected a slightly below average share of central government bonds, while the share of financials and pfandbriefe/covered bonds was above average. The share of smaller public-sector issuers, i.e. agencies, local government and supranational institutions, was also above average. Reflecting the recovering trend in issuance volumes, the share of corporates remained on a rising trend, which has now extended over four quarters.

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2 The yield rankings must be treated with caution, as the underlying data may not be strictly comparable across the various government issuers.

3 All figures quoted are from the DG ECFIN database unless stated otherwise. In this database all euro denominated issues of an amount of €50mn or more are recorded. It should be noted that the database includes all issues of a maturity of 1 year or more (incl. in particular Italian and French discounted paper of usually significant issue amount). Throughout this note, payment dates - as opposed to announcement dates - of new issues have been taken into account unless stated otherwise. Data are subject to revision.

TABLE 1 – EURO ISSUING ACTIVITY IN THE LAST FOUR QUARTERS

Issue volumes in € million	3Q 2002	4Q 2002	1Q 2003	2Q 2003	Average
Agencies	14,853	9,733	21,610	19,202	16,350
Central Government	147,532	141,195	236,938	218,743	186,102
Local Government	11,447	10,256	17,327	12,288	12,830
Supranationals	5,801	300	5,583	6,195	4,470
Asset-Backed Securities	14,249	26,392	13,501	17,679	17,955
Financials	67,970	62,947	107,062	103,327	85,327
Pfandbriefe/Covered Bonds	46,887	53,963	73,987	64,306	59,786
Corporates	12,193	19,343	38,615	42,346	28,124
Total	320,932	324,129	514,623	484,086	410,943
in % of total issuance	**3Q 2002**	**4Q 2002**	**1Q 2003**	**2Q 2003**	**Average**
Agencies	4.6	3.0	4.2	4.0	4.0
Central Government	46.0	43.6	46.0	45.2	45.3
Local Government	3.6	3.2	3.4	2.5	3.1
Supranationals	1.8	0.1	1.1	1.3	1.1
Asset-Backed Securities	4.4	8.1	2.6	3.7	4.4
Financials	21.2	19.4	20.8	21.3	20.8
Pfandbriefe/Covered Bonds	14.6	16.6	14.4	13.3	14.5
Corporates	3.8	6.0	7.5	8.7	6.8

Public-sector issuance

Total gross issuance of central government bonds amounted to €219bn in Q2/2003, which is lower than in Q1/2003 but markedly higher than in second quarters since 2000. The strength of central government issuance reflected not only the usual front-loading of central government borrowing at the beginning of a year but also the cyclical deterioration of the budgetary situation in some countries and higher redemption than in the previous years. Against this backdrop of relatively high issuance volumes for both Q1/2003 and Q2/2003, the continuing decline in government bond yields until mid June is particularly notable.

On the other hand, low yields and investor fears of a market bubble resulted in low subscription levels for some new benchmark issues. Subscription levels were below 1.5% for a 5-year Bund auction in May (and again for a 10-year auction at the beginning of July), while the issuance volume for the new 15-year French bond in June was scaled down due to low demand. Low demand for bunds was partly related to Germany's increased borrowing needs – the German finance agency announced at the beginning of July that the German net borrowing requirement for 2003 had been revised up to €35bn from €18.9bn – and similar concerns about the near-term supply of French debt. Nevertheless, more global concerns were clearly at play also, as auctions in the United Kingdom and the United States were also poorly subscribed towards the end of Q2/2003.

Despite the deterioration in underlying budgetary conditions, German bunds remained the main reference for pricing euro-denominated bonds, although the swap rate has emerged as a more relevant pricing tool. Indeed, new bond issues by smaller euro-area Member States (e.g. Spain, Austria, Finland and Belgium) achieved very good pricing levels, trading broadly flat or even through the German benchmark in the 5-year and 10-year maturities. With investors in search of additional yield, issues by lower-rated Member States (e.g. Italy, Portugal and Greece) were also very well received in the market. There was also significant issuance by non euro-area sovereigns such as Denmark (€2bn), South Africa (€1.25bn), Poland (€800mn) and the Slovak Republic (€500mn). The Netherlands attracted market attention by employing a new issuance technique that combines the advantages of a syndication-like book building process with issuance via a single price auction.

TABLE 2 – QUARTERLY EURO ISSUING ACTIVITY SINCE 2000

Issue volumes in € million	2Q 2000	2Q 2001	2Q 2002	2Q 2003	Average
Agencies	12,039	8,985	14,093	19,202	13,580
Central Government	155,120	170,757	180,846	218,743	181,367
Local Government	3,919	5,182	12,710	12,288	8,525
Supranationals	831	1,800	6,215	6,195	3,760
Asset-Backed Securities	6,309	19,608	14,289	17,679	14,471
Financials	56,590	76,760	77,489	103,327	78,542
Pfandbriefe/Covered Bonds	60,667	32,456	37,796	64,306	48,806
Corporates	37,997	58,855	49,990	42,346	47,297
Total	333,472	374,403	393,428	484,086	396,347
In % of total issuance	**2Q 2000**	**2Q 2001**	**2Q 2002**	**2Q 2003**	**Average**
Agencies	3.6	2.4	3.6	4.0	3.4
Central Government	46.5	45.6	46.0	45.2	45.8
Local Government	1.2	1.4	3.2	2.5	2.2
Supranationals	0.2	0.5	1.6	1.3	0.9
Asset-Backed Securities	1.9	5.2	3.6	3.7	3.7
Financials	17.0	20.5	19.7	21.3	19.8
Pfandbriefe/Covered Bonds	18.2	8.7	9.6	13.3	12.3
Corporates	11.4	15.7	12.7	8.7	11.9

Total gross issuance by smaller public borrowers (i.e. agencies, local authorities and supranationals) was €38bn in Q2/2003, compared to €45bn in Q1/2003, but again higher than in second quarters since 2000. Bonds in these segments continued to attract investors' interest, particularly insofar as issuers have mostly avoided the 5-year and 10-year segments, which are traditionally the domain of central government issuers. Demand in this segment was underpinned by Asia – and particularly Japan where the new fiscal year has begun – as the swap spread narrowing to EU central government bonds made new issues more attractive. Indeed, prime supra-national institutions like the European Investment bank achieved remarkably narrow launch spreads over benchmark government bonds.

- **Total gross issuance by agencies was €19bn in Q2/2003, compared to a record €21.6bn in Q1/2003.** Issuance by agencies consisted mainly of shorter maturities (up to 5 years) in response to investors' preferences. Quite unusually, issuance was not dominated by Freddie Mac and KfW (which concluded its purchase of DtA) – but by the French agency ERAP, which had been mandated by the French government to finance the State's share in the capital increase of France Telecom. Total issuance of €9.4bn was split into three bonds with an explicit state guarantee – a €4bn 5-year, a €3bn 3-year and a 2.4bn 7-year bond. The Dutch municipal financing agency BNG was also quite active in the market, issuing a €1bn 10-year and a €1.5bn 4-year bond. Another agency bond with an explicit state guarantee was a €1bn 5-year bond by Spain’s Instituto de Credito Oficial (ICO). Finland's local authority funding agency, Municipality Finance of Finland, surfaced with an €500mn 5-year inaugural euro bond.

- **Total gross issuance by <u>local authorities</u> was €12bn in Q2/2002, compared to €17bn Q1/2003.** Berlin was particularly active in the market issuing a total amount of €3.5bn, split between a €2bn 10-year bond and several smaller issues. There was a new €1.5bn 6-year joint issue and several individual issues from the German Länder – including a €2bn 7-year issue from North Rhine-Westphalia and a €1bn 5-year issue from Saxony-Anhalt. Outside of Germany, the largest transactions were a €400mn 20-year bond from the Region of Marche and a €750mn 10-year bond from the Canadian province Ontario.

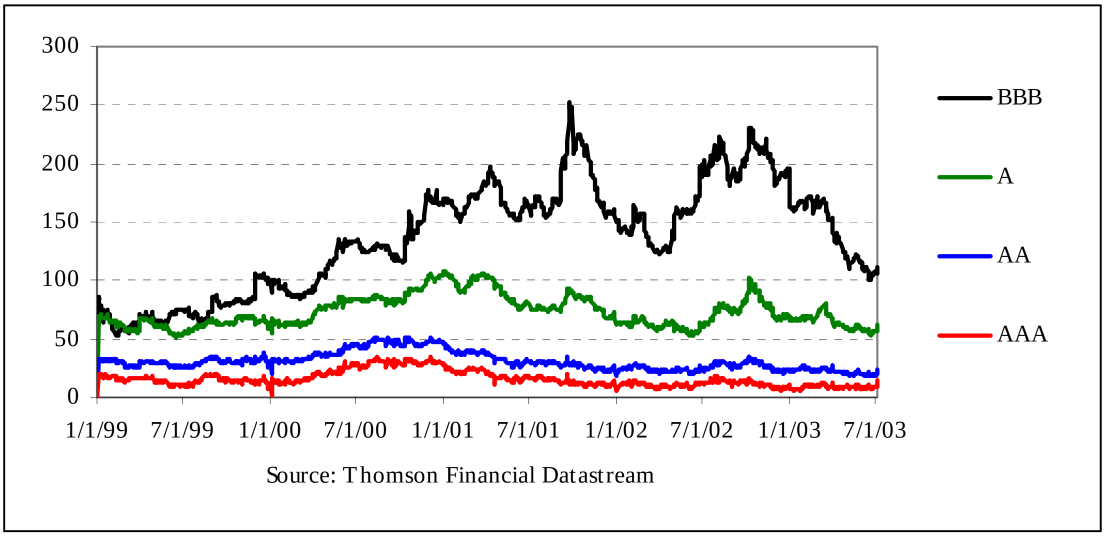
- **Total gross issuance by <u>supranational institutions</u> in Q2/2003 was €6bn, broadly unchanged from the previous quarter.** The main issue was the new €5bn 10-year EIB benchmark bond in June. Due to Nomura’s inclusion in the bookrunner trio (beside Citigroup and Deutsche bank) the share of Japanese investors was very high with 26%.

Private-sector issuance

Total gross issuance of corporate bonds was €42bn in Q2/2003, which is higher than in Q1/2003 (€38.6bn) and reflects a continued recovery since mid 2002, except for a brief interruption related to the Iraq war. This segment has now recovered from the difficult market conditions and subdued issuance in the second half of 2002, implying a relatively optimistic view of progress in the pace of corporate restructuring. As investors have become less risk-averse and have returned to higher-yielding markets, prices of both euro- and US dollar-denominated corporate bonds have rallied since the end of 2002, resulting in a significant spread reduction – especially for lower-rated bonds. ***(See Chart 6B.)***

Improved financing conditions in Q2/2003 attracted not only strong issuance from the automobile sector but also from the utility sector, while issuance from the telecom sector played no major role. Indeed, the three largest issues were a €2bn 10-year and a €2bn 6-year bond from Volkswagen, followed by a €1.5bn 3-year bond from Ford. Issuance from the utility sector included a total volume of €3bn (split on a 7-, 12- and 20-year bond) from Gie Suez Alliance, a €1.5bn bond from Eni Spa, a €1bn 5-year bond from General Electric and a €750mn 10- and a 15-year bond from Enel Societa per Azoni. There were also prominent newcomers on the euro-denominated bond market, such as the pharmaceutical company GlaxoSmithKline with a €1bn 5-year bond from the UK based mother company and a €500mn 6-year bond from its Japanese subsidiary and the media company Bertelsmann with its first public offering in euro (a €650mn 7-year bond). **It is notable that issuance of corporate bonds was dominated by longer maturities as borrowers tried to lock in historically low yields and some investors (notably insurance and pension funds) were ready to extend maturity in the search of higher yields.**

CHART 6B - CORPORATE BOND SPREADS IN THE EURO-AREA (BASED ON REUTERS CORPTOP INDICES, DAILY DATA, IN BASIS POINTS)



Total gross issuance by the <u>financial sector</u> in Q2/2003 remained high by historical standards at €103bn and was only marginally below the record level in Q1/2003. In an attempt to widen their investor base before the withdrawal of the state guarantee (Gewährträgerhaftung) from 18 July 2005[4], German State banks (Landesbanken) continued to be very active in the market. The most important single issue was a €3bn 20-year hybrid bond from Munich Re with a call option in June 2013. After some short term price volatility, the bond performed quite well, giving possibly some indication that the health of the insurance sector in general – and Germany in particular – has improved. Eurohypo also launched a €600m bond callable after 10-years. A newcomer to the market was the third largest US mortgage provider Countrywide Home Loans with an inaugural €500mn 3-year bond.

Total gross issuance in the <u>pfandbriefe/covered bonds</u> segment in Q2/2003 was €10bn lower than in Q1/2003 but still relatively strong with €64bn. Demand was supported by a good performance of covered bond deals, related to smaller swap spreads and a narrowing of the gap between the funding levels of smaller-sized pfandbriefe/covered bonds and jumbos. Although German jumbo pfandbriefe performed well this year, issuance under the new Irish covered bond law was particularly attractive. In April, DEPFA ASC BANK[5] increased its first (5-year) benchmark bond issued in February by €1bn to €5bn, gaining admittance to the EuroMTS trading platform. Subsequently, the bank launched its second global benchmark, a €3.5bn 10-year bond in July. The second largest deal of the quarter was a €2bn 5-year bond form Bayerische

[4] Bonds issued before 18 July 2005 and maturing before 31 December 2015 will however keep this privilege.

[5] In October 2001, the shareholders of DEPFA Deutsche Pfandbriefbank AG, a German publicly held corporation whose origins trace back to 1922, approved plans to separate the company’s public finance and property finance activities into two separate privately-held companies. Following the split, a new Irish company DePfa Holding plc became the new parent of DEPFA Deutsche Pfandbriefbank AG and was subsequently renamed DEPFA BANK plc. It acts as parent company of the public finance group and manages the Group’s public sector finance activities. The Group's funding activities by means of European covered bonds are now conducted by two subsidiaries, DEPFA Deutsche Pfandbriefbank AG and DEPFA ACS BANK.

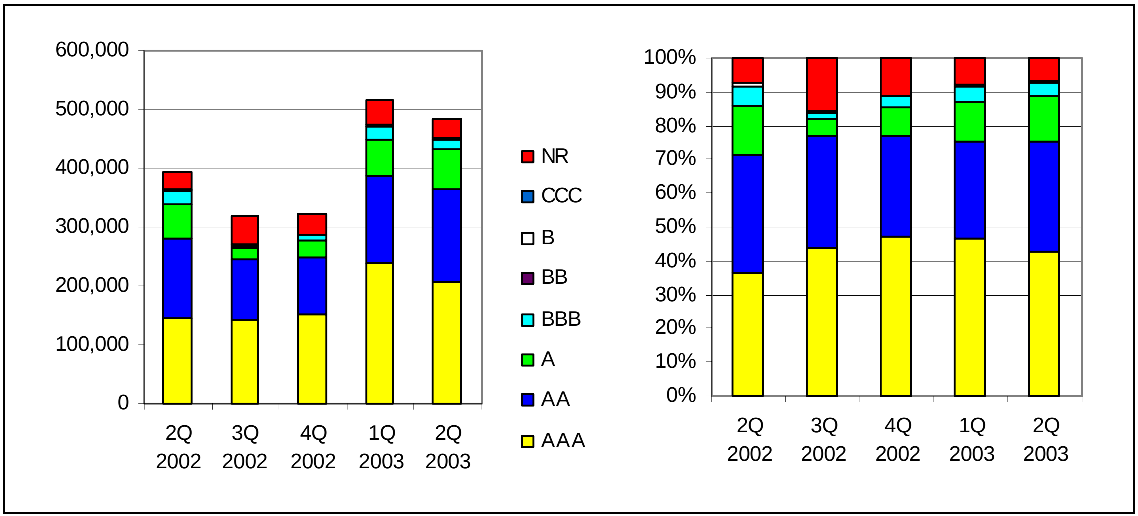
HypoVereinsbank (HBV). Moody's announcement of a modified rating approach[6] for pfandbriefe/covered bonds had little impact on the market.

As usual for the beginning of a year, issuance of asset-backed securities (ABS) was relatively subdued in Q2/2003, but nevertheless rose to €17.6bn after €13.5bn in Q1/2003. The securitisation initiative for German bank loans, which is currently under discussion, has not yet resulted in a significant pick up in ABS issuance in Germany.

2.2 Credit quality of issues in euro

The rebound in corporate bond issuance and continuing heavy issuance by financial institutions both contributed to a higher share of single A and triple B rated bonds. **(*See Chart 7.*)**

CHART 7 - RATINGS OF ISSUES IN € MILLION AND % OF TOTAL VOLUME ISSUED

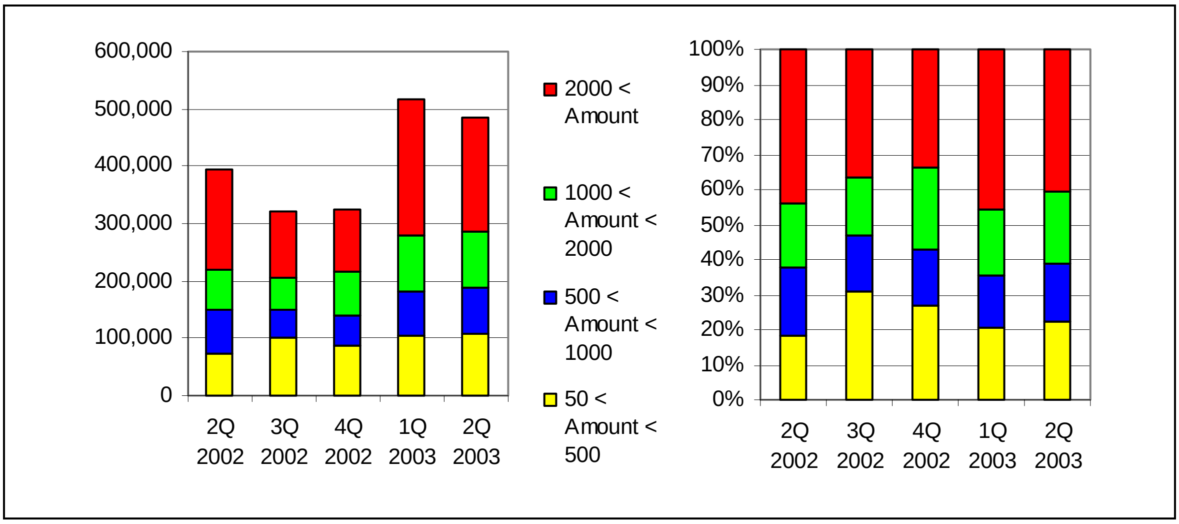


6 While S&P has so far awarded AAA ratings to all Luxembourg and German covered bonds on the basis of a certain degree of over-collateralisation, Moody's old approach did not allow a special bonus for particularly good asset quality. Pfandbriefe from several mortgage banks were thus automatically downgraded just because the ratings of their parent banks were cut. Under Moody's new rating approach, issuers could now also obtain Aaa ratings if the credit quality and liquidity enhancements are in accordance with its standards for Triple A securities.

2.3 Size of issues in euro

The share of large bonds over €2bn declined in Q2/2003 compared to Q1/2003. This is in accordance with the usual seasonal pattern of progressively declining central government bond issuance – which are dominated by large issues – over the year ***(See Chart 8.)***

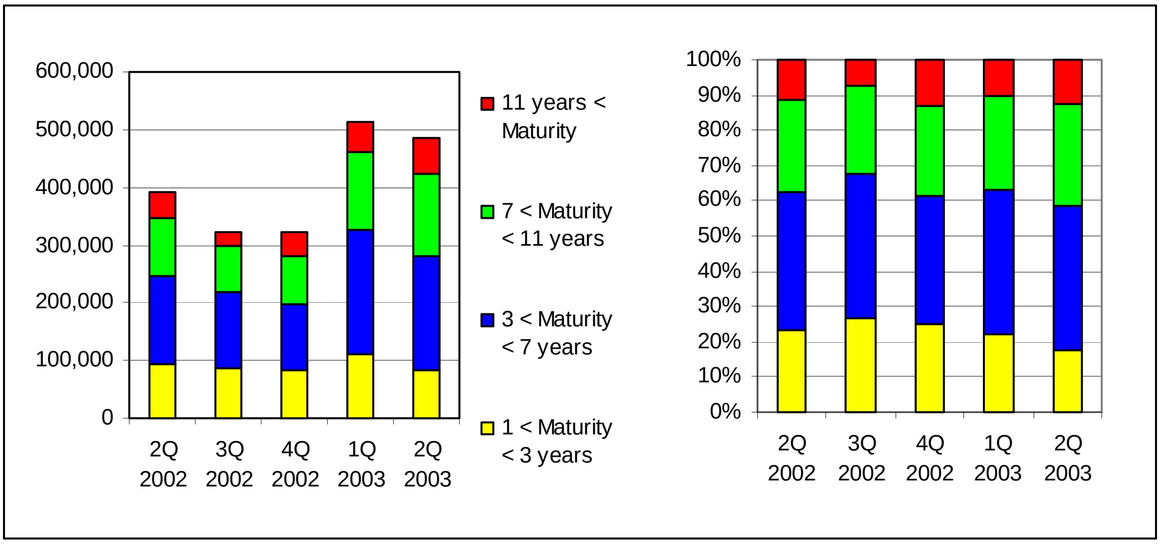
CHART 8 - ISSUE SIZE IN € MILLION AND AS % OF TOTAL VOLUME ISSUED[7]



2.4 Maturity of issues in euro

A decline in the share of short-term maturities (1 to 3 years) over the last four quarters illustrates the attempt of investors to lock in the comparably attractive long-term yields for a longer time period. ***(See Chart 9.)***

CHART 9 - MATURITY OF ISSUANCE € MILLION AND % OF TOTAL VOLUME ISSUED

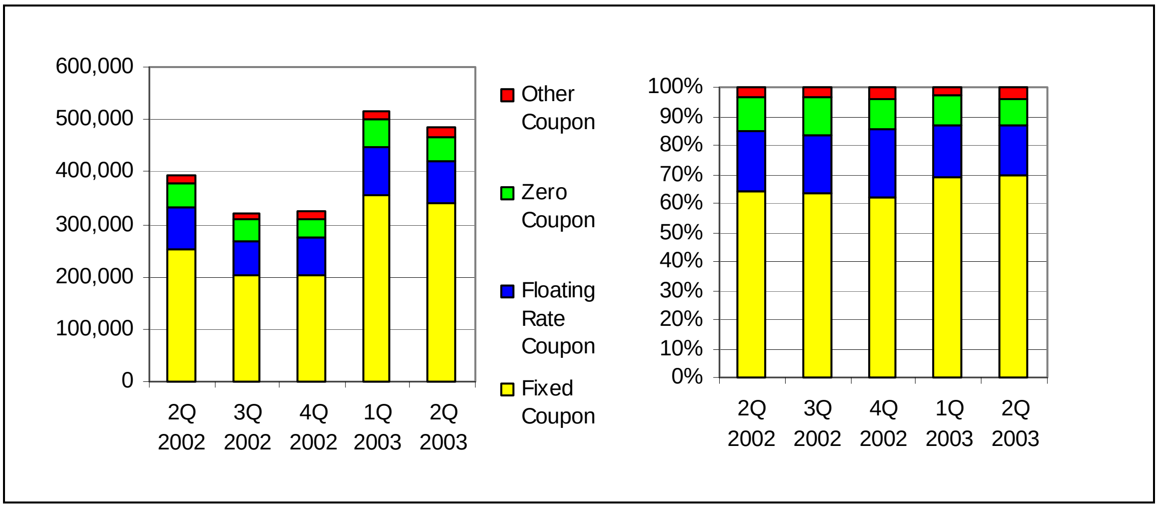


7 It should be noted that the share of very big issues is substantially lower if only international issues are considered because issues of domestic short-term instruments are usually very large in size.

2.5 Coupon types of issuance in euro

Compared to the last three quarters of 2002, the share of fixed coupon issuance has increased, while the share of floating rate notes has fallen. A factor explaining this development would be the increased use of fixed coupon bonds in the financial sector. ***(See Chart 10.)***

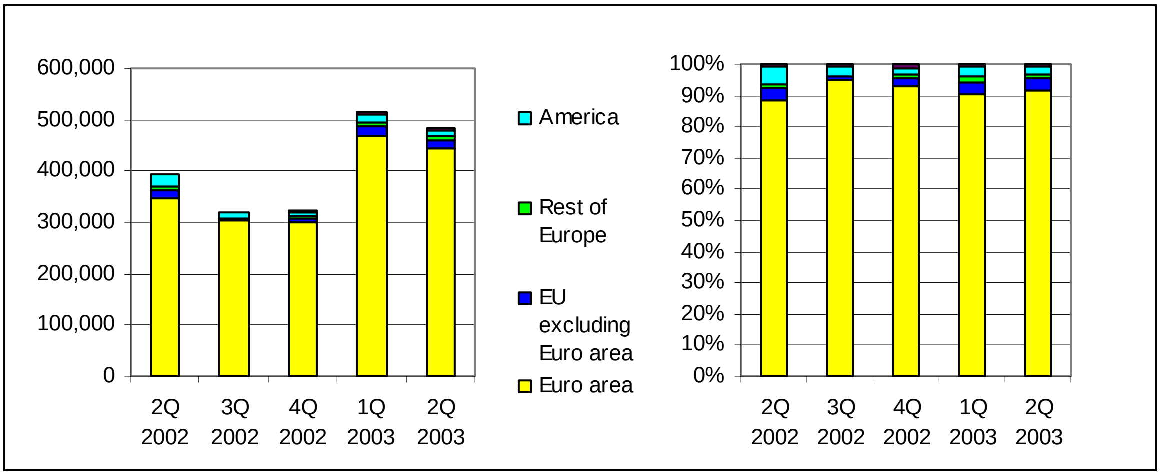
CHART 10 – COUPON TYPE OF ISSUANCE IN € MILLION AND % OF TOTAL VOLUME



2.6 Geographical distribution of issuance in euro

The geographical distribution of euro-denominated bonds confirms that investors have become less risk-averse in the first half of 2003, resulting in a larger share of bonds issued from outside of the euro-area. ***(See Chart 11.)***

CHART 11 – ORIGIN OF ISSUERS IN € MILLION AND % OF TOTAL VOLUME ISSUED



<u>SPECIAL FEATURE:</u>

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2ND GIOVANNINI GROUP REPORT ON EU CLEARING AND SETTLEMENT ARRANGEMENTS

In April 2003 the Giovannini Group issued the second report on EU clearing and settlement arrangements. The Giovannini Group was formed in 1996 to advise the Commission on issues relating to EU financial integration and the efficiency of euro-denominated financial markets. The Group consists of financial-market participants and meets under the chairmanship of Dr. Alberto Giovannini. Apart from the first report on Clearing and Settlement of 2001, the Group has produced three previous reports. The 1997 report considered the likely impact of the introduction of the euro on capital markets[8]; it helped to forge a common approach to the re-denomination of public debt in euro and in establishing common bond-market conventions for the euro-area. In 1999 a further report focused on the EU repo market, addressing problems related to national differences in infrastructure, market practices and legal/fiscal frameworks.[9] The scope for improving the efficiency of euro-denominated government bond markets by means of more co-ordinated issuance among the euro-area Member State[10] was analysed in a report in 2000. The following is a reproduction of the executive summary of the Group's second report on EU clearing and settlement arrangements, which was published on 15 April 2003.

EXECUTIVE SUMMARY OF THE 2ND GIOVANNINI GROUP REPORT

This is the second report of the Giovannini Group on EU cross-border clearing and settlement arrangements and complements the first report published in November 2001 (hereafter referred to as the 2001 report)[11]. The Giovannini Group is composed of financial-sector experts – meeting under the chairmanship of Alberto Giovannini – to advise the Commission on financial-sector issues. The work of the Group on clearing and settlement is expected to inform Commission policy in this field and responds to a mandate received from Commissioners Solbes and Bolkestein. The 2001 report was a diagnostic exercise. The objective was to introduce clearing and settlement to the uninitiated reader, highlight the specific problems of cross-border clearing and settlement and to identify the source of these problems. The Group identified the source of the problems in 15 barriers – based in market practice/regulatory requirements[12], tax

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8 "The Impact of the Introduction of the Euro on Capital Markets", A Communication from the Commission – COM(97) 337 of July 1997.

9 "EU Repo Markets: Opportunities for Change", October 1999.

10 "Co-ordinated Public Debt Issuance in the Euro Area", (Mimeo) November 2000.

11 See http://europa.eu.int/comm/economy_finance/publications/giovannini/clearing1101_en.pdf

12 i.e. Barrier 1: National differences in information technology and interfaces; Barrier 2: National clearing and settlement restrictions that require the use of multiple systems; Barrier 3: Differences in national rules relating to corporate actions, beneficial ownership and custody; Barrier 4: Absence of intra-day settlement finality; Barrier 5: Practical impediments to remote access to national clearing and settlement systems; Barrier 6: National differences in settlement periods; Barrier 7: National differences in operating hours/settlement deadlines; Barrier 8: National differences in securities

procedures[13] and issues of legal certainty[14]. In the time since the publication of the 2001 report, there has been little or no dissent from the identification of these barriers.

This second report attempts to provide solutions to the problems identified in the November 2001 report and has three main parts. The first part focuses on removing the 15 barriers and reflects a conviction within the Group that efficiency in EU clearing and settlement arrangements cannot be optimized within an environment of multiple regulatory, fiscal and legal regimes. Accordingly, a coherent strategy for removing the barriers is presented.

This strategy has been derived on the basis of several considerations:

(i) some barriers are more important than others and so there is a need to establish priorities;

(ii) some barriers are inter-dependent so that there is merit in establishing a sequence for their removal that minimizes the logistical effort and risk that may be involved;

(iii) it is necessary to identify the specific action that is needed to remove each barrier and to identify who – private or public agent – is responsible for that action;

(iv) the need for co-ordinated action in removing each barrier requires that a coordinator be identified in each case; and

(v) (v) there is a need to provide the necessary momentum and sense of urgency by establishing realistic but aggressive deadlines for removing each barrier.

The priority barriers – from the perspective of integration – are clearly those that restrict the location of settlement activities[15]. If these are removed, investors can choose where to locate their post-trading activities and set in train a market-led integration of clearing and settlement arrangements across the EU. Removal of these barriers would encourage a significant increase in cross-border securities trade but, if other barriers remain in place, there may be unacceptable levels of operational and legal risk. To avoid this outcome, an appropriate sequencing is required for removing the barriers – a sequencing that ends rather than begins with the removal of the "restriction barriers". This sequencing applies to the actual removal of barriers but not to preparatory work. In effect, preparatory work for removing each of the barriers will begin at the same time.

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issuance practice; Barrier 9: National restrictions on the location of securities; Barrier 10: National restrictions on the activity of primary dealers and market makers.

13 i.e Barrier 11: Domestic withholding tax regulations serving to disadvantage foreign intermediaries; Barrier 12: Transaction taxes collected through a functionality integrated into a local settlement system.

14 i.e. Barrier 13: The absence of an EU-wide framework for the treatment of interests in securities; Barrier 14: National differences in the legal treatment of bilateral netting for financial transactions; Barrier 15: Uneven application of national conflict of law rules.

15 i.e. Barriers 2, 5, 9 and 10.

As far as the private sector is concerned, barriers relating to information technology and operating hours[16] should be removed first. The removal of these two barriers would facilitate the removal of four other technical barriers[17] relating to differences in settlement periods, in rules on corporate actions, in issuance practices and intraday settlement finality. Barriers related to taxation and legal certainty[18] should be lifted by national governments at the same time as these remaining technical barriers – ultimately paving the way for the safe removal of the restriction barriers. For the removal of each barrier, the Group has identified the action required, the party responsible for that action and a deadline.

If the strategy for removing the barriers is credible, market participants can immediately prepare for life in a "barrier-free" environment. In such an environment, many of the obstacles to delivering efficient and integrated clearing and settlement arrangements for the EU – which seem insurmountable today - would be manageable. Although consolidation is not an inevitable feature of the integration process, some degree of consolidation is likely. The <u>second part</u> of this report deals with public policy considerations in the integration/consolidation of clearing and settlement providers in the EU and examines several models of integration in this context. Three such public policy considerations have been identified - cost effectiveness, competition and safety. Cost effectiveness is of interest to public policy as this is a central objective of the internal market, i.e. to exploit the integration of clearing and settlement arrangements so as to deliver economic benefits. The delivery of benefits to the economy as a whole – rather than to any sub-set of economic agents – requires an appropriate degree of competition. Competition implies freedom of access for both users and providers and the absence of any restrictive practices that might limit the extent of or distort competition among providers. If competition cannot be assured, then more regulation-based solutions might be appropriate. Finally, integration of clearing and settlement arrangements must be consistent with a desired level of systemic stability.

The various possible models of integration/consolidation affect these public policy considerations differently. As it is not feasible to cover all possible models in this report, a representative subset has been chosen. Each of the (three) models chosen implies a progressively higher degree of consolidation and has been examined in the context of the public policy considerations identified. The analysis in this section shows clearly that alternative structures could emerge in the consolidation process, and that an ex-ante assessment of these structures does not lead to a preferred solution, without much more clarity on the type of regulatory environment that will be needed to support integration and consolidation. However, the analysis provides practical guidance on the kind of issues that such a regulatory environment will need to address. The Group believes that, to build a system of clearing and settlement that constitutes a strong pillar of a truly integrated and liquid European financial market, a clear drive towards the elimination of barriers will have to be accompanied by a regulatory/supervisory structure which can function effectively on a pan-EU basis. With this set of conditions in place, the convergence towards the most efficient structure will occur rapidly and without disruptions.

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16 i.e. Barriers 1 and 7.

17 i.e. Barriers 6, 3, 8 and 4.

18 i.e. Barriers 11 to 15.

The final part of the report addresses the next steps required for integrating EU clearing and settlement arrangements and highlights the role of national governments. The Group believes that market participants should play the greatest role possible. However, the fundamental importance of clearing and settlement to the functioning of securities markets imposes a special responsibility on the public sector in promoting the integration process. In this context, the Group believes that progress cannot be achieved without the strong commitment of national governments and the EU Commission.

The full text of the 2nd Giovannini Group report on EU clearing and settlement arrangements is available at:

http://europa.eu.int/comm/economy_finance/publications/giovannini/clearing_settlement_arrangements140403.pdf