Division of Regulation Policy

Research Department

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2007 RISK AND TREND MAPPING FOR FINANCIAL MARKETS AND RETAIL SAVINGS

Risk and Trend Mapping - n°1

AUTORITÉ DES MARCHÉS FINANCIERS

AMF

CONTENTS

Introduction

Following the adoption this year by the AMF of a Better Regulation" approach, a major review of the role of the regulator was launched to promote and increase our efficiency. In this context, and to guide the AMF in its strategic choices, it appeared desirable to rationalise the use of financial analyses available to us.

An initiative has consequently been undertaken to collect basic information, compare the views of economists and market practitioners, and have a more comprehensive and coherent view of the environment in which the securities regulator has to make its decisions. This undertaking must not only provide an objective basis for our strategic choices but also ensure that these are more transparent and easier to understand.

The mapping presented below is still in its "experimental" phase. As such it is submitted to consultation both on the substance: our views and our resulting priorities, and on the method, i.e an analysis focusing on global trends accompanied by the collection of microeconomic information based on the views of different stakeholders. The usefulness of this mapping can only be truly established once it has become a permanent and recognised basis for exchange between regulators, investors and market professionals. It is with this goal in mind that we wish for the success of this initiative.

Michel PRADA
Chairman of the AMF

Methodology

When defining its regulatory policy at the national and international levels, the AMF wishes to have a rational approach of the way to monitor fundamental financial trends. This objective has led to the implementation of a project to analyse medium and long-term financial trends and their underlying risks in all areas within the purview of the securities regulator. This initiative is part of the more general "better regulation" approach adopted by the AMF both at the national level and within various international bodies, to improve processes for developing regulations and assessing their impact.

The purpose of this document, which is to be regularly updated, is to identify the major market risks and trends affecting participants in financial markets. This mapping exercise does not claim to be exhaustive. It rather offers a general overview that must be sufficiently broad to provide a basis for dialogue between the various market participants. It is designed to assist the regulator in better understanding and selecting sources for analysis in an environment where markets, products and participants at national and international levels are increasingly complex and interdependent. The trends identified fall under the scope of the strategic watch assured by the regulator. However, they must not be confused with the AMF working program, despite their bearing on the latter's content.

This risk mapping exercise has been challenging given the scope of the fields covered by the AMF. A decision was therefore made to focus on two main fields: retail markets and end-investors on the one hand, and wholesale financial markets, financial intermediaries, listed companies and institutional investors on the other. The first area concerns the behaviour of household savings and investments, and the retail financial product offering. Areas covered include the efficiency of the savings product selection process by individuals, financial literacy of retail investors and trends in fund management. The second area concerns risks incurred by direct participants in financial markets and their infrastructures. The analysis focuses especially on financial risks associated with the development of complex products and the disintermediation of the credit market, as well as trends affecting trading systems and post-trade infrastructures.

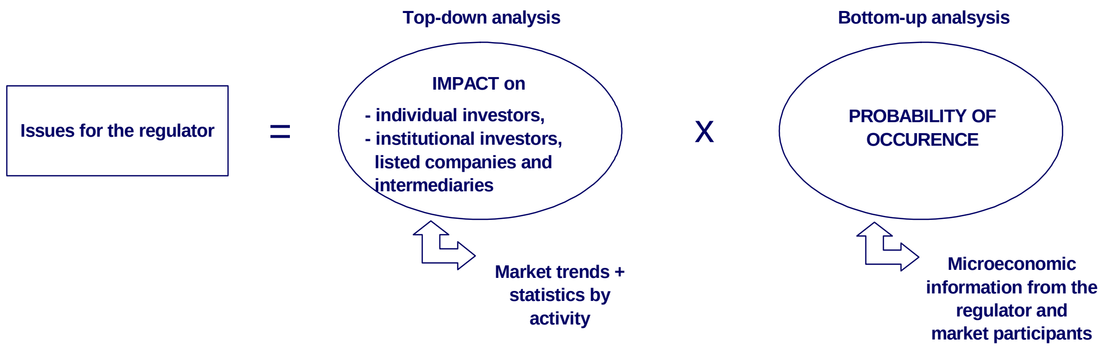
To ensure its operational nature, this risk mapping exercise has applied two complementary approaches drawing on their own sources of information.

Our bottom-up approach has consisted in first identifying shortcomings and concrete difficulties encountered in day-to-day practice, and more generally, the concerns of market participants, whether professionals, investors or regulators. This draws upon sources of information that are often unstructured in nature, and requires dialogue with, as well as the active participation of, the parties concerned. Such sources of course include the surveillance and supervision teams of the regulatory authority itself, as well as other national regulators or international regulators. It also concerns other financial market stakeholders, investors, market participants or professional associations that may have dealings with the regulator directly, or through consultative bodies and exchanges: the AMF consultative commissions, the meetings organised with professionals, or the scientific advisory board in which representatives of the academic community participate. Information of this nature generally identifies past shortcomings of a more or less specific nature. This approach is consequently retrospective and microeconomic in nature. Finally, such information must be assessed by consultation with market participants. This bottom-up risk mapping approach must be complemented by input from this consultation process to ensure its practical interest and coverage of relevant issues.

This was supplemented by a top-down approach using statistical analysis of economic data and market information available to the regulator covering the different areas within its oversight. This approach draws upon data collected notably through the regulator's supervisory and licensing activities as well as various market information systems, official sources of statistics and strategic analysis of market participants or strategic consultants. This latter approach offers the added value of economic research and a global perspective of markets provided by the vantage point of the financial regulator. In addition to the synthesis it gives of different sources of information on strategic issues, this analysis also takes into account issues involving longer-term horizons that exceed those of market practitioners, enabling it to identify trends and, in some cases, offer forward-looking insights on market and financial industry developments.

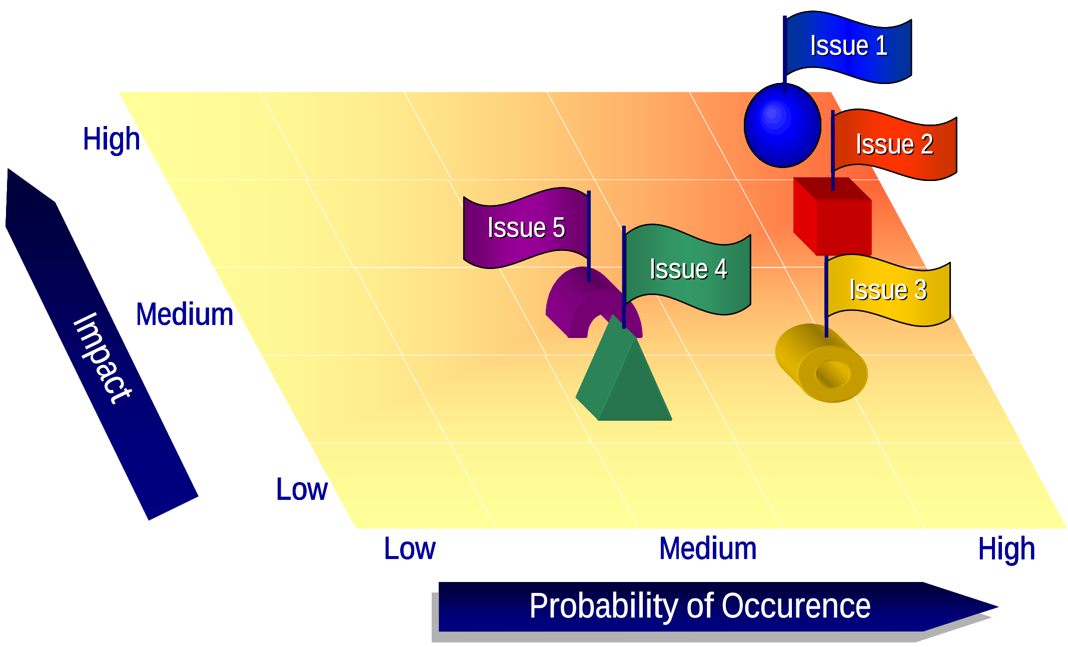
A systematic comparison between these bottom-up and top-down approaches provides a basis for an objective view of issues and perspective on their interrelatedness. This, in turn, enables the financial regulator to rank issues according to strategic importance in the following manner.

Ranking of risks by the market regulator



Risks and trends identified through these two approaches to the mapping exercise are then evaluated for this purpose using two criteria. The first is the scope of their potential impact on stakeholders: retail investors, listed companies, institutional investors and market intermediaries. The second is the likelihood that the risks or trends identified might occur, i.e. their relative degree of probability. By combining these two criteria, it is possible to rank the issues, risks or trends. The most significant are thus both highly probable and likely to have material impact on the parties concerned. This approach makes it possible to situate the overall position of different types of risks on a "risk map" and hence to determine the relative importance of the issues. This approach thus provides an objective basis for the financial regulator to make strategic decisions and in so doing renders the decision-making process more comprehensible and transparent.

Risk map (example)



By submitting the resulting map for consultation, market professionals can provide input on and their vision of current trends. This in turn will enhance the proposed map by providing a more informed basis for strategic choices on the part of the regulator.

General overview of risks and trends

MARKET TRENDS FOR HOUSEHOLD SAVINGS AND FUND MANAGEMENT PRODUCTS AND RISKS FOR RETAIL INVESTORS

Household savings

Over the last few years, French households have continued to invest heavily in life insurance products and traditional bank deposits. Household demand for high equity content assets has however significantly picked up, reversing the trend of 2002-2004. This renewed demand fuelled purchases of shares of equity-based funds or diversified schemes in connection with life insurance vehicles. Households moved back into equities despite the sustained period of growth, confirming their procyclical investment behaviour. This trend mirrors massive purchases of equities, both directly and through different types of investment vehicles, at the peak of the stock market bubble in the late 1990s.

Both procyclical investment behaviour and the tendency of household financial holdings to be insufficiently diversified or too liquid, expose retail investors to the shortfalls of an ineffective allocation of their savings and a potentially unfavourable risk/return trade-off. This issue is all the more significant as the transfer of financial risk from financial intermediaries to households is increasing, particularly through unit-linked life insurance products, at the very time they should be building their long-term savings to prepare for retirement. In addition, the accelerating pace of financial innovation contributes to the reduced transparency of increasingly complex investment products, making it more difficult for households to make investment decisions.

The poor allocation of savings resulting from unsuitable investment choices demonstrates the importance of financial education for retail investors. It also highlights the importance of the marketing of financial products, the need to pay particular attention to the quality and accuracy of financial advertising and the responsibility of retail distribution networks in providing investment advice and guidance.

Fund management

Growth in investments in collective investment schemes has been very strong in all countries. This trend has been accompanied by a rapid pace in the diversification of the product offering and profound changes in the organisation of the asset management industry, particularly in Europe.

Innovation in the asset management industry has resulted in the progressive diversification of the product offering into three main categories:

- Actively managed funds, such as alternative funds;
- Structured funds;
- Passive index products, including Exchange Traded Fund (ETFs).

These various asset management products may be offered within very different legal frameworks (insurance, banking and investment funds), depending on applicable laws and regulations involving potential differences in terms of transparency, tax treatment or the responsibility of intermediaries.

For the asset management industry, focus on productivity gains has accelerated the reorganisation of production and distribution processes. This has led to greater delegation of certain functions, which has in turn increased the complexity of the legal and geographical distribution of functions within and around asset management companies. In addition, beyond the historical role exercised by integrated sales networks, an open architecture is developing in Europe in favour of new players such as independent investment advisors or “financial supermarkets” for the distribution of savings products. The actual impact of this new competitive landscape in terms of reduced costs for investors remains to be assessed.

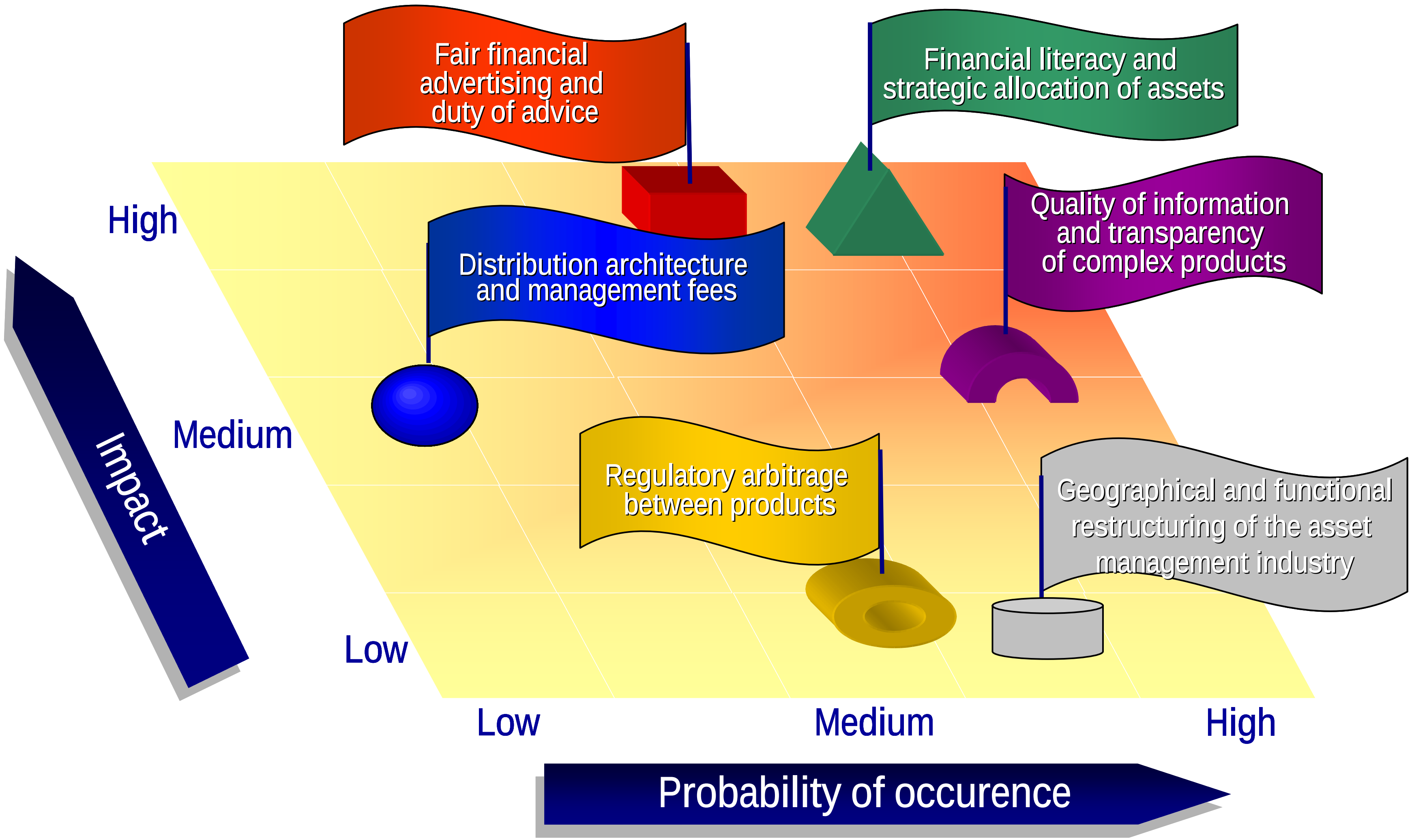
These trends raise the following questions:

- Do the increasing scope and complexity of the offering adversely affect the clarity of products and the risk/return trade-off for retail investors?
- Will the geographical and functional reorganisation of industrial producers result in the creation of increasingly fragmented entities, complicating the task of regulators in assuring their oversight?
- Will the productivity gains and economies of scale expected by the asset management industry in Europe translate into reduced costs for investors within a context of progressive opening of the architecture of distribution networks?

Based on this analysis of trends and risks concerning the market of retail investors and collective investment schemes, we have identified six key issues:

- the financial literacy and the ability of retail investors to rationally allocate their savings among asset classes;
- the quality of information and the transparency of complex products;
- the duty of savings products distributors to advise customers and provide accurate financial advertising;
- the level of asset management fees and commissions in an environment marked by rapid changes in products and in the organisation of production and distribution;
- the arbitrage opportunities between regulations applicable notably to the insurance, banking and asset management industry, and their impact on the choice of investment products;
- the increasing complexity of the organisation of management companies due to geographical and functional segmentation of activities and the impact of this trend on the regulatory authorities' ability to assure oversight.

Map of trends for household savings and risks for retail investors



TRENDS IN THE WHOLESALE FINANCIAL MARKETS AND RISKS FOR INTERMEDIARIES, LISTED COMPANIES AND INSTITUTIONAL INVESTORS

Global Financial environment

Considerable liquidity built up in recent years has contributed to lower yields in bond markets, particularly government bonds. In response, investors have sought out new opportunities involving greater risk and/or less liquidity through emerging markets or alternative assets such as hedge funds, private equity or debt securitisation funds. This diversification raises several questions from the point of view of the regulation of financial markets, in particular:

- Will investor portfolios become progressively over weighted in certain classes of assets that are more complex and potentially less liquid in the case of a reversal in the market or yield curves?

- Is credit risk in a disintermediated market, whether centralised by rating agencies or carried by individual investors, being correctly measured?

Bond and credit markets

Since a few years, in Europe and, to a lesser extent, in the United States, the offering of bonds has largely consisted of issuance by government and financial institutions, primarily banks. Issuance of debt securities by non-financial companies has been marginal as robust corporate profits of large companies have provided resources to meet their capital spending requirements. Institutional demand for bonds has been sustained by abundant long-term savings, particularly in the life insurance sector in France, and, in some countries, changes in the accounting treatment of pension funds. In particular, the increasing recognition of assets at market value has fuelled investments in debt securities with reduced volatility.

A growing share of securities issued by financial institutions have involved securitisation deals in the form of asset backed securities and collateralised debt obligations. These issues are intended to meet excess institutional demand in relation to the supply of high yield corporate bonds. Securitisation more and more involves complex techniques which sometimes include the use of credit derivatives. The constant growth of the market for structured products raises a number of questions. For example, will the multiplication of the roles of intermediaries putting together the deals generate conflicts of interest? Are we witnessing an increasing though insufficiently measured correlation between classes of assets resulting from a permanent arbitrage by certain investors across these markets? Furthermore, do investors understand the transfer of credit or liquidity risks associated with these products?

Equity markets

The decline in the number of listed securities in Continental Europe and the United States has continued. The number of initial public offerings was not sufficient to offset delistings. This trend has been accentuated by resurgence in cross-border mergers and acquisitions (M&A), the loss of appeal of multiple listings or, in some countries, the development of public-to-private deals launched by funds frequently through leveraged buyouts.

For companies already listed, net equity issuance (equity issuance less share buybacks and cancellations) posted moderate gains in Europe while losing ground in the United States. This trend reflects both a modest use of market financing and increasing recourse to share buyback programs as a means of rewarding shareholders. On the buy side, with the development of life insurance products (or defined benefit retirement plans in Anglo-American markets), the share in household savings of equities held by institutional investors and investment funds is regularly increasing.

This decline in the number of listed securities could undermine the attractiveness of equity markets, as an increasing number of companies turn to private equity financing. The growing number of alternative investment funds that are shareholders of companies has also increased focus on how these participants understand their role as shareholders. This has led in particular to greater attention being paid to shareholders' meetings of publicly traded companies, ensuring equal treatment for different types of shareholders, especially concerning the transparency of securities lending techniques used by certain investment funds, or the role of proxy providers.

Derivative markets and post-trade infrastructures

Three main trends have appeared. In the first place, since the advent of the euro, the geographical fragmentation of markets in Europe has resulted in a need for rationalisation. Varying degrees of consolidation have occurred depending on the level of vertical or horizontal integration involved in the different segments of securities business: trading, clearing and settlement. This has rapidly resulted in the development of alliances and mergers in the main European markets, and perhaps, in the future, between Europe and North America.

The second major area of change has been in derivatives markets which, due to their increasing size and diversity, are becoming the directional driver of the underlying cash markets. The upsurge in OTC derivative trading volume and of the hyper of derivatives that multiply opportunities of arbitrage, creating new challenges for effectively managing transaction settlements and the associated concentration of counterparty risk.

The third change concerns the boundaries between the participants to the securities chain. Competition among organised stock exchanges is no longer limited to entities of the same nature. In the future, markets will be marked by the evolution of new electronic trading or "reporting" platforms managed by stock exchanges or intermediaries – or by both – according to the profitability of such undertakings. The traditional concept of market members should also evolve to include new kinds of less regulated participants such as hedge funds. The post-trade segment is likely to see the same transformation as the competitive boundaries between settlement infrastructures and banks evolve with the development of added value services beyond those of basic registrar services. The role of clearing houses, particularly in OTC markets should continue to expand, raising possible concerns about the increase of systemic risks and of legal and technical concentration on a global level.

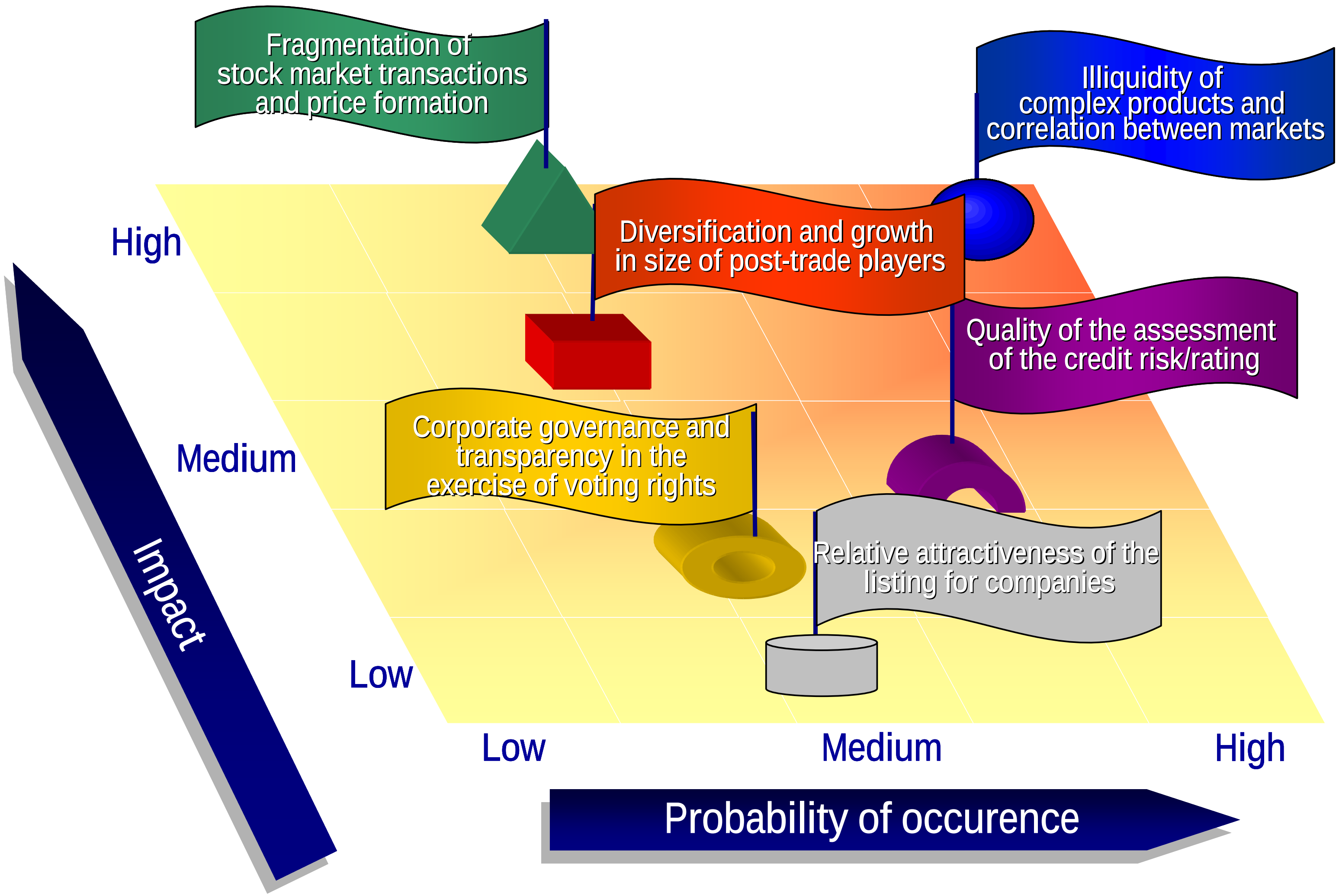
This increasing diversification of players and integration of market infrastructures is the subject of many controversies. Some question the economic efficiency of this new configuration in terms of price-setting process. Others invoke the risks incurred by players as the scope of their activity diversifies, particularly in the area of securities clearing. Finally, the intermediated holding of securities and increasing recourse to international banks for the booking and collateralisation of transactions render increasingly important the question of applicable law and competence of competing jurisdictions for the securities concerned.

* * *

In summary, the analysis of trends highlights six major issues for wholesale financial markets:

- the quality of the process of direct and indirect credit assessment by investors;
- the potential lack of liquidity for increasingly complex or specialised products, its impact in the event of a market reversal and the growing correlation between different market segments;
- the relative attractiveness of listing for companies;
- the role of investors in corporate governance and the necessary balance between the level of activism, stability and transparency in the holding and management of ownership rights in listed companies,
- efficiency and transparency of price-setting mechanisms in the event of a fragmentation of the European landscape of stock exchanges and competing trading venues;
- the legal and economic impact of the diversification of players in the post-trade industry and the concentration of clearing and settlement infrastructures.

Map of trends for wholesale financial markets and risks for intermediaries, listed companies and institutional investors



MARKET TRENDS FOR HOUSEHOLD SAVINGS AND FUND MANAGEMENT PRODUCTS AND RELATED RISKS FOR RETAIL INVESTORS

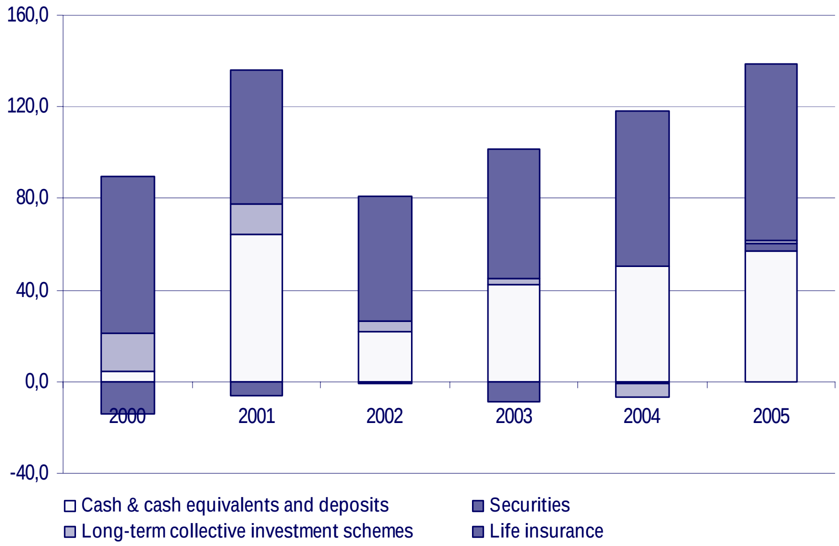
Household savings

➲·Investments are still concentrated in insurance and banking products

In 2005, French households invested EUR 140 billion in financial assets. This represents a sizeable increase over the previous year's acquisitions that totalled EUR 111 billion. Aside from the greater magnitude, however, there was no significant change in the overall structure of these investments. The trend towards investing in life insurance products was still strong in 2005, even though the returns on conventional contracts were pulled down by low bond yields. In 2005, life insurance vehicles attracted EUR 77 billion, or 56% of total household financial investment flows. Bank deposits also accounted for a substantial share of financial asset saving, at nearly EUR 57 billion. In contrast, securities and shares in collective investment funds[1] (excluding those held in connection with unit-linked life insurance vehicles) represented only EUR 4.4 billion.

Household investment in financial assets in France

(EUR billions)



Source : Banque de France

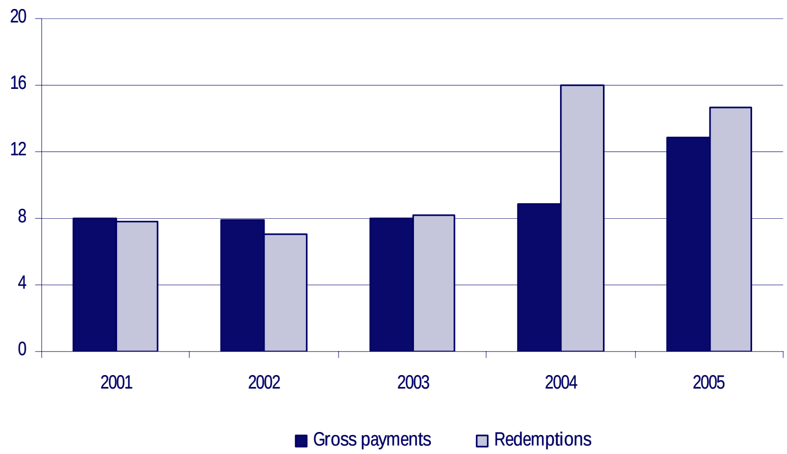
[1] *Total funds shares with the exception of money market funds.*

➲ Massive outflows from company savings plans

Statistics published by the AMF clearly show net saving in company savings plans was negative in 2005 with a shortfall of EUR 2 billion. This comes in despite the products' tax incentives and matching contribution mechanisms, and the fact that income from profit-sharing schemes is automatically invested in them. The decline was attributable not to a decrease in new payments, which soared to nearly EUR 13 billion in 2005, but to massive outflows totalling almost EUR 15 billion for the year as a whole. This follows the EUR 16 billion withdrawn in 2004 after the finance ministry decided to authorise an early release of funds in a number of exceptional cases. These huge outflows show that households no longer see company savings plans as a way of accumulating long-term savings and that, consequently, they may not be considered comparable to a company retirement savings plan. On the contrary, employees seem to be pulling out of the plans as soon as fiscally possible, i.e., after five years. Further analysis is warranted into the origin of this tendency to shun instruments that nevertheless offer attractive tax and financial characteristics.

Subscriptions and redemptions of company saving plan shares

(EUR billions)



Source : AMF

➲ Significant renewal in retail demand for equities

Having shunned the equity market for four years, French households invested much more heavily in risky assets in 2005. For the year as a whole, they acquired some EUR 43 billion worth of assets with high equity content, compared with an annual average EUR 12 billion for the period 2001-2004. These acquisitions break down as follows:

- EUR 15 billion of net payments into unit-linked life insurance vehicles;

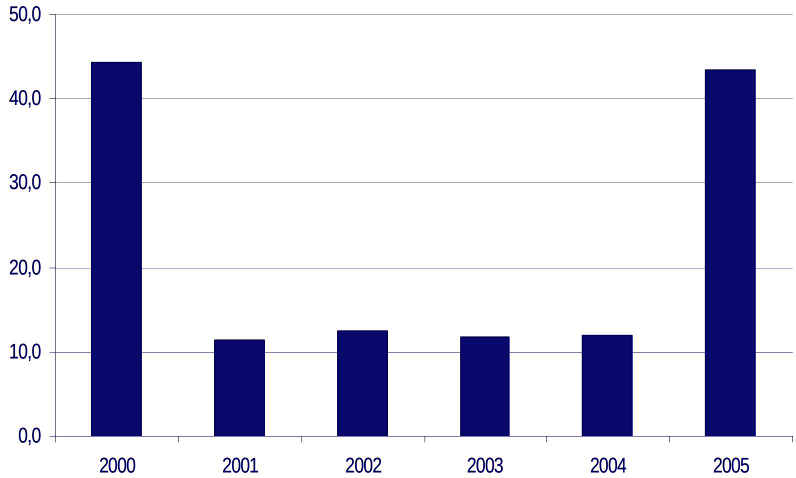
- EUR 22 billion in collective investment funds (excluding guaranteed funds);

- EUR 6 billion in directly held equities, following the flotation of the power utilities EDF and GDF.

At this stage, it may be noted that households have decided to move back into equities following an extended period of brisk growth. It should be recalled that the CAC 40 index of leading shares gained 16% in 2003, 7% in 2004 and 23% in 2005. As a result, households did not benefit from the attractive prices seen during the post-bubble period, as can be seen from the trend in valuation multiples over the past decade or so. The procyclical nature of investments in risky assets, also seen with collective investment scheme products, is a trend of sufficient economic and social importance to justify more detailed analysis of its origins.

Inflows to high equity content assets*

(EUR billions)



Sources : Banque de France, FFSA, AMF

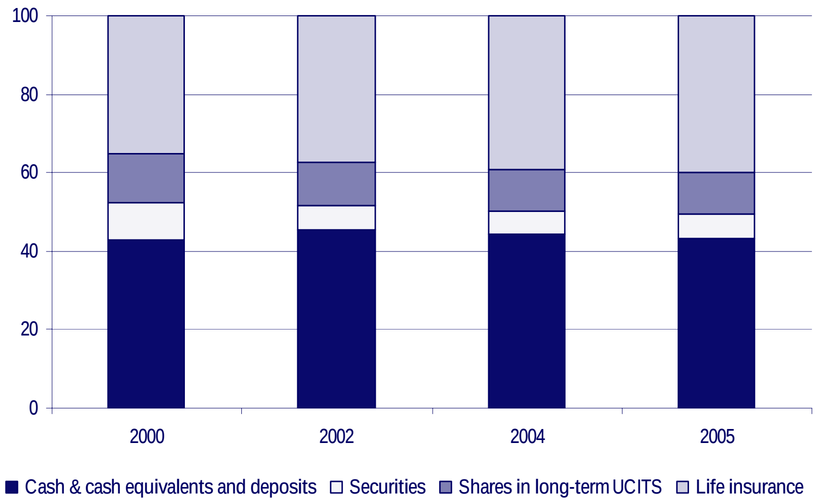
**Includes directly held equities, equity-based collective investment schemes, balanced schemes, « securities of miscellaneous investment funds » (including employee profit-sharing funds) and unit-linked life insurance vehicles.*

➲ Preference for life insurance products versus a lesser appeal for directly held equities

By definition, outstandings are much more stable than inflows into equities so that 2005 did not mark a major change in the makeup of household financial wealth. Bank intermediaries and insurance companies continue to share approximately equal amounts of household savings (roughly 40%). The weight of insurance products, already high in the early 2000s, continues to grow, though at a less rapid pace. And because inflows into equity markets have been very modest, the share of equities in household financial assets remains low. Combined direct holdings of bonds and equities represent only slightly more than 6% of total financial assets. The balance of approximately 11% consists of shares in funds. Their share in total financial assets has remained stable for several years now. It should be noted, however that holdings of shares in funds appear increasingly in insurance company balance sheets via unit-linked insurance vehicles.

A more detailed analysis of the makeup of investments highlights the exposure of household savings to equity market risk. In 2005, that exposure rose back from 2002 levels with high equity content holdings accounting for approximately 20% of household financial wealth (versus 17% in 2002). It should however be noted that some of the products chosen by investors are actually balanced products with roughly equal exposure to fixed income and equity markets. This is especially the case for unit-linked life insurance contracts which are only partially invested in shares.

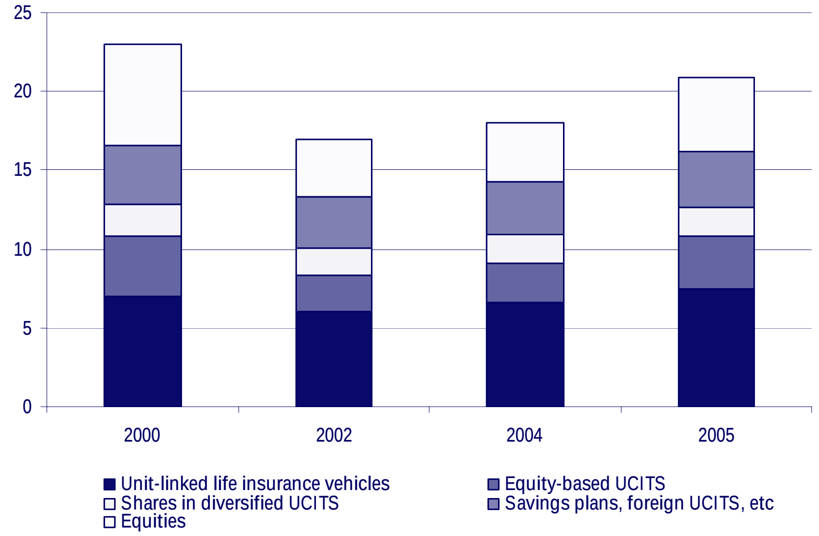
Outstanding investments of households in financial assets
(% of outstanding investments)



Source : Banque de France

Investments in high equity content assets

(% of financial assets)



Sources : Banque de France, FFSA, AMF

Fund management

➲·Worldwide growth in assets under management

In the last 15 years, inflows into collective investment funds at the international level have expanded at a significant pace. In nominal terms, assets under management by insurance companies, pension funds and investment funds increased nearly twofold between 1995 and 2004, or 90% for a selected sample of eight large industrial countries. This growth has largely been driven by strong gains by collective investment schemes (mutual funds or UCITS) whose assets under management surged by 167% over the same period in the same panel of countries.

Assets under management by institutional investors

	Assets under management (2004, USD billions)		Growth rate 1995-2004 (% and in local currency)	
	Mutual funds	Total institutional investors	Mutual funds	Total institutional investors
Italy	487	990,8	447,1	353,5
France	1.289,7	2.562,9	132,7	127,3
Germany	1.422,7	2.891,5	189,9	123,9
United States	7.787,7	18.931,7	185,1	101,7
Netherlands	135,5	1.304,7	110,3	99,2
United Kingdom	679,5	3.876,0	128,8	75,9
Japan	563,8	4.972,1	30,8	15,6
Spain	304	666,6	29,3	25,5
Total	12.669,9	36.196,3	166,7	90,1

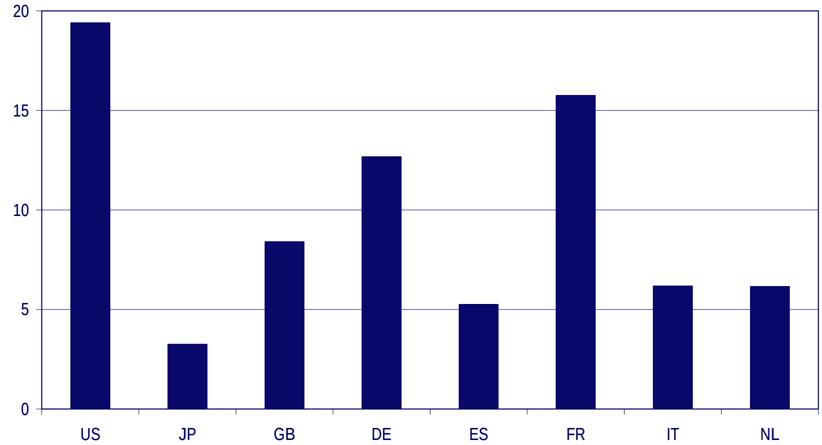
Sources : National accounts and AMF calculations

These performances vary significantly from one country to another. There are many possible explanations for these variances. In Italy and in Germany, where the spread of such products was particularly low, the rapid growth of collective investment schemes is the result of a classical catch-up phenomena and the introduction of new savings products. The increasing importance of fully funded pension schemes has also fuelled inflows into assets under management by institutional management companies in general and collective investment schemes in particular.

In 2004, despite this catch-up phenomena, the size of national markets vary significantly. In the United States, per capita holdings in mutual funds were close to USD 20,000 in 2004 versus barely USD 7,000 in Italy or the Netherlands. The amount in France is approximately USD 16,000.

Investment funds per capita

(2004, USD thousands)

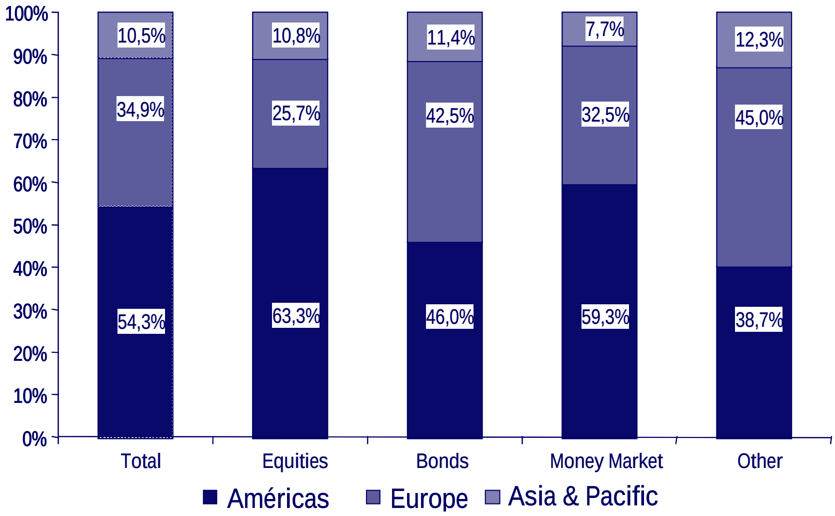


Source : EFAMA , AMF

A review of national markets of collective investment schemes also highlights a number of differences in the nature of products managed. Accordingly, in the United States, equity and money market funds are the preferred investment vehicles. In Europe, investors have a much greater preference for bond funds and more complex funds, including balanced or diversified funds, structured funds.

The opposition of investments in fixed income and equity products is clearly shown in the statistics on the international breakdown of collective investment scheme assets among major product categories.

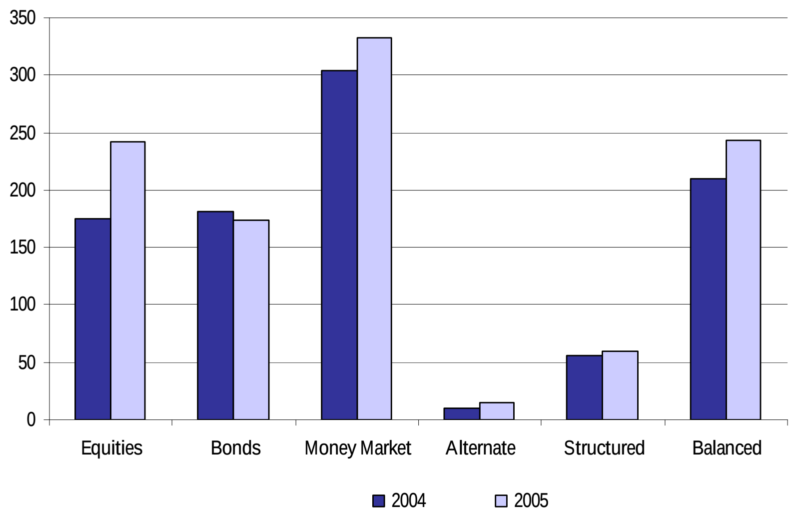
Regional breakdown of mutual fund allocations in 2004



Source : EFAMA

With total assets under management amounting to EUR 1,066 billion, the French market for UCITS funds is particularly vast. In 2005, this sector registered brisk growth, with assets under management increasing 14% in response to the combined effects of the increase in price of financial assets and new sales. Money market funds are a significant component of this market, reflecting a legacy of the monetary history of France that launched a process of market liberalisation in the mid-1980s, opening it up to all participants on both the supply and demand sides. It also may be noted that balanced funds account for an important 23% share of outstandings. This category includes structured products and in particular guaranteed funds for which France is one of the primary markets worldwide.

UCITS Market in France
(EUR billions, 2005)



Source : AMF

Generally speaking, the specific characteristics of the countries mentioned above appear to result from different factors including:

- The choice of government, especially policies concerning welfare benefits and the financing of pension plans, and their regulatory and tax impact on financial products;

- The current and historical importance of bank networks and infrastructures in the development of collective investment schemes and notably in respect to their marketing;

- Certain specific factors of household demand for savings products that can also explain differences in national preferences. However these factors are difficult to identify.

➲·Richer fund offering and more complex products

In recent years, the offering of investment products has significantly expanded. Alongside conventional long-only type funds that have accounted for the major share of outstandings, new inflows have been marked by the progressive development of three categories of investment. This has included active management products or alternative funds seeking to enhance the risk/return trade-off, structured funds and finally lower-cost passive instruments.

- Active management and alternative funds enhancing the risk/return trade-off

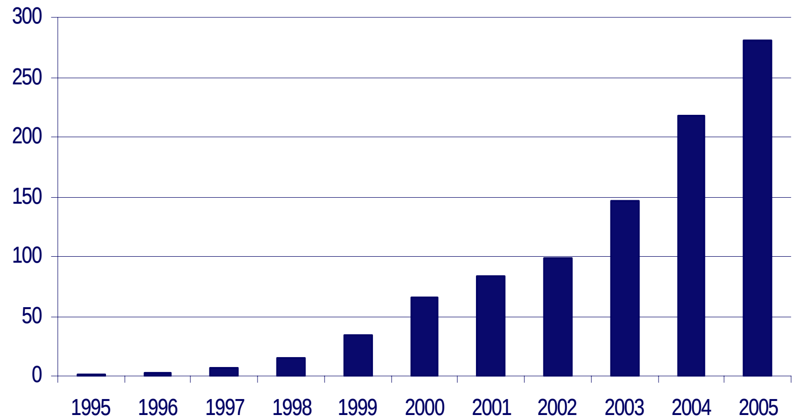
Following the burst of the stock market bubble, absolute return funds developed in an environment of very low yields in conventional bond markets. These vehicles focus on non-traditional asset classes and/or management methods. Their goal is to generate a return independent from that of traditional assets. This category of funds includes private equity, real estate, products resulting from securitisation transactions (ABS, CDO) and commodities. This category also includes investment funds that make use of alternative management techniques such as leveraging positions in derivatives or securities lending markets. It is not easy to estimate amounts under management for these funds because the diversity of their management methods makes them difficult to identify and classify. According to Lipper, in 2005, they accounted for 5% of assets under management in Europe.

Some of these funds are defined in terms of level of risk. The fund manager's offer is thus defined in terms of a certain level of risk rather than in terms of an asset allocation policy. Managers of such funds can invest in different types of financial instruments according to market conditions and trend forecasts.

- Passive management

This category, which includes index-based exchange-traded fund products (ETFs) has grown significantly in some countries in recent years. Between 1998 and 2005 the share of ETFs in total equity fund outstandings in the United States has increased more than twofold, to 5%. In France, ETF outstandings at 2005 year-end was approximately EUR 25 billion or 2.5% of total UCITS outstandings.

ETFs in the United States (USD billions)

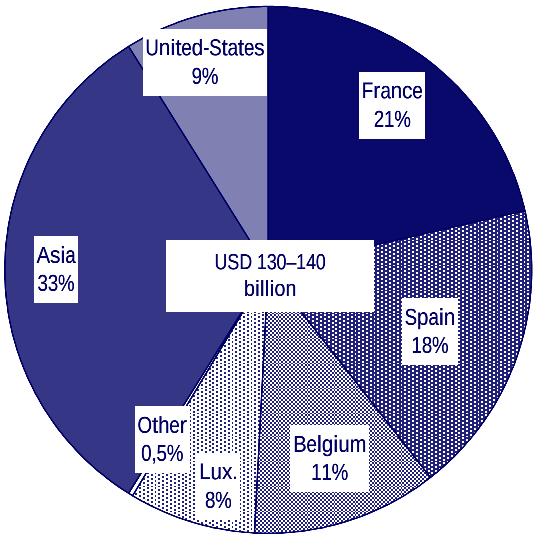


Source : Federal Reserve

- Structured funds

These products have seen more or less sustained growth, with regional variances. The popularity of this type of product has been greater in some countries in Continental Europe, such as France, Spain, Belgium and Luxembourg. However the amounts involved remain relatively small compared with total assets under management. In France, assets under management in structured funds (*fonds à formule*) in 2005 totalled EUR 61 billion or close to 6% of total assets under management in UCITS.

Worldwide breakdown of structured funds in 2004



➲·Limited rationality of a demand largely driven by the supply side

Against the backdrop of the increasing complexity of the offering, an analysis of demand shows:

- the growing importance of long-term savings and retirement goals in the management of collective investment schemes;

- the limited rationality of household investment behaviour characterised by procyclical investment decisions and infrequent comparisons of different products on their part.

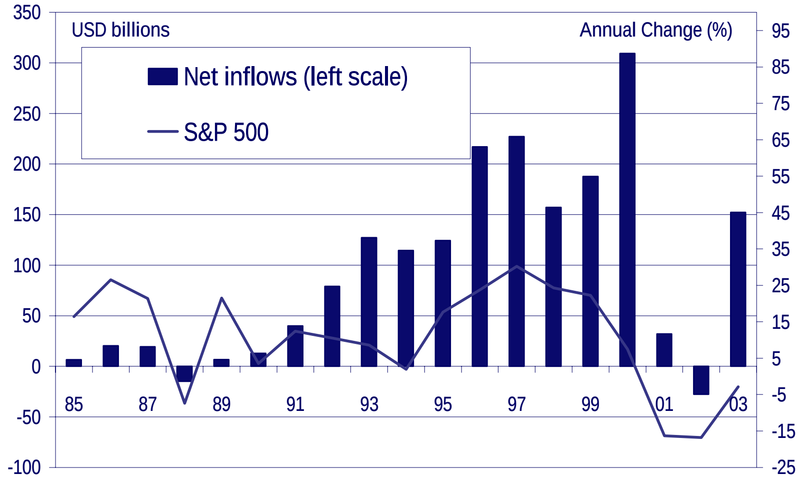
Academic literature has documented this situation in a body of work referred to as "behavioural finance"[2]. In particular:

- fund demand appears relatively indifferent to prices. Studies in this area are rare in the United States and almost inexistent in Europe, due in large part to the lack of a statistical base. Some studies on long-run management costs in the United States nevertheless demonstrate the impact of fund marketing costs on sales and underline the importance of the supply effect on demand;

[2] *Study by Bruno Séjourné "Why Is the Behaviour of French Savers so Inconsistent with Standard Portfolio Theory?" Published in the Working Papers of the AMF - September 2006 .*

- Often, there is a positive association between investment inflows and past performances of the fund concerned. This phenomenon has been observed in the United States, but is also found in Europe (see chart). The tendency can also be observed for investments in hedge funds.

United-States: net inflows equity funds and market performance



Source : Investment Company Institute, AMF

➲·Powerful forces driving the reorganisation of the industry

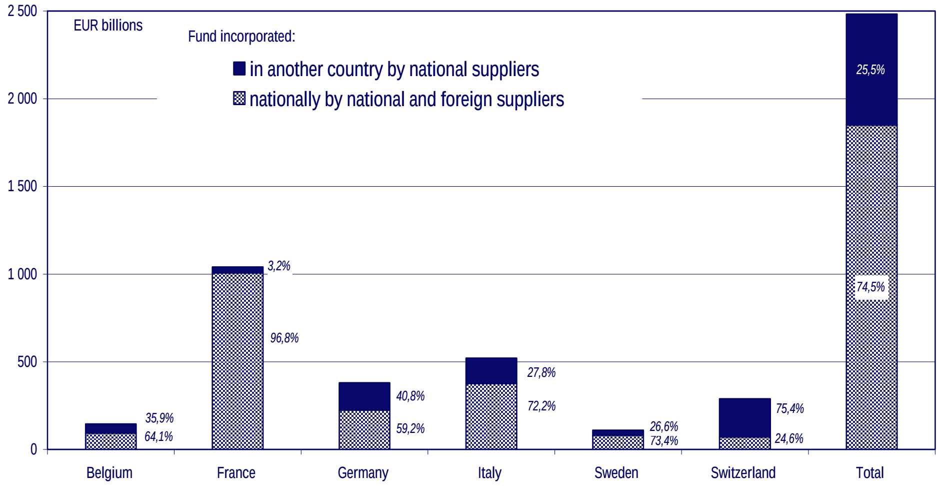
Against the backdrop of the growth in assets under management, the asset management industry has undergone reorganisation and concentration, rationalising management techniques and the handling of investment flows. Big international players have also emerged, in most cases from large banking or insurance groups. The competitors of these new market entrants are primarily management companies of more modest size that benefit from a high degree of specialisation, for example, in the small and mid-caps segment.

These developments recall questions regarding competitive conditions most favourable to the asset management industry's optimal development in a unified European economic area, with particular insight into the value chain, the outsourcing of certain functions and the geographical location of different asset management-related activities.

From a functional point of view, some management companies outsource activities not within the scope of their core business (such as administrative and other back-office activities, liabilities management, marketing, middle office activities, i.e., performance analysis and ranking, reporting, accounting and valuation, internal control, etc.). Others sometimes delegate management activities entirely or in part, depending on the degree of specialisation they seek to obtain in certain market segments. At this stage however, questions concerning a possible trend over time of the segmentation of fund management companies' activities and the economic origins of this phenomenon have not yet been sufficiently analyzed.

Moreover, from a geographical perspective, some countries like Luxembourg and Ireland have reaped great benefits from fund management for historic, regulatory and tax reasons. While the trend of incorporating funds in other countries has not been as pronounced in France as for German funds or those of smaller European countries (see chart), the question of the location of management activity remains an issue for further investigation. In this respect, it would be useful to seek out the causes for relocating operations by carefully analyzing the incentives driving this trend and the activities potentially involved.

Fund management locations in 2004

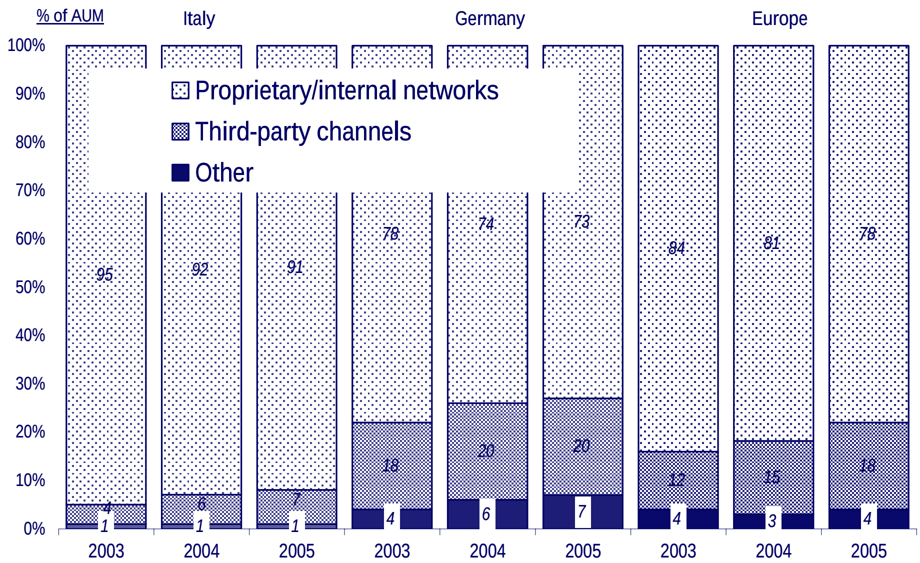


Source : EFAMA

Methods of selling funds also vary significantly from one country to another. There are two main models for these products. In most countries in Continental Europe, fund management activities are carried out by universal or full-service banks. Under this model, traditional banking activities coexist with capital market, insurance and third-party asset management services. The distribution of management products designed by subsidiaries specifically devoted to this activity is primarily carried out by the bank branch network. Independent management companies occupy a marginal role in this landscape. In the second model, of Anglo-American inspiration, asset managers are independent of the banking groups. This independence has both historical and regulatory reasons. Distribution of management products is assured by independent financial advisers (for example in the United Kingdom) that offer competing products available on the market. As such, this represents an "open architecture" sales model.

These models are evolving. In the United Kingdom, where independent financial advisers do most of the distribution, bank networks have also been authorised to market products of third parties (de-polarisation) since 2004. They are distributing an increasing share of UCITS. In Continental Europe, the shift from a "banking" to an open architecture system has not yet been significant, except in Germany. The increasing role of UCITS for retirement plans, the growing complexity of the product offering and marketing techniques underscore the need for a more systematic and comparative analysis of the marketing techniques for UCITS throughout Europe.

Distribution by independent networks (% of AUM)

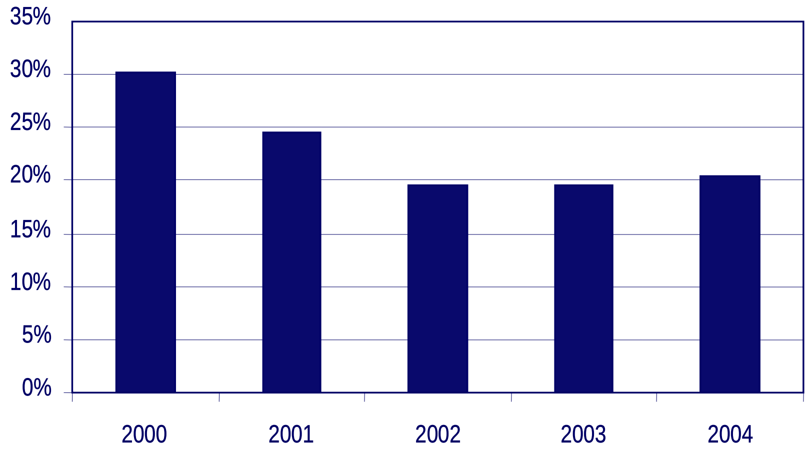


Source : McKinsey

➲·Investors have yet to see the benefits of economies of scale

Due to a lack of homogeneous data and a statistical framework (international economic statistical nomenclature only broadly identifies asset managers, placing them within the category of "other financial intermediaries"), bases for analysis of the asset management industry remain highly insufficient. As a result, very few academic studies have covered this subject in Europe. With European market integration, it nevertheless appears essential to measure the impact of potential economies of scale for the industry. It also seems necessary for the regulator to quantify these economies to determine the potential benefit to market participants, in particular for individual investors.

France - Operating margin of management companies

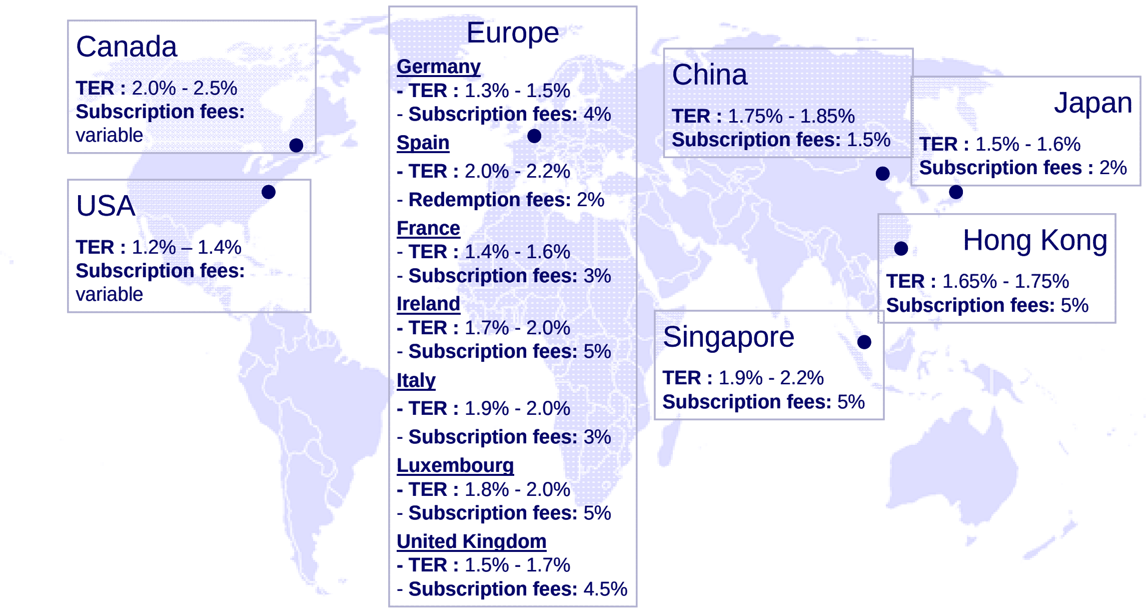


Source : AMF

The frequent claim by the asset management industry that the relatively small size of European funds in comparison with US funds hinders the development of the market in this region raises a number of questions.

First, the significance of economies of scale, which stand to benefit a consolidated European industry, remains to be measured precisely – though it is easily intuited, since it seems evident that doubling outstandings managed does not require a twofold increase in managers.

Management costs:* « typical » levels



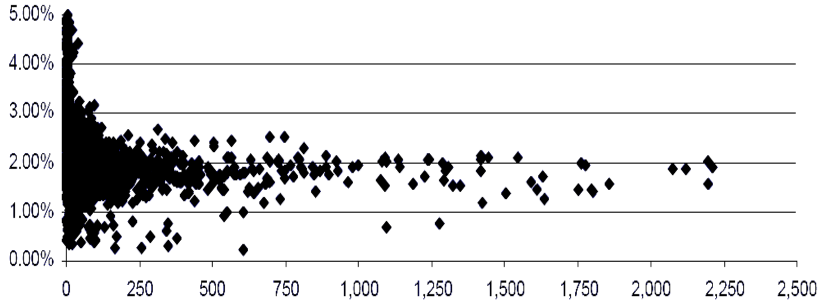
* TER (Total Expense Ratios) constitutes average measurements of management costs. See also: Khorana, Servaes, *Mutual Fund Fees Around the World* (May 2006))

Source : Lipper Fitzrovia

Second, and more important, in an environment where management fees continue to vary significantly from one European country to another, it has not yet been demonstrated that economies of scale translate into benefits for investors. In any case, a study conducted by Lipper-Fitzrovia on management fees for a sample of Luxembourg equity funds according to their size (see chart), shows that:

- Fees decrease significantly as the size of "small" funds (between USD 0 and 250 million) increases. This confirms the perception whereby very small funds, whether they be highly specialised or recently launched, are relatively speaking more expensive at start up;
- Beyond this threshold, however, costs stabilize. Consequently, the slope of the regression line between costs and the size of the fund is low or even possibly slightly positive in the following chart.

Luxembourg : TERs of actively managed equity funds (« retail » market)



Source : Lipper-Reuters

Unitholders do not benefit, as in the United States, from a system of "breakpoints" assuring a gradual decrease of management fees when the size of assets under management of the funds increases. In the current European environment, which is characterised by a relatively captive European asset management industry and distribution market, investors do not receive any direct benefit from market consolidation.

Finally, it should be noted that while studies of this nature exist for significant selections of Luxembourg and Italian funds, it is not possible to carry out a satisfactory analysis of the French situation on the basis of data currently available given the present degree of transparency of the market .

MARKET TRENDS FOR HOUSEHOLD SAVINGS AND FUND MANAGEMENT

PRODUCTS AND RISKS FOR RETAIL INVESTORS

Household savings

Over the last few years, French households have continued to invest heavily in life insurance products and traditional bank deposits. Household demand for high equity content assets has however significantly picked up, reversing the trend of 2002-2004. This renewed demand fuelled purchases of shares of equity-based funds or diversified schemes in connection with life insurance vehicles. Households moved back into equities despite the sustained period of growth, confirming their procyclical investment behaviour. This trend mirrors massive purchases of equities, both directly and through different types of investment vehicles, at the peak of the stock market bubble in the late 1990s.

Both procyclical investment behaviour and the tendency of household financial holdings to be insufficiently diversified or too liquid, expose retail investors to the shortfalls of an ineffective allocation of their savings and a potentially unfavourable risk/return trade-off. This issue is all the more significant as the transfer of financial risk from financial intermediaries to households is increasing, particularly through unit-linked life insurance products, at the very time they should be building their long-term savings to prepare for retirement. In addition, the accelerating pace of financial innovation contributes to the reduced transparency of increasingly complex investment products, making it more difficult for households to make investment decisions.

The poor allocation of savings resulting from unsuitable investment choices demonstrates the importance of financial education for retail investors. It also highlights the importance of the marketing of financial products, the need to pay particular attention to the quality and accuracy of financial advertising and the responsibility of retail distribution networks in providing investment advice and guidance.

Fund management

Growth in investments in collective investment schemes has been very strong in all countries. This trend has been accompanied by a rapid pace in the diversification of the product offering and profound changes in the organisation of the asset management industry, particularly in Europe.

Innovation in the asset management industry has resulted in the progressive diversification of the product offering into three main categories:

- Actively managed funds, such as alternative funds;
- Structured funds;
- Passive index products, including Exchange Traded Fund (ETFs).

These various asset management products may be offered within very different legal frameworks (insurance, banking and investment funds), depending on applicable laws and regulations involving potential differences in terms of transparency, tax treatment or the responsibility of intermediaries.

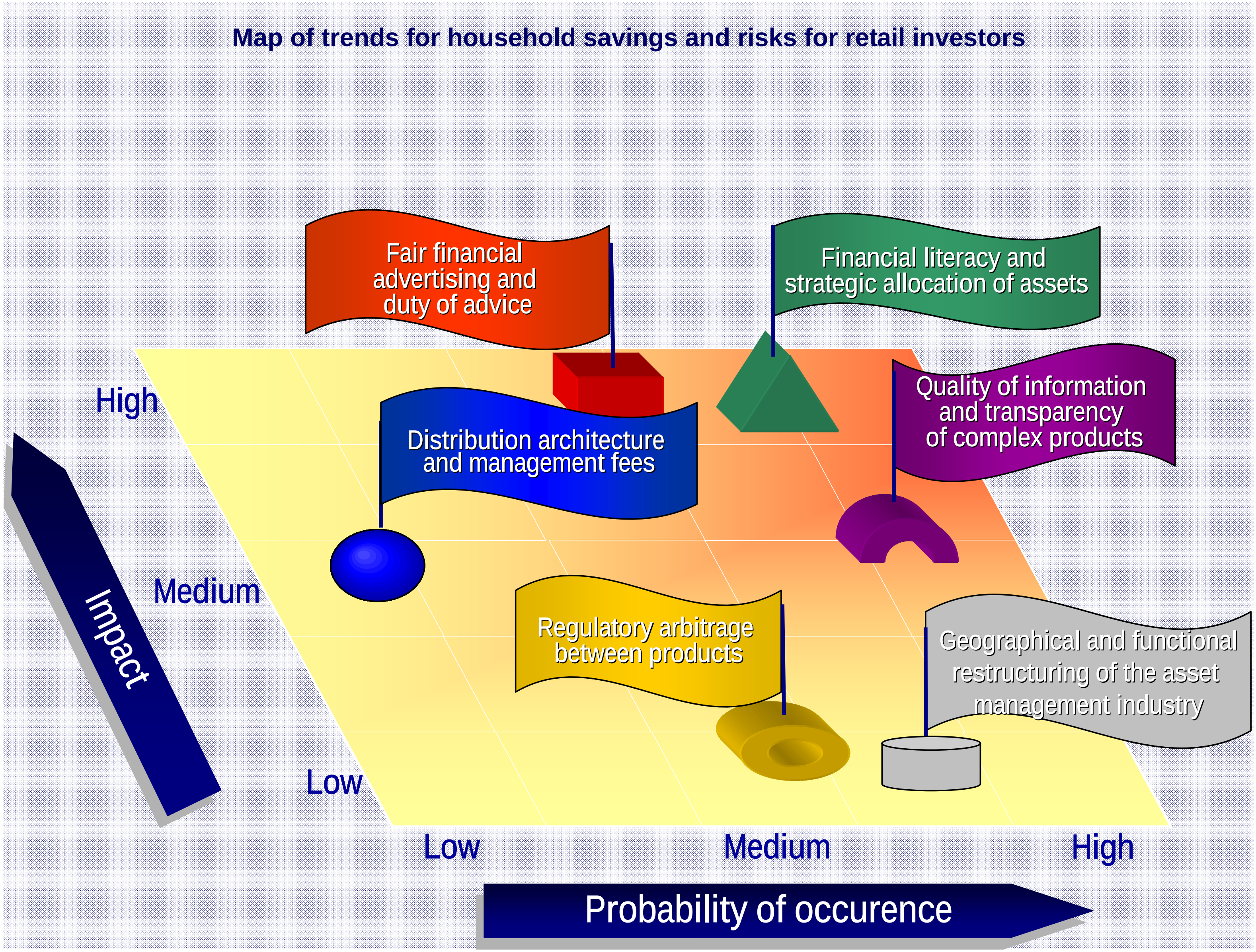
For the asset management industry, focus on productivity gains has accelerated the reorganisation of production and distribution processes. This has led to greater delegation of certain functions, which has in turn increased the complexity of the legal and geographical distribution of functions within and around asset management companies. In addition, beyond the historical role exercised by integrated sales networks, an open architecture is developing in Europe in favour of new players such as independent investment advisors or "financial supermarkets" for the distribution of savings products. The actual impact of this new competitive landscape in terms of reduced costs for investors remains to be assessed.

These trends raise the following questions:

- Do the increasing scope and complexity of the offering adversely affect the clarity of products and the risk/return trade-off for retail investors?
- Will the geographical and functional reorganisation of industrial producers result in the creation of increasingly fragmented entities, complicating the task of regulators in assuring their oversight?
- Will the productivity gains and economies of scale expected by the asset management industry in Europe translate into reduced costs for investors within a context of progressive opening of the architecture of distribution networks?

Based on this analysis of trends and risks concerning the market of retail investors and collective investment schemes, we have identified six key issues:

- the financial literacy and the ability of retail investors to rationally allocate their savings among asset classes;
- the quality of information and the transparency of complex products;
- the duty of savings products distributors to advise customers and provide accurate financial advertising;
- the level of asset management fees and commissions in an environment marked by rapid changes in products and in the organisation of production and distribution;
- the arbitrage opportunities between regulations applicable notably to the insurance, banking and asset management industry, and their impact on the choice of investment products;
- the increasing complexity of the organisation of management companies due to geographical and functional segmentation of activities and the impact of this trend on the regulatory authorities' ability to assure oversight.



Map of trends for household savings and risks for retail investors
Fair financial advertising and duty of advice
Financial literacy and strategic allocation of assets
Distribution architecture and management fees
Quality of information and transparency of complex products
Regulatory arbitrage between products
Geographical and functional restructuring of the asset management industry
High
Medium
Low
Impact
Low
Medium
High
Probability of occurence

Global financial environment

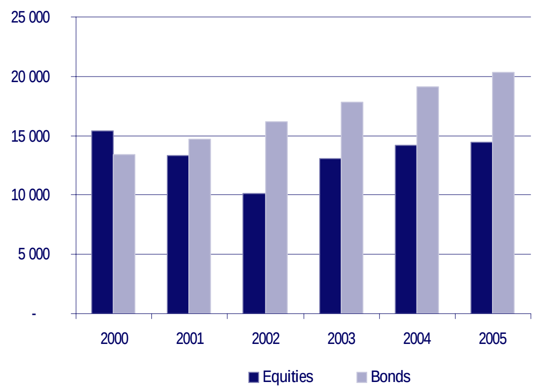
➲·Significant growth of financial markets since 2002

Since the beginning of the decade, the different financial markets have experienced uneven growth rates:

- Bond markets have registered sustained and uninterrupted growth fuelled by growing Government borrowing requirements and the trend of financial institutions to secure and increase their resources through this market. In the United States and in the euro area, outstanding bond debt of residents increased respectively by 8.7% and 7.5% on average per year over 2000-2005:
- Equity markets experienced more lacklustre trends. In an environment characterised by low or even negative equity issuance levels in response to earnings distribution policies involving share buy-backs, growth in outstandings was fuelled primarily by rising share prices. After a sharp downturn over 2001-2002 with the burst of the technology stock bubble, by the end of 2005, outstandings of publicly-traded companies recovered rapidly, reaching the levels attained at the height of the speculative bubble at the end of 2000.

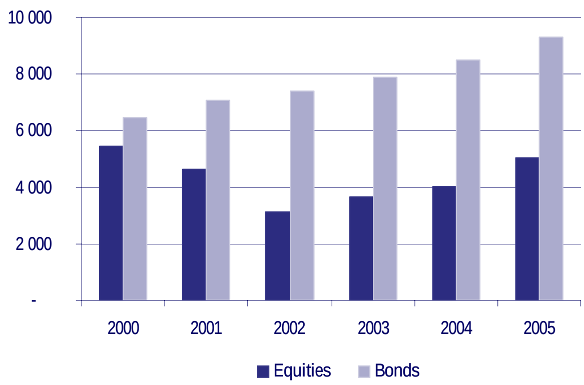
Outstandings of long-term debt securities issued by residents

(i) United-States (USD billions)



Source : Federal Reserve

(ii) Euro area (EUR billions)



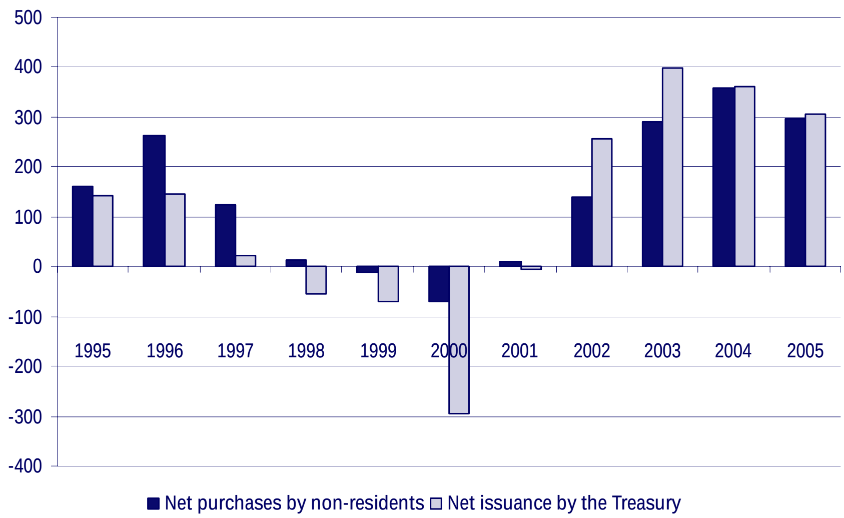
Source : European central bank

➲·Capital flows driven by the negative balance of payments in the US

Financial flows and the formation of asset prices internationally were determined by major macroeconomic imbalances in certain countries. Undersaving by US households and a correlating major US deficit in current account balance (USD 804.9 billion in 2005, or 6.4% of GDP) fuelled a massive inflow of foreign currency by creditor countries, primarily from emerging Asian nations. These currencies, which were not converted into the national currency, resulted in purchases by central banks denominated in US dollars to limit the appreciation of the local currency on foreign exchange markets. At the same time, rising oil prices starting in 2002 made US financial assets more attractive for oil exporting countries (invoicing in US dollars). Statistics on the purchase of US treasuries clearly highlighted the role of non-residents, who in 2004/2005 purchased volumes of debt securities that were more or less equal to the total amount of debt security issuance by the U.S. Treasury.

Treasury security purchases by non-residents compared with net issuance of US treasuries

(USD billions)

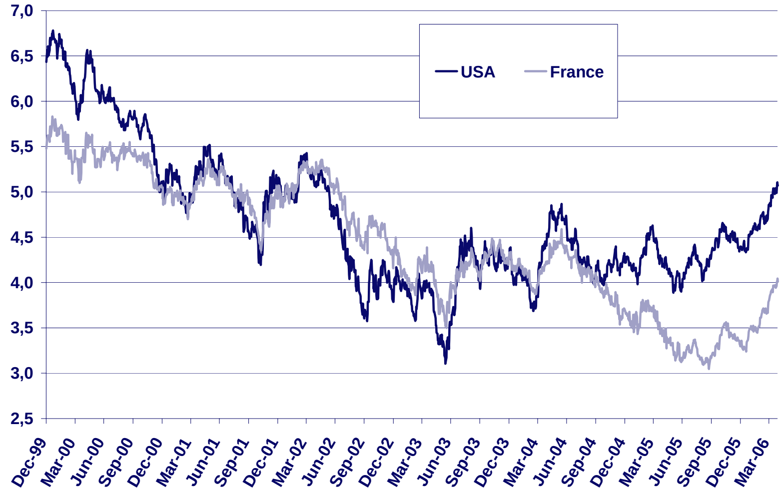


Source : Federal Reserve

➲·Exceptionally low interest rates and risk premiums

Expansion of the worldwide monetary base resulting from the behaviour of US and Asian central banks provided the global economy with massive amounts of liquidities, keeping interest levels down. In an international environment in which large companies that issue securities have been reducing their balance sheet debt, and consequently, their recourse to equity financing, bond market yields have remained very low over 2004-2005, despite concerns about inflation in response to the sharp increase in prices of certain real assets, notably in real estate and commodities markets.

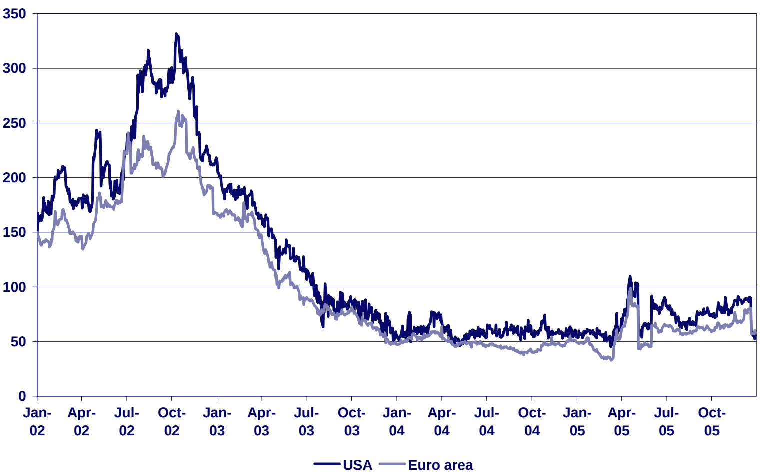
Government bonds: Long term interest rates (%)



Source : Datastream

The high level of liquidities and low yields of traditional assets, combined up to May 2006 with record low volatility, has driven investors to riskier assets. The low yields of riskless assets has consequently spread to different financial markets, in particular contributing to growth in equity prices in certain emerging countries and the general narrowing of spreads in the bond market for non-sovereign issues both in developed and emerging countries. Similarly, increasing investment inflows have been registered in favour of alternative investments such as hedge funds and different types of structured products (CDOs, etc.) as well as private equity. These trends in financial markets have been strengthened by positive economic growth and corporate earnings trends in all regions whereby the latter have contributed to a reduction in risk premiums for corporate and emerging country issuers and a rise in stock prices.

***Spreads* BBB against the 10-year swap (bp)**



Source : Lehman Brother/CDC-IXIS

Bond and credit markets

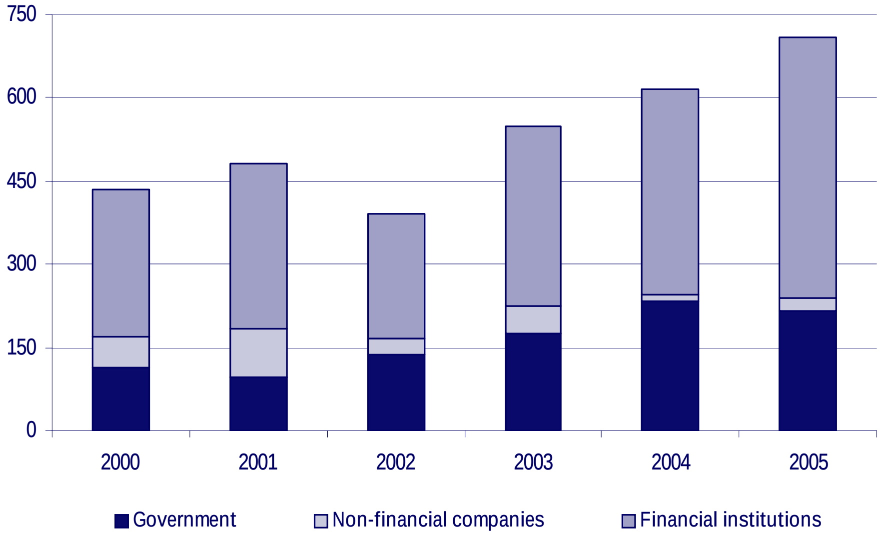
➲·Euro area growth in bond issuance despite a decline in the number of new corporate bonds

Following the 2002 low, net issuance of bonds has registered sustained growth in the euro area. In 2005, this trend continued with debt securities issued totalling EUR 710 billion versus EUR 615 billion the prior year. These issues naturally boosted growth in outstandings combined with the impact of valuations resulting from declining interest rates. Similar trends were seen in the United States. However, the massive volume of US federal government debt offerings was not sufficient to offset the decline in issues by government-sponsored enterprises (GSEs). As a result, total issuance decreased in 2004-2005.

This increase in total bond debt nevertheless includes significant differences in the breakdown of issues by type of issuer. The balance of the bond market in the euro area was consequently again achieved in an environment of reduced issues by non-financial companies. According to the European central bank, non-financial companies in the euro area had recourse to debt financing for only EUR 21 billion. As statistics of the Bank of France indicate, France was not an exception to this trend. In 2005, redemptions by companies significantly exceeded new issues. As a result, net issuance was largely negative with a decline of EUR 12.5 billion. The reasons for this trend are well known: robust corporate earnings combined with restrained capital spending in the face of insufficient economic growth reduced companies' need for additional debt financing. In the United States, a similar observation could be made. Since the beginning of the decade, recourse to the bond market has significantly declined, and in 2005 net issuance of debt securities totalled only USD 61 billion versus USD 78 billion in 2004.

Bond issuance in the Euro area

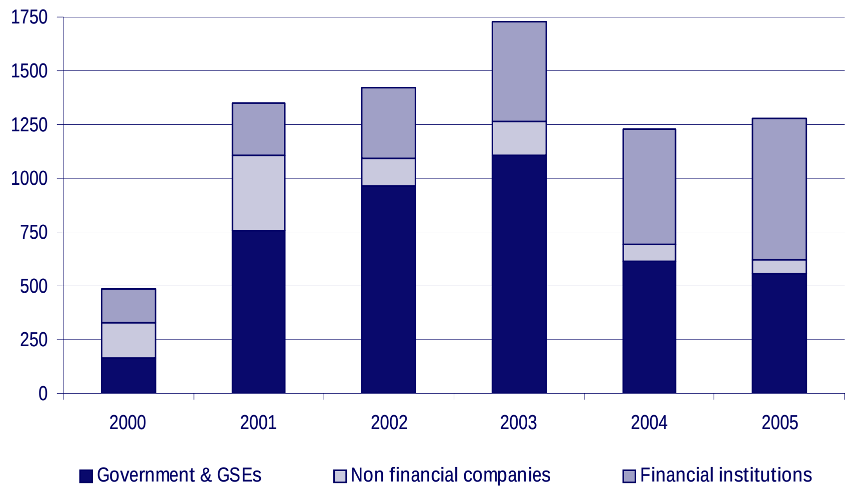
(EUR billions)



Sources : BCE, AMF calculations

Bond issuance in the United States

(USD billions)



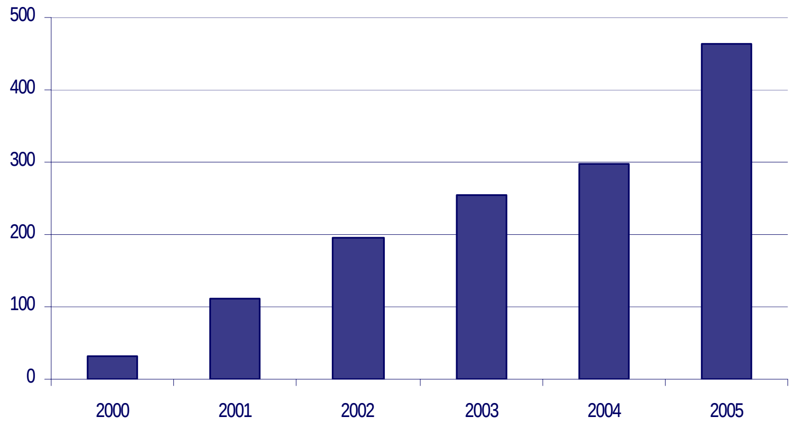
Sources : Federal Reserve, AMF calculations

➲·Success of securitisation in the US and in Europe

The predominance of public sector and financial company issuers in the European and US bond markets is accompanied by a significant development of securities issued as part of securitisation activity included in the statistics for the financial sector. In the United States, ABS Issuers, to use the terminology of US financial accounts, issued in 2005 USD 463 billion in this category, up from USD 298 billion in 2004. In Europe, the year was marked by a similar trend, although the lack of statistics makes it difficult to measure. According to the European Securitisation Forum (ESF), gross issuance (the only statistic available) totalled EUR 320 billion, up 31% from 2004. Besides, 45% of assets serving as collateral for the deals were securities issued in the United Kingdom. Representation by French underliers was more modest, at just 3% of total collateral.

Issuance of asset backed securities in the United States

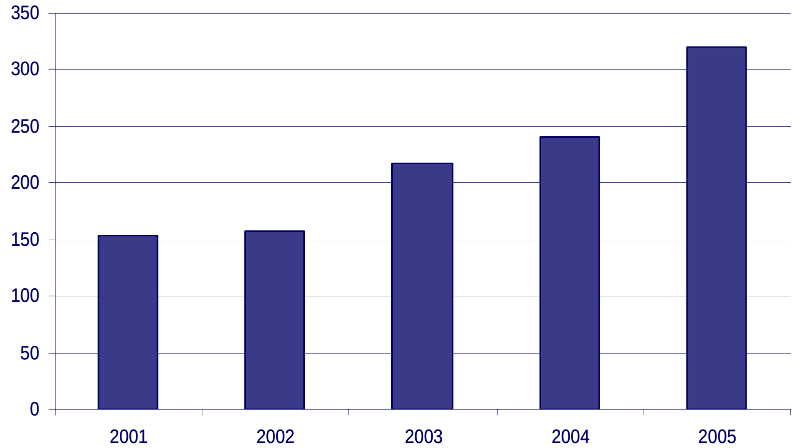
(USD billions)



Source : Federal Reserve

Gross issuance of securitisation vehicles in Europe

(USD billions)



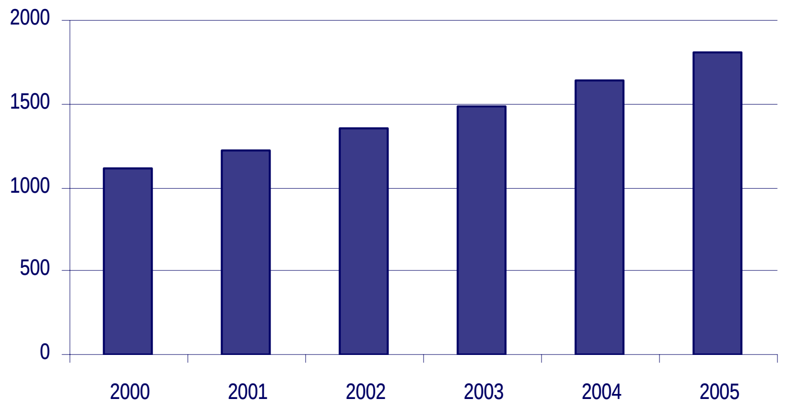
Source : European Securitisation Forum

➲·Growing demand for debt securities from institutional investors

Development of structured products can be interpreted as a necessary response to institutional investors' strong demand for debt securities. Statistics for the euro area indicate that insurance company and pension plan bond portfolios have significantly increased in size since the beginning of the decade. In France, the weighting of bonds in insurance company portfolios, which was already preponderant, increased further.

Bond portfolio of insurance companies and pension funds in the euro area

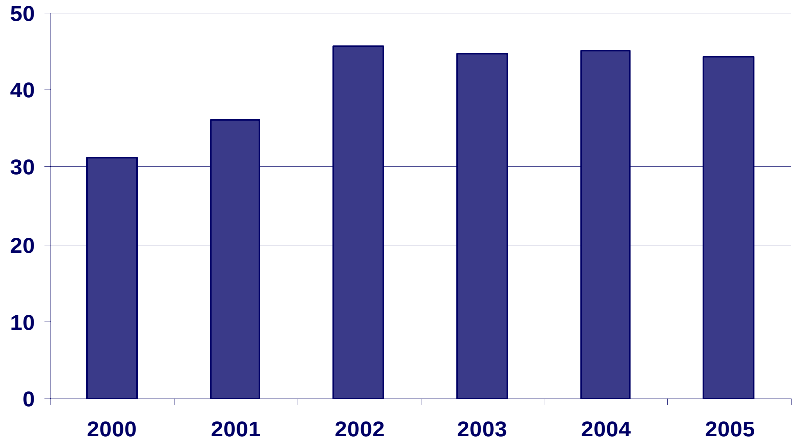
(EUR billions)



Source : BCE

This preference for bonds in some countries is accentuated by regulatory reforms affecting the recognition of certain balance sheet items by defined benefit pension schemes. This is the case in the United Kingdom, where pension fund portfolio allocations have been modified to comply with stricter rules governing provisions and new rules requiring assets and liabilities be recognised at market value. Since 2000, the weighting of bonds in the portfolios of UK pension funds and life insurance companies has increased from 31% to 44%. An interesting development, since countries such as the Netherlands and the United States are also in the process of reforming their retirement systems. While imbalances have been seen in some market segments (for example for very long-term maturities in the United Kingdom), caution must be exercised in drawing conclusions as to the implications of these reforms for the balance of bond markets. The role of demand, frequently invoked, should not in effect be exaggerated. In the United States, for example, defined benefit pensions funds of the private sector represent a very modest share of the US bond market, and the impact of reforms currently underway on financial balances at the national level will probably be rather modest (cf. box).

Weighting of bonds in UK pension fund and insurance company portfolios (%)

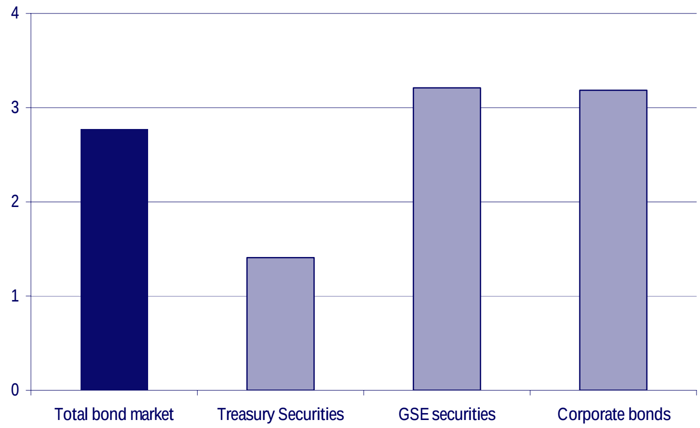


Source : ONS

Pension funds and the bond market in the United States

Somewhat surprisingly given the existence of fully funded pensions, pension fund managers (public and private defined benefit and defined contribution schemes) are second-tier participants on the US bond market, which features a significant presence by foreign investors, and, depending on the market segment, commercial banks, government sponsored enterprises (GSEs), life insurers and households (as direct investors). In 2005, private sector defined benefit pension schemes —the only ones concerned by the reform launched by the US government—had marginal weight in the bond market. More precisely, the bond portfolio of these funds amounted to USD 520 billion, or less than 3% of outstanding bond debt.

Percentage of US bonds held by private sector defined-benefit pension schemes (%, 2005)

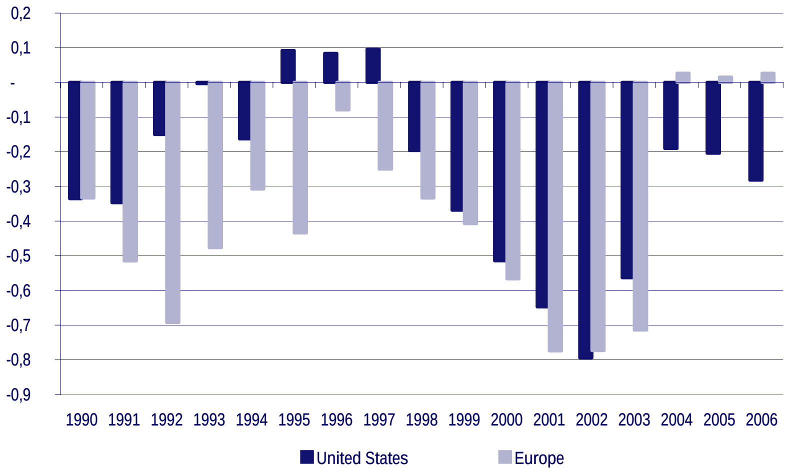


Sources : Federal Reserve, AMF

➲·High-grade debt quality at record levels

For the debt market, 2005 was a good year, maintaining the positive momentum of 2004. This performance was driven by a number of positive factors such as high earnings, reduced volatility in equity markets, low interest rates and limited financing requirements. This favourable environment was highlighted by the number of upgrades by rating agencies. The upgrades/downgrades ratio, which increased significantly over 2003-2004, remained at a high level in 2005. In Europe, this ratio averaged 1.2 upgrades for 1 downgrade; in the United States, the ratio was 0.8 upgrade for 1 downgrade. The rising stars in this performance included Alcatel, Corning, Gap and Ericsson. In addition, France Telecom and Deutsche Telekom were upgraded back to an “A” rating. The year was marked by the downgrading of GM and Ford, among other fallen angels. The impact of these latter downgrades on the market was short lived, however. The satisfactory quality of credit was also exemplified by the default rate, which declined again in 2005. This improvement continued the trend begun in 2002 with the default rate declining to 0.6% for issuers worldwide, and 0.11% for European issuers.

Upgrades versus downgrades*



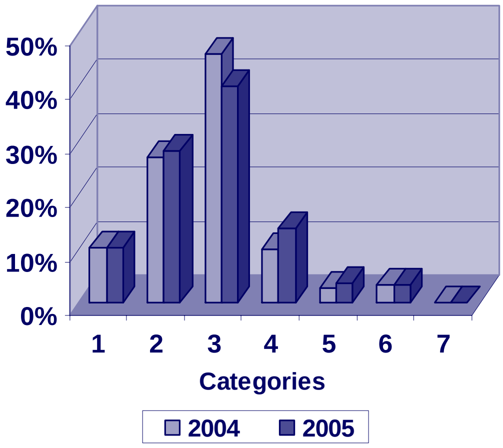
* Ratio: $\frac{Upgrades - Downgrades}{Upgrades + Downgrades}$

Source : Bloomberg

In this environment, a study of newly rated issuers nevertheless shows a market downturn in the quality of new issuers from the historical high of 2002. This most likely reflects the pickup in M&A activity and LBOs. More specifically, the inclusion of new French issuers has resulted in an increase in the percentage of medium and low grade ratings. Overall, the breakdown of ratings for French issuers remains largely centred in the medium/low risk segment. Only 7% of issuers (all in the manufacturing sector) are rated as "speculative grade”[3].

[3] *For further details, see the AMF’s 2006 report on rating agencies.*

Rating agencies by different categories*



Source : AMF

* *By decreasing order of quality. Categories 1 to 4 relate to « Investment grade », while 5 to 7 relate to « Spectulative grade ».*

➲·Issuance in France concentrated on a few high quality names

In mid-March 2006, the value of outstanding non-government bonds listed in Paris totalled EUR 246 billion. Agency ratings had been assigned to more than 70% of this amount, accounting for nearly half of the bonds issued. The breakdown by rating shows that the outstanding debt is of excellent quality. Investment grade ratings were attributed to 98.5% of the securities, with the remaining 1.5% being rated as speculative grade. A breakdown of investment grade securities also reflects the high quality of debt. Nearly 80% of outstanding debt is very highly rated, ranging from AAA/Aaa to AA/Aa, thus with a very low risk of default. On the other hand, bonds with the lowest investment grade ratings (BBB/Baa) account for barely 9% of rated debt.

Rating of bonds listed in Paris

(excl. Government bonds and international organisations bonds, data at mid-March)

	Public sector (excl. Govt. bonds)	*Manufacturing and trading companies*	*Financial companies*	*Aggregate*
Unrated debt				
. EUR billions	9.7	21.4	39.7	70.8
. As a % of rated debt	4%	9%	16%	**29%**
Rated debt				
. EUR billions	57.3	26.3	91.1	174.7
. en % de la dette cotée	23%	11%	37%	**71%**
Breakdown by rating (as a % of rated debt)				
- Investment grade				
. AAA/Aaa	91.9%	0.0%	67.6%	65.4%
. AA/Aa	7.8%	6.7%	19.5%	13.7%
. A	0.3%	33.3%	9.9%	10.3%
. BBB/Baa	0.0%	50.9%	2.7%	9.1%
- Spéculative grade: lower than BBB/Baa	0.0%	9.1%	0.3%	1.5%

Sources : Datastream, AMF calculations

The high quality of rated debt securities listed on the Paris market is largely due to the nature of the issuers. The French bond market is dominated by issuers from the conventional financial sector (primarily banks) and features substantial issues by public-sector entities. At mid-March 2006, the financial sector accounted for more than half of rated outstanding debt, as opposed to one-third for the public sector and 15% for the manufacturing and trade sector.

Around fifty of the bonds listed in Paris are deemed to be of medium or poor quality and rated at the lower end of the investment grade spectrum or as speculative grade securities. These bonds come from some thirty issuers and represent total outstandings of approximately EUR 19 billion. Three-quarters of the issuers in question are from the manufacturing and trading sector and the remaining quarter are from the financial sector. More than half these securities will have matured by the end of 2008 .

Equity markets

Since the beginning of the decade, equity markets in Western countries have been marked by two main trends. First, companies already listed have less frequent recourse to market financing, despite the recent upturn in share performances. Secondly, the number of companies listed has declined in response to the combined effect of a decrease in the number of IPOs and a high number of delistings.

➲·Net equity issuance is negative in the US and very low in Europe

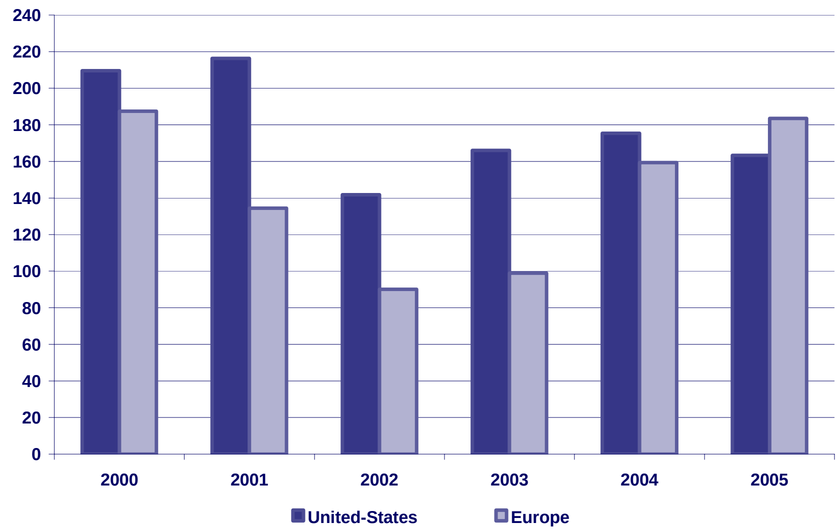
In Europe, publicly-traded companies, and especially non-financial companies, have very limited recourse to market financing. Net issuance (equity issuance less share buybacks and cancellations), has remained very low since 2001. In the euro area and the United Kingdom combined, new issuance totalled EUR 33 billion in 2005, down from EUR 44 billion in 2004. In the United States, the practice of company share buybacks has accelerated in 2005. As a result net issuance has fallen to a negative and historically low level, of USD 312 billion.

Net equity issuance (EUR billions)

Sources : Federal Reserve, Central Banks, AMF calculations

These trends are the result of the coexistence of a low level of equity issuance, and, above all, of significant share buybacks in some markets. Gross issuance of equity securities in the last two years has increased by two basis points compared with 2002-2003. In 2005, this figure increased to USD 163 billion in the United States and USD 183 billion in Europe. Overall, these levels are relatively modest in a macrofinancial environment that is particularly demanding in terms of return on equity, and more favourable to self-financing or the payment of dividends to shareholders (given corporate earnings), debt financing (low interest rates) and off-balance sheet financing through the deconsolidation of assets (securitisation).

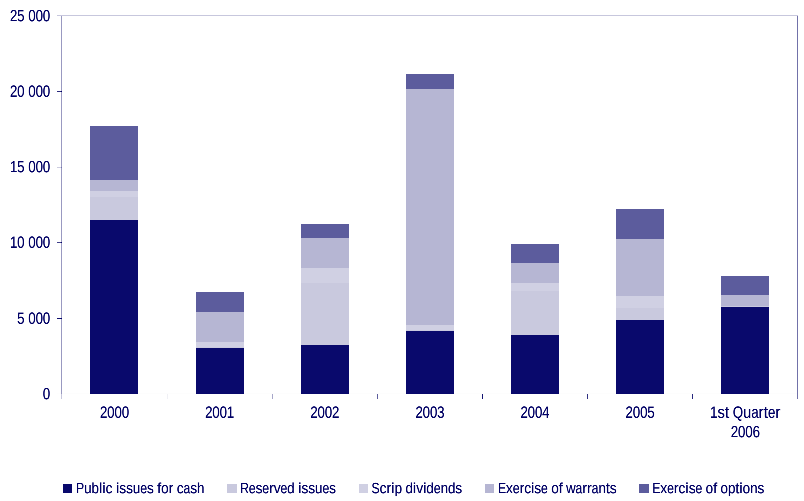
Gross issuance of equities and convertible bonds per year and region (USD billions)



Source : Bloomberg

In France, trends for equity issuance have been comparable to that of the euro area as a whole between 2000 and 2005, with the exception of 2003, where the significant exercise of stock options (notably those of France Telecom) fuelled a surge in total issuance. Overall, the level of public issues of shares for cash remained low. In 2005, they represented less than EUR 5 billion, whereas in the second half of the 1990s this figure was closer to EUR 10 billion per year.

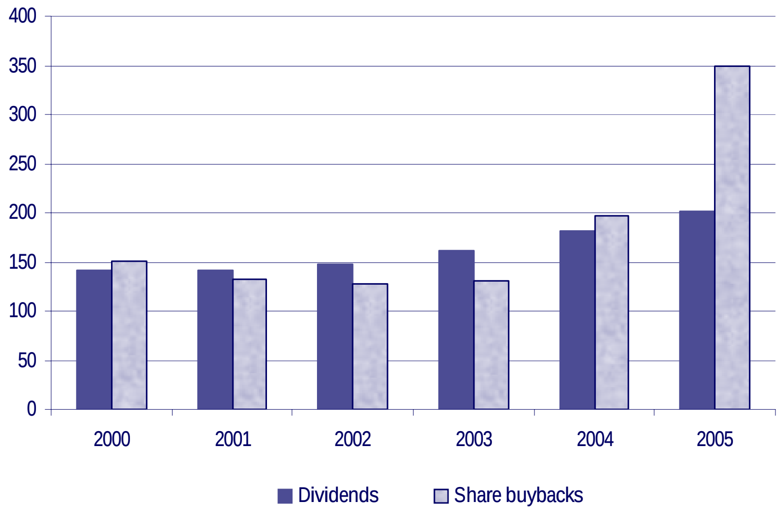
Equity issuance of companies listed on the French stock exchange (excl. *Marché Libre*, EUR millions)



Source : AMF

Increasing recourse to share buybacks had a significant impact on net issuance, especially in the U.S. Share buybacks, as opposed to dividend payouts, have become the preferred means of distributing earnings in the United States over the last two years. This phenomenon has accelerated significantly in the last five years in an environment marked by a combination of robust corporate earnings and limited opportunities to reinvest profit. Accordingly, Standard and Poor's has noted a record level of buybacks for S&P 500 companies, up from USD 151 billion in 2000 to USD 349 billion in 2005. In Europe, and particularly in France, companies have had less recourse to share buybacks. Between 2000 and 2004, companies on the CAC 40 nevertheless spent EUR 36 billion to buy back shares, or 38% of total dividends paid out over the same period (in 2004 share buybacks accounted for more than 55% of dividends paid).

S&P 500 companies : share buybacks and dividend payments (USD billions)



Source : Standard and Poor's

Share buybacks in France

Amounts allocated by French publicly-traded companies to share repurchase programs have remained relatively stable since 2002--within a range of EUR 10 million and EUR 13 million. 2001 was an exception (EUR 23 billion), with the activity of the last quarter following the 11 September terrorist attacks and the acquisition by France Telecom of Orange from Vodafone.

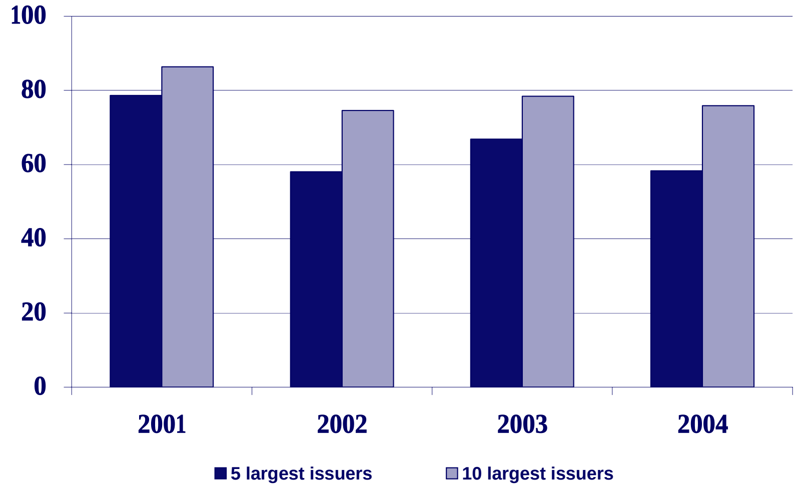
Share buybacks

	2001	2002	2003	2004
Total market				
EUR millions	23,183.3	11,068	10,282	13,035
Number of issuers	282	273	282	276
Premier marché				
EUR millions	23,002	10,823	10,123	12,900
Number of issuers	122	120	117	106
Second marché				
EUR millions	149.3	230	147	114
Number of issuers	119	121	127	125
Nouveau marché				
EUR millions	32	15	12	21
Number of issuers	41	32	38	44

Source : AMF

However, the volume of share buybacks was concentrated in the Premier Marché among a very small number of companies. In 2004, more than three quarters of the total allocated to share buybacks came from only 10 companies. Total led the way (EUR 3.5 billion), followed by BNP Paribas (EUR 1.8 billion) and Société Générale (EUR 961 million).

Percentage of top issuers in the total amount of share buybacks in France



Source : AMF

➲·Declining number of listed companies, particularly in France

A second factor affecting equity markets has been a decline in the number of listed companies. The significant drop in initial public offerings (IPOs) following the burst of the stock exchange bubble, combined with the number of delistings, poses a challenge to maintaining the size of key equity markets. The rebound in initial public offerings in the last two years has not been sufficient to offset the structural decline in the number of listed companies in the major stock exchanges, with the notable exception of London (where the number of listed companies rose by 30 %) and Tokyo (+12 %). In five years, NASDAQ has seen a 30% decline in the number of listed companies. In the wake of this contraction, Deutsche Börse and Euronext Paris registered declines of up to 22%.

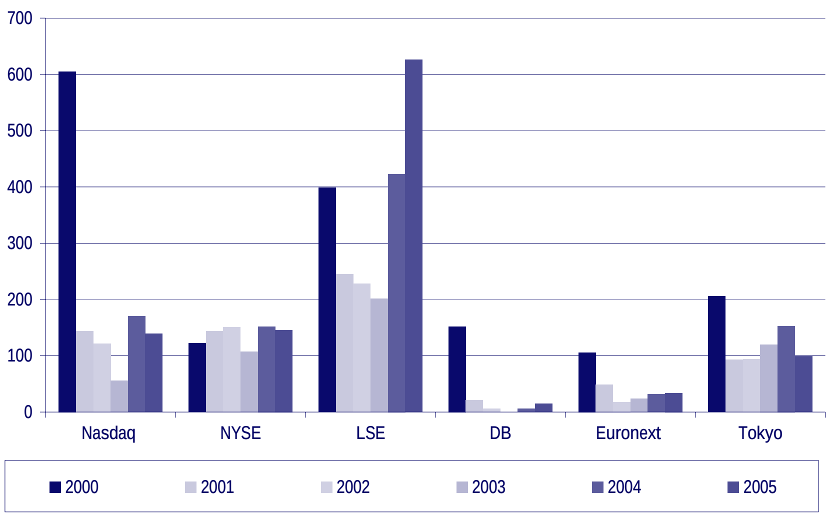
Number of listed companies

	2000	2001	2002	2003	2004	2005
Nasdaq	4,734	4,063	3,649	3,294	3,229	3,164
NYSE	2,468	2,400	2,366	2,308	2,293	2,270
Tokyo SE	2,096	2,141	2,153	2,206	2,306	2,351
Deutsche Borse	983	983	934	866	819	764
Euronext	1,216	1,195	1,114	1,392	1,333	1,259
o/w Euronext Paris	*965*	*936*	*873*	*817*	*797*	*749*
London SE	2,374	2,332	2,824	2,692	2,837	3,091

Source : World Federation of Exchanges

While the number of IPOs has been on the increase since 2003, the scope of this recovery varies according to the market. The London Stock Exchange has been remarkably buoyant with 1,250 IPOs in three years. This rapid expansion has been driven by the strong growth of the Alternative Investment Market (AIM), a sub-market of the London Stock Exchange dedicated to small and mid caps that accounts for 70% of the London market's total number of IPOs since 2003. The number of companies listed on this market surpassed the 1,000 milestone (1,179 at 2005 year-end). By contrast, Euronext has added only 90 new listings, with 72 in Paris. The US market has registered a positive inflow of 365 new listings for the NASDAQ and 405 for the NYSE.

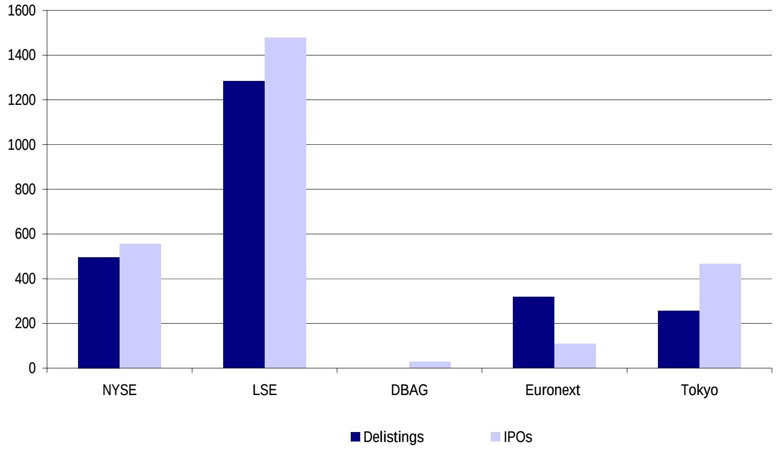
Initial public offerings



Source : World Federation of Exchanges

This rebound in IPOs since 2003 has not been sufficient to prevent a decline in the number of listed companies in Continental Europe caused by the sustained trend of delistings that began in early 2000. This decline in the number of listed companies can be attributed to a number of factors, including the loss of appeal of multiple listings, delistings by smaller companies, the resurgence of cross-border mergers and, finally, the development of private equity funds.

Changes in the number of listed companies
(aggregated data for 2002-2005)

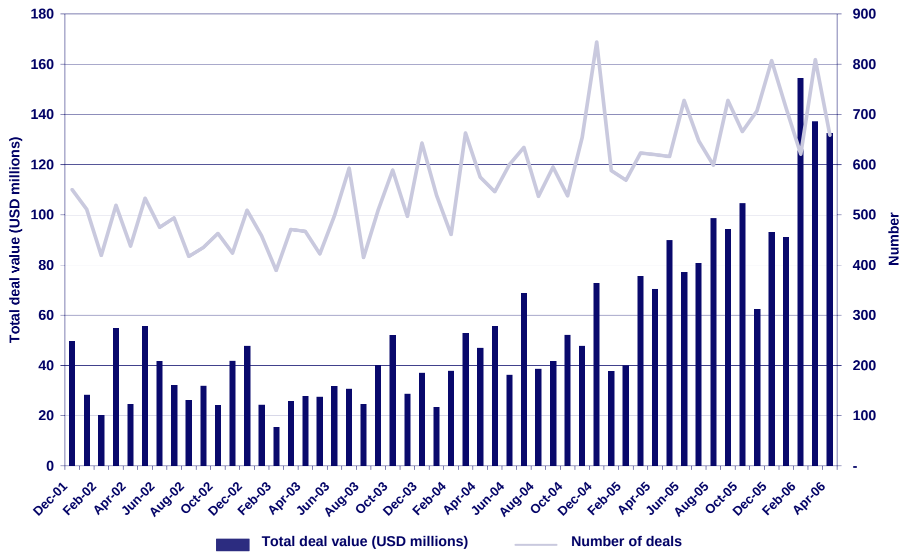


The abandonment of the practice of multiple listings appears to be widespread. Increased requirements imposed by the Sarbanes-Oxley Act have made listings in New York for non-US companies less attractive. Multiple listings also involve both IPO costs and the costs of monitoring share prices that may vary from one exchange to another. This is the case, for example, for ABN AMRO, which announced its intention to delist its ordinary shares from as many as six foreign stock exchanges, including London and Frankfurt, on the grounds that "*associated costs and requirements exceed the benefits provided.*" Similarly, Alstom's American Depositary Receipts (ADR) were officially delisted from the New York Stock Exchange. Finally, more recently, Royal Dutch Shell has opted in favour of a single listing in London.

As has been the case with the 37 French companies still listed on at least one US market, if multiple listings continue to decrease, the structure of these highly internationalised markets' security listings could suffer.

On the other hand, cross-border merger activity has been robust since the beginning of the decade. In the last three years, their number and deal value has increased by more than 40%, to reach nearly USD 1,000 billion for 8,000 cross-border mergers in 2005. This upswing has concerned both mergers between US and European companies and mergers between European companies, and covered all sectors (pharmaceutical industry, telecommunications, petroleum, etc.).

Worldwide M&A cross-border activity



Source : Bloomberg

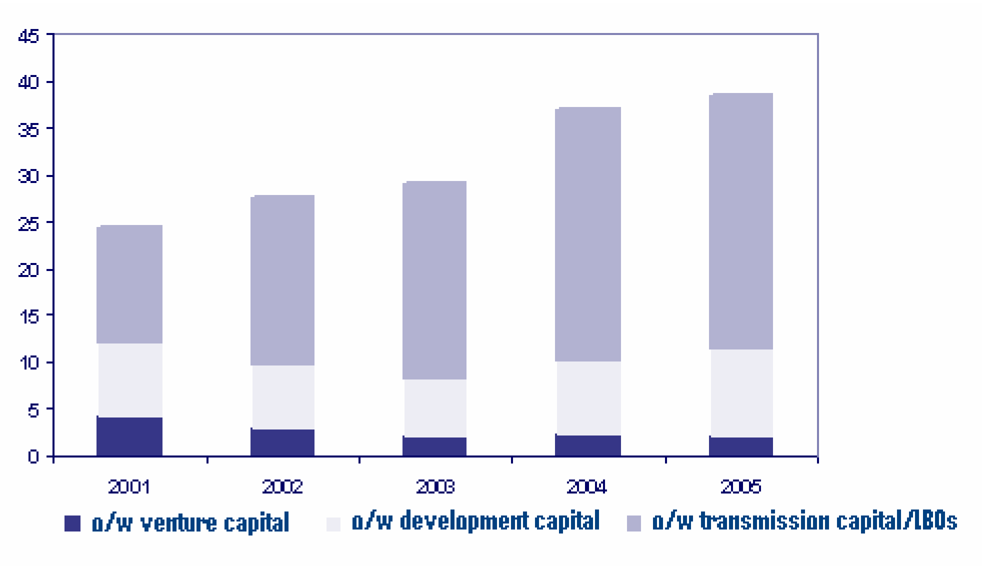
The banking sector, for example, still has considerable potential for further concentration, and a high number of cross-border mergers may thus be expected. Because multinationals tend to privilege proximity to their lead markets, this could benefit continental Europe, particularly when these mergers do not concern Anglo-American companies. However, in a context where the European Directive on cross border mergers remains to be transposed into national laws[4] and given the absence of European companies and of a tax system consistent across Europe, these mergers continue to raise serious legal and tax issues.

This broad-based trend of delisting has gained momentum in recent years with the development of Public-to-Private (P-to-P) deals by financial investors within the framework of LBOs[5]. The growth of European private equity was initially fuelled by high technology industries from the end of the 1990s through the beginning of 2000. This solution contributed to the financing and development of a large number of European companies in the early stages of their activity. Following the slide in share prices in 2000 and 2001, European private equity has declined significantly. However, from a long-term perspective, it has been relatively sustained, up approximately EUR 27 billion. This trend was sharply reversed in 2005, with nearly EUR 60 billion raised in just one year.

In addition to being required to adjust their portfolio holdings in response to adverse economic and financial market trends, funds investing in venture capital were faced with reduced opportunities to divest their holdings, through IPOs or sales to manufacturing companies. In fact, only LBOs have been relatively exempt from this trend, fuelling growth of the sector since 2001, accounting for approximately two thirds of this market in 2005. In addition to low interest rates, this activity has benefited from the phenomenon of spin-offs by major groups seeking to reduce their debt and refocus on their core businesses as well as the development of delistings.

[4] *Adopted by the European Parliament on 26 October 2005, this directive on cross-border mergers of limited liability companies will have to be transposed into national laws by the 31 December 2007 .*
[5] *This issue is addressed in a more general study entitled "Private equity: physionomie d'un marché en croissance" to be published by the Service des Etudes of the AMF in early 2007.*

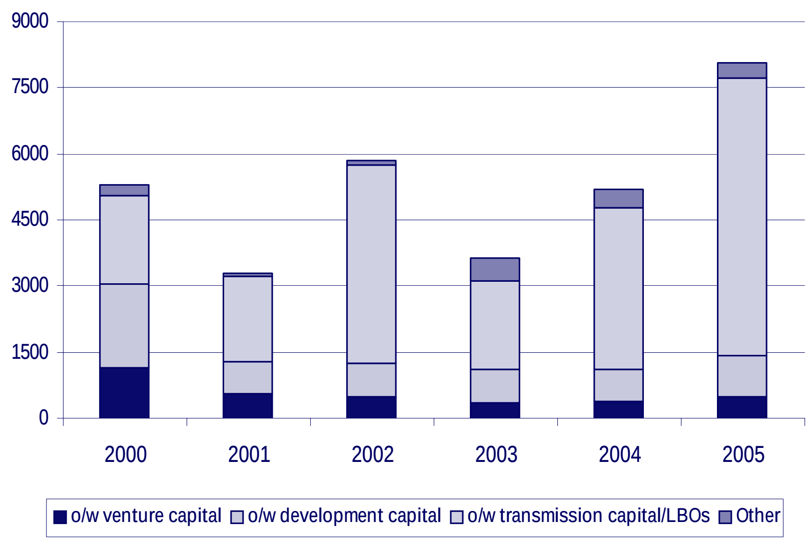
Private equity in Europe
(EUR billions)



Source : EVCA

Since the beginning of the decade, and in line with overall European trends, the French private equity market has expanded significantly, (funds raised rose by 52% increase in between 2000 and 2005), even if deal sizes still remain modest. This growth has been concentrated in LBOs, which have increased twofold in one year, in contrast to the net decline (-50%) in other more traditional segments of venture capital. A significant portion of the activity of private equity companies has consequently been focused on LBOs which, in France, account for 80% of this market. These LBOs are generally followed by a delisting, as the targets are generally midsized manufacturing companies with marginal analyst coverage, potentially undervalued[6] due to the low level of their free float.

Private equity in France
(EUR millions)



Source : AFIC

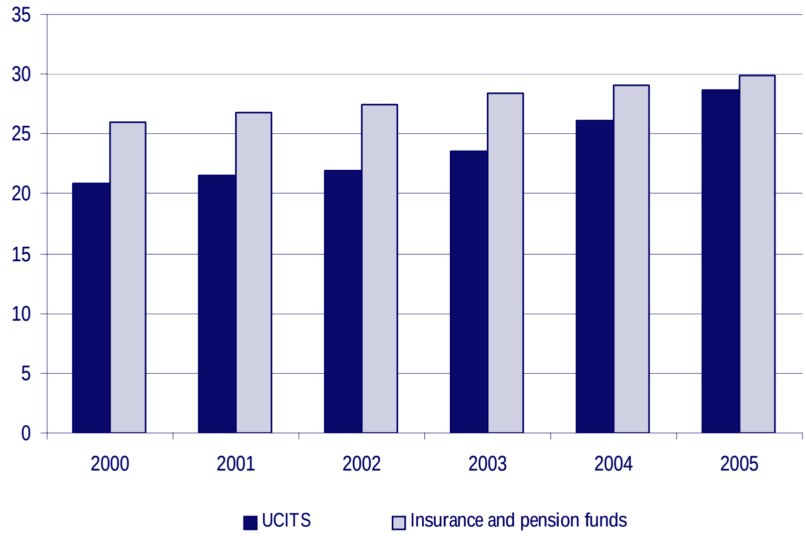
[6] We add here that individual investors in private equity funds do not appear at this stage to be significant. In contrast, the role of institutional investors could increase. See the article "Is retail investment fuelling the private equity boom?" Published in the Economic and Financial Newsletter - Autumn 2006 of the AMF.

➲·Increasing weight of institutional and fund managers in the equity markets

Since the beginning of the 1990s, the role of institutional investors in financial markets at the international level has experienced a broad-based expansion both for bonds and equities. The burst of the speculative bubble at the end of this decade did not slow this trend. In the United States, mutual funds and insurance companies/pension funds are occupying an increasingly important place in this landscape. As a result, their share in holdings of domestic equities increased to 58% in 2005.

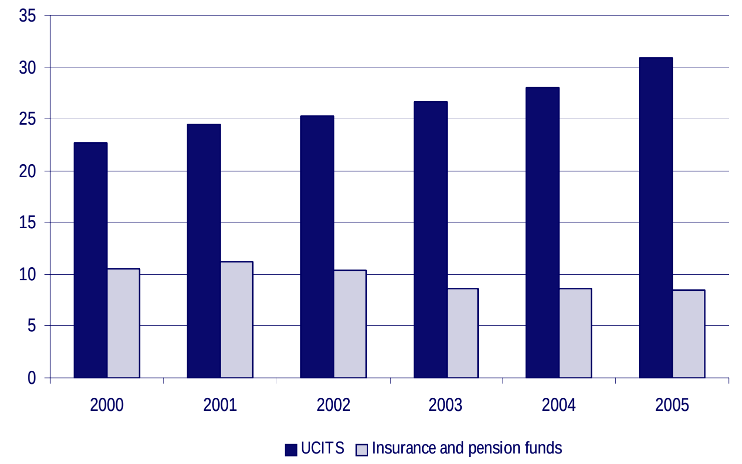
In France, the weight of institutional investors is much less important, mirroring the trend of continental Europe as a whole. Sustained growth of mutual funds has nevertheless fuelled their significant expansion in equity markets. In 2000, institutional investors accounted for 23% of holdings by residents. In 2005, this percentage had increased to 31%. It may be noted that this expansion was achieved in an environment of declining stock prices and limited inflows into equity funds. The direct role of insurance companies has been considerably more modest, with their holdings accounting for only 8.5%. This difference reflects the investment policy of insurance companies whereby risky assets in connection with unit-linked insurance products are held primarily through investment funds.

United states : Domestic holdings of equities held by institutional investors (%)



Source : Federal Reserve

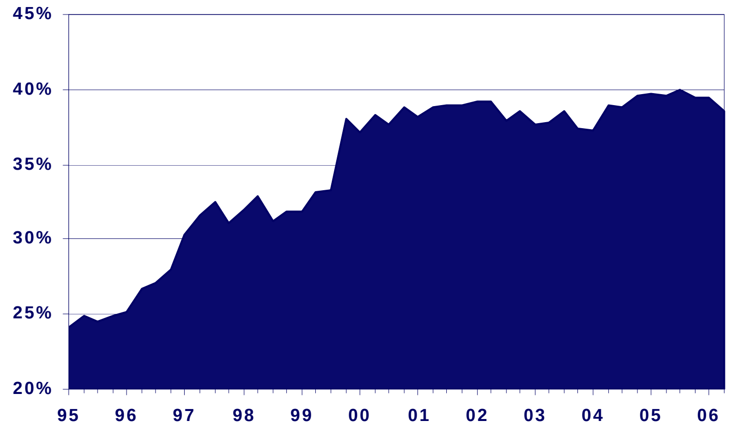
France: Domestic holdings of equities held by institutional investors (%)



Source : Banque de France

At the same time, the share of institutional investors has been constantly increasing as Anglo-American pension funds pursue geographical diversification and managers of hedge and alternative investment funds apply arbitrage strategies across different markets.

Shares of French listed companies held by non-residents (%)



Source : Banque de France

The traditionally more active role of these investors in corporate governance has re-started the debate on the organisation of shareholders' meetings, oversight of company management and the need for shareholders to adopt a long-term perspective. Balanced corporate governance implies compliance with a number of different criteria:

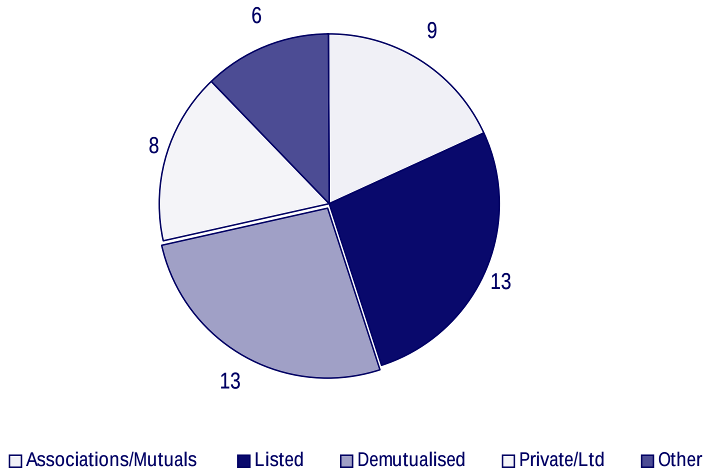
- Clarity and fairness in procedures for exercising voting rights in shareholders' meetings;
- Prior transparency concerning the respective or aggregate interests of different shareholders in the share capital, particularly with respect to the development of securities lending or financial derivatives techniques in order to better distinguish between economic interests and legal ownership;
- The position and role of consultants specialised in this field and proxy providers;
- Homogeneity of the laws applicable to deposit agreements or collateralisation of securities in an environment where custodial functions are being concentrated among a limited number of financial firms at the international level.

Derivative markets and post-trade infrastructures

➲·Recent transformation of stock exchanges and their revenue mix

The legal status of stock exchanges has continued to evolve in recent years, with the mutualised model losing ground. Market undertakings are increasingly adopting the form of joint stock companies, ultimately leading to their listing (two in 1999 and eight in 2000 as opposed to 13 in 2005). In 2000, mutualised exchanges accounted for 44% of the total number of stock exchanges. In 2004, this figure had declined to 35%. Conversely, self-listed stock exchanges like Euronext, the London Stock Exchange or the Deutsche Börse, currently account for more than one quarter of the world's market undertakings.

Legal form of stock exchanges
(number of undertakings)

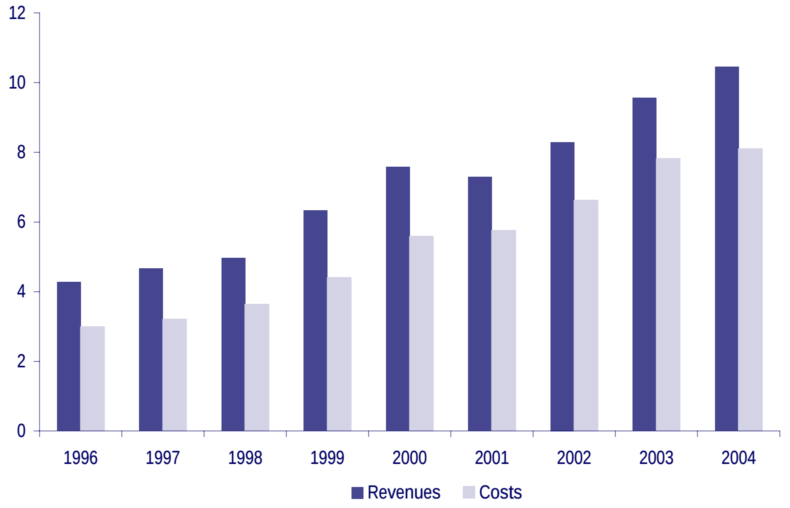


Source : WFE

Stock market revenue has increased at a rapid pace in recent years, particularly after the downturn in 2001. According to the World Federation of Exchanges, that revenue increased from USD 7.3 billion in 2001 to USD 10.5 billion in 2004, an increase of 43%. Stock exchange growth has been driven by services and trading revenues. In 2004, each of these activities accounted for approximately 40% of total stock exchange revenue. By contrast, listing revenues registered a modest gain and contributed marginally to total stock exchange revenues.

Costs and revenues of Exchanges

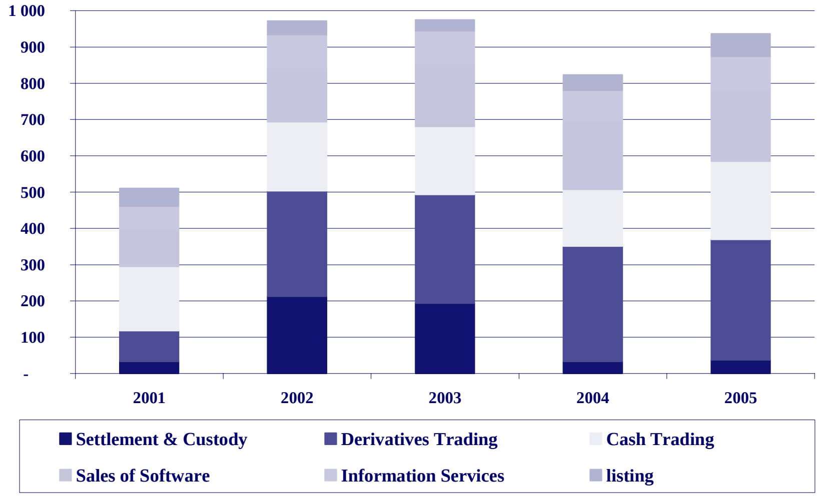
(USD billions)



Source : WFE

Cash equity markets still account for the major share of trading revenues (52%) but derivative trading (43%) is gaining ground and strategic importance. An analysis of Euronext revenue provides a good illustration of this changing revenue mix. Accordingly, in 2005, Euronext generated trading revenue from derivatives of EUR 332 million, compared with just EUR 216 million from cash equity.

Euronext revenue mis since 2005
(EUR millions)

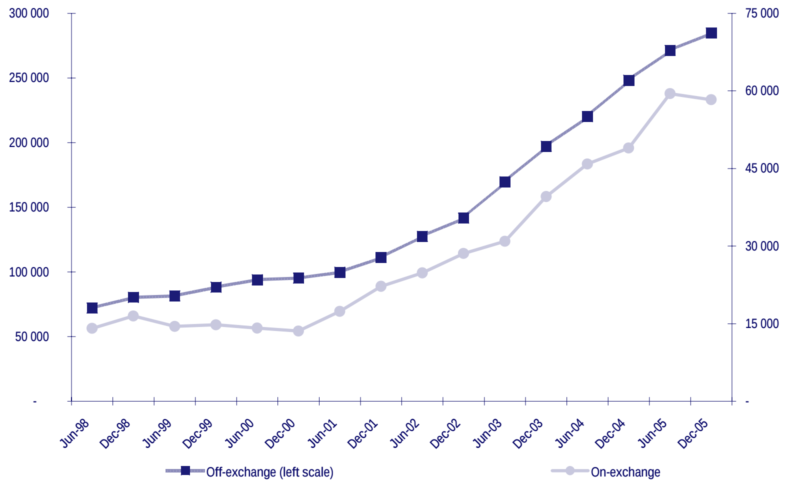


Source : Euronext

➲ Strong growth of derivatives trading

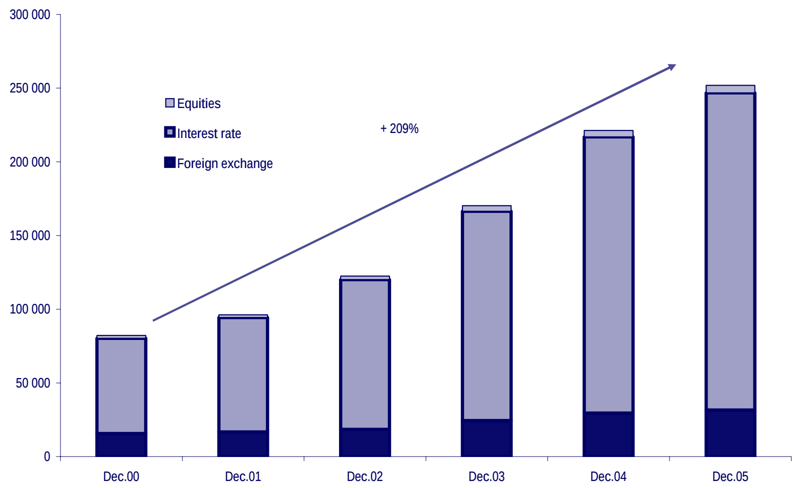
Strong growth in revenue from derivative products is the result of these markets' massive expansion. Measured by the number of contracts traded both off and on-exchange, gains have been significant since 2001, with average annual growth approaching 35 %. The notional amounts of derivative contracts traded off-exchange increased more than 200% since the beginning of 2000. Beyond a general market environment marked by post-11 September uncertainties, solid growth of the derivatives market has been sustained by the sophistication of techniques used in asset management for third parties and notably the development of alternative management funds.

Trading volume of derivatives off and on-exchange (thousands of contracts)



Notional amounts of derivative contracts traded off-exchange

(USD billions)



Source : BRI

While trading volume of derivatives in organised markets has surged fourfold since the beginning of the decade, this volume is still considerably below the level of over-the-counter markets. However, this share has been gaining ground *(cf.* box below on France) in response to growing concerns about the cost of contracts (benefits of standardisation in organised markets) and credit risks for counterparties, compared with the benefits of a centralised clearing system.

France : the world's third largest market for off-exchange trading

The last Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity published by the BIS, which was conducted in April 2004, highlighted strong growth in trading on increasingly concentrated and globalised markets, in which cross-border activity accounts for more than 60% of total transactions. Worldwide, USD 1,800 billion is traded in foreign exchange markets versus USD 1,220 billion on derivative markets. The latter have registered spectacular growth (+77 %) since April 2001, driven notably by the development of arbitrage strategies and more dynamic hedging activity in an environment marked by the increasing sophistication of financial players and the development of credit derivatives. Market share of French banks accounts for approximately 10% of daily derivative trading (versus 12% for foreign exchange activity). Accordingly, Paris has moved back to third place in terms of over-the-counter derivative trading after London and New York. The asset management industry now accounts for more than one third of foreign exchange activity, and relates more particularly to hedge funds and the insurance sector. This trend highlights investors' growing interest in currency vehicles as a class of assets in itself.

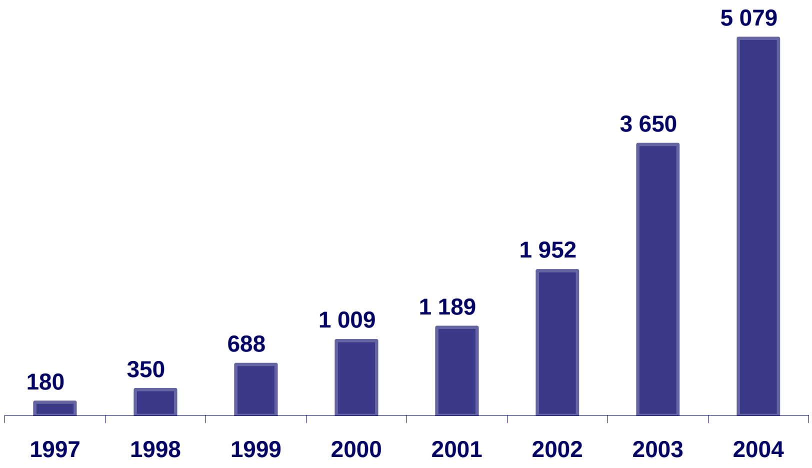
➲ Increasing popularity of credit derivatives

This market is relatively limited compared to other markets for derivative products that have reached maturity, representing only 2% of the notional amount of outstandings of OTC derivative products worldwide (BIS). This segment is however rapidly expanding.

Information on worldwide credit derivative activity is difficult to obtain. Only estimates based on surveys published by Fitch and BBA provide an indication of market trends. Based on these estimates, this market appears to be expanding significantly with the notional amount of outstandings increasing from USD 1,009 billion in 2000 to USD 5,079 billion at year-end 2004.

Notional outstandings of credit derivatives

(USD billions



Source : BBA

According to a BBA survey, the market is dominated by Credit Default Swaps (CDS) that in 2003 accounted for close to 51% of the market versus 45% in 2001, followed by synthetic Collateralised Debt Obligations (CDOs) with 16% of the market in 2003 (21% in 2001). Finally, index derivatives have also registered strong growth, and currently represent 7% of the market versus a level close to nil at the beginning of the decade. The London market accounts for half of total trading volume, which was estimated at USD 2,230 billion at the end of 2004.

Results of surveys conducted by BBA

	2003		2004		**2006 (outlook)**	
	USD billions	Market share (%)	USD billions	Market share (%)	**USD billions**	**Market share (%)**
London	1,586	45%	2	44%	**3,563**	**43%**
United States	1,459	41%	2	40%	**3,173**	**39%**
Asia et Australia	287	8%	446	9%	**858**	**10%**
Other European	216	6%	345	7%	**612**	**8%**
TOTAL (excluding assets swap)	**3,548**	**100%**	**5,021**	**100%**	**8,206**	**100%**

Source : BBA

As in previous years, despite the decrease in their relative share of the market, banks have remained the primary actors. Insurers, and more recently hedge funds, have increased their activity on both sides of the market as both protection buyers and sellers.

Finally, the role of brokers as protection buyers is becoming increasingly significant, with 21% of the market in 2006 (forecast), versus 43% for banks and 70% for hedge funds .

Users of credit derivative markets (%)

	Protection buyers		Protection sellers	
	2003	2006 outlook	2003	2006 outlook
Banks	51	43	38	34
Brokers	16	15	16	14
Hedge funds	16	17	15	15
Insurers			20	21

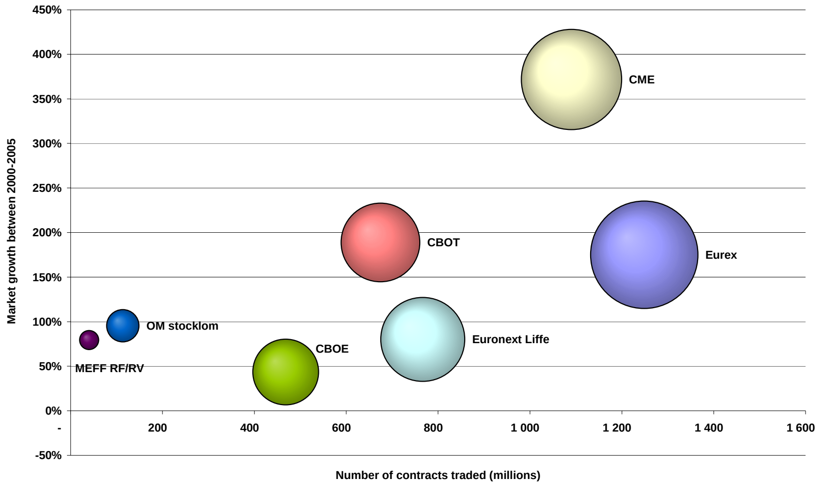
Source : BBA

Today, the creation of new benchmark indexes DJ CDX (North America and Emerging Markets) and DJ iTraxx (Europe and Asia), increasing standardisation in the legal form of the contracts and new procedures for the settlement of transactions through centralised clearing platforms should improve liquidity in the secondary market for credit derivatives. This should boost competition among organised derivative markets in their search for new products.

➲ Strengthening competitive position of organised derivative markets

The following chart simultaneously shows growth for each market in the number of contracts traded over 2000-2005 and its weighting on the basis of the absolute values of these contracts. By combining these two criteria, several trends emerge from the allocation of activity between the different markets. Growth in trading volume has been seen in all markets, with higher growth rates in the US markets, which are also the largest. In particular, the Chicago Mercantile Exchange (CME) has chalked up phenomenal growth over the entire period of 400%, advancing to second place behind Eurex.

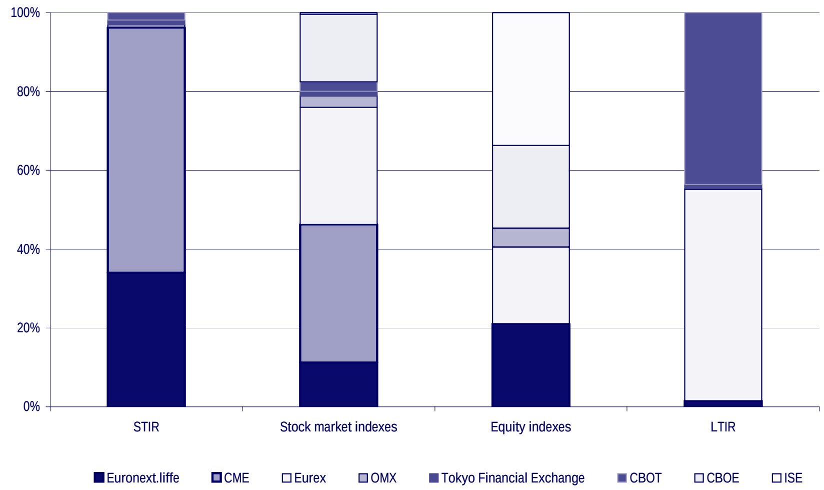
Growth trends of organised derivative markets



National sources

A more fine-tuned analysis of the types of contracts traded indicates the specialisations and strong positions of certain markets in specific products. For example, for LTIR derivatives, Eurex is the market leader, surpassing the CBOT, the second-largest market in this segment. By contrast, the US market CME is a leader in STIR derivatives, followed by Euronext Liffe. Competition is much fiercer for the other types of underliers: equity derivatives or index derivatives. In Europe, the segment of equity options remains the most active in terms of the number of contracts traded. By contrast, the loss of momentum in this segment in US markets has been offset by the strong growth of a new market, the ISE (International Stock Exchange). For index derivatives, Europe and the United States have attained comparable market shares.

Structure of derivative markets by types of products traded in 2005



National sources

Meeting the challenge of multi-form competition will depend on the ability of organised markets to expand into new products or segments offering increased growth opportunities through new platforms providing added value in relation to off exchange trading, particularly with regard to their relationships with post-trade infrastructures.

➲ Complex evolution of post-trade activities

Mergers between trading infrastructures have naturally been fuelled by a similar restructuring of post-trade activities seeking to provide investors with an integrated service offering, generating economies of scale and improved service quality (possibility of clearing in several currencies, pooling of collateralised transactions of a single participant within several systems, etc.). This activity has in effect given rise to new competition and sources of profit. Clearing and settlement services by Clearstream, following the merger with Deutsche Börse, constitute the most important source of the company's revenue (34% in 2005), far ahead of commission income from derivatives trading by Eurex (close to 13% of total revenue). Among other things, these functions respond to intermediaries' growing needs as they are faced with the challenges of off-exchange transactions to ensure the successful closing of positions, especially for credit derivatives. The central counterparty service provided by a clearing house offers an immediate and particularly effective response for managing credit risks between counterparties. It does, however, raise questions for regulators about the concentration of systemic risk and the operational management of an increasing volume of transactions for a single platform, especially if the clearinghouses open up their services to less regulated players such as hedge funds.

The consolidation of infrastructures covers the handling of different forms of back-office activities, both in terms of geographical scope and degree and type of integration chosen (vertical[7] or horizontal[8]). Consequently, the European post-trade landscape is currently in a phase of increasing consolidation, reducing the number of central depositories (down from 23 in early 1999 to 12 at the end of 2005) and clearinghouses (from 14 to 8 over the same period). The 2003 merger of Clearnet (the clearinghouse of Euronext) and the London clearinghouse (serving notably the London Stock Exchange) is a particularly noteworthy example of this trend, which involves increasingly loose capital links to the Euronext trading platforms. In 2002, after acquiring Cedel, Deutsche Börse created Clearstream through a merger with its local depository while maintaining exclusive links between the trading and clearing platforms both for cash equity and derivatives.

[7] *A vertical organisation proposes an integrated chain of services to market participants (trading, clearing, a settlement-delivery) in which the respective participants are privileged partners. Partners of a single activity can in this way maintain exclusive relations, hence the designation of a "silo model" .*

[8] *By contrast, this organisation proceeds by regrouping functions at every stage of the activity, restructuring measures involving potential alliances or structural links between the systems which provide the same function in the securities services chain .*

In the United States, two major derivative markets the CME and the CBOT have also pooled their resources to provide common clearing services while also maintaining an exclusive link with the two markets.

This trend, which affects the different groupings, is continuing in North America, particularly for derivative markets. The different clearing platforms may in the future compete with each other to attract off-exchange transactions involving a range of underliers. These markets have already witnessed several attempts by the German clearinghouse, Eurex-Clearing to gain a foothold in the United States, and more recently, the definition of a new role for the US Depository Trust Company and the National Securities Clearing Corporation (DTCC) moved to create an international infrastructure to process OTC derivatives contracts. These trends raise questions for regulators concerning both the sharing of data and the definition and division of roles for overseeing transactions, notably OTC derivatives, whose geographical location is by definition uncertain.

Finally, growth in cross-border transactions and corresponding revenue[9] have heightened competition between banks serving as custody account keepers for securities, as well as between the latter and these market infrastructures. This competition is fuelling concentration in favour of the four leading global custodians that in 2005 accounted for nearly 70% of the USD 60 trillion of assets in custody. The changing nature of the sharing of roles between these international banks and the existing infrastructures could result in more intense competition to attract activities involving greater economic added value, bearing in mind that the positioning of the non-competitive sector in this area is subject in Europe to a pending decision by the European Central Bank on the Target 2 Securities project[10]. Increased vigilance by regulators appears in any case indispensable concerning the consequences of these trends for the appropriate level of control of risks for the transparency of securities movements both for the markets and the listed companies concerned and the laws applicable to ownership rights and their registration in the books of depositories.

[9] *A study conducted in November 2002 at the request of the AFTI demonstrated that post-trade activities represented between 20% and 35% of the total cost of a cross-border transaction, so that the cost price is 2.5 to 4 times higher than a domestic transaction.*

[10] *One may note in this regard that the European Commission wishes to reinforce competition among market infrastructures through the adoption of a code of conduct. This code of conduct, signed on 7 November 2006 by infrastructures (exchanges, clearing agencies and central depositories), relates to the transparency of prices, rights of access and interoperability, as well as the unbundling of prices and separate accounting .*

TRENDS IN THE WHOLESALE FINANCIAL MARKETS AND RISKS FOR INTERMEDIARIES, LISTED COMPANIES AND INSTITUTIONAL INVESTORS

Global Financial environment

Considerable liquidity built up in recent years has contributed to lower yields in bond markets, particularly government bonds. In response, investors have sought out new opportunities involving greater risk and/or less liquidity through emerging markets or alternative assets such as hedge funds, private equity or debt securitisation funds. This diversification raises several questions from the point of view of the regulation of financial markets, in particular:

- Will investor portfolios become progressively over weighted in certain classes of assets that are more complex and potentially less liquid in the case of a reversal in the market or yield curves?

- Is credit risk in a disintermediated market, whether centralised by rating agencies or carried by individual investors, being correctly measured?

Bond and credit markets

Since a few years, in Europe and, to a lesser extent, in the United States, the offering of bonds has largely consisted of issuance by government and financial institutions, primarily banks. Issuance of debt securities by non-financial companies has been marginal as robust corporate profits of large companies have provided resources to meet their capital spending requirements. Institutional demand for bonds has been sustained by abundant long-term savings, particularly in the life insurance sector in France, and, in some countries, changes in the accounting treatment of pension funds. In particular, the increasing recognition of assets at market value has fuelled investments in debt securities with reduced volatility.

A growing share of securities issued by financial institutions have involved securitisation deals in the form of asset backed securities and collateralised debt obligations. These issues are intended to meet excess institutional demand in relation to the supply of high yield corporate bonds. Securitisation more and more involves complex techniques which sometimes include the use of credit derivatives. The constant growth of the market for structured products raises a number of questions. For example, will the multiplication of the roles of intermediaries putting together the deals generate conflicts of interest? Are we witnessing an increasing though insufficiently measured correlation between classes of assets resulting from a permanent arbitrage by certain investors across these markets? Furthermore, do investors understand the transfer of credit or liquidity risks associated with these products?

Equity markets

The decline in the number of listed securities in Continental Europe and the United States has continued. The number of initial public offerings was not sufficient to offset delistings. This trend has been accentuated by resurgence in cross-border mergers and acquisitions (M&A), the loss of appeal of multiple listings or, in some countries, the development of public-to-private deals launched by funds frequently through leveraged buyouts.

For companies already listed, net equity issuance (equity issuance less share buybacks and cancellations) posted moderate gains in Europe while losing ground in the United States. This trend reflects both a modest use of market financing and increasing recourse to share buyback programs as a means of rewarding shareholders. On the buy side, with the development of life insurance products (or defined benefit retirement plans in Anglo-American markets) the share in household savings of equities held by institutional investors and investment funds is regularly increasing.

This decline in the number of listed securities could undermine the attractiveness of equity markets, as an increasing number of companies turn to private equity financing. The growing number of alternative investment funds that are shareholders of companies has also increased focus on how these participants understand their role as shareholders. This has led in particular to greater attention being paid to shareholders' meetings of publicly traded companies, ensuring equal treatment for different types of shareholders, especially concerning the transparency of securities lending techniques used by certain investment funds, or the role of proxy providers.

Derivative markets and post-trade infrastructures

Three main trends have appeared. In the first place, since the advent of the euro, the geographical fragmentation of markets in Europe has resulted in a need for rationalisation. Varying degrees of consolidation have occurred depending on the level of vertical or horizontal integration involved in the different segments of securities business: trading, clearing and settlement. This has rapidly resulted in the development of alliances and mergers in the main European markets, and perhaps, in the future, between Europe and North America.

The second major area of change has been in derivatives markets which, due to their increasing size and diversity, are becoming the directional driver of the underlying cash markets. The upsurge in OTC derivative trading volume and of the hyper of derivatives that multiply opportunities of arbitrage, creating new challenges for effectively managing transaction settlements and the associated concentration of counterparty risk.

The third change concerns the boundaries between the participants to the securities chain. Competition among organised stock exchanges is no longer limited to entities of the same nature. In the future, markets will be marked by the evolution of new electronic trading or "reporting" platforms managed by stock exchanges or intermediaries – or by both – according to the profitability of such undertakings. The traditional concept of market members should also evolve to include new kinds of less regulated participants such as hedge funds. The post-trade segment is likely to see the same transformation as the competitive boundaries between settlement infrastructures and banks evolve with the development of added value services beyond those of basic registrar services. The role of clearing houses, particularly in OTC markets should continue to expand, raising possible concerns about the increase of systemic risks and of legal and technical concentration on a global level.

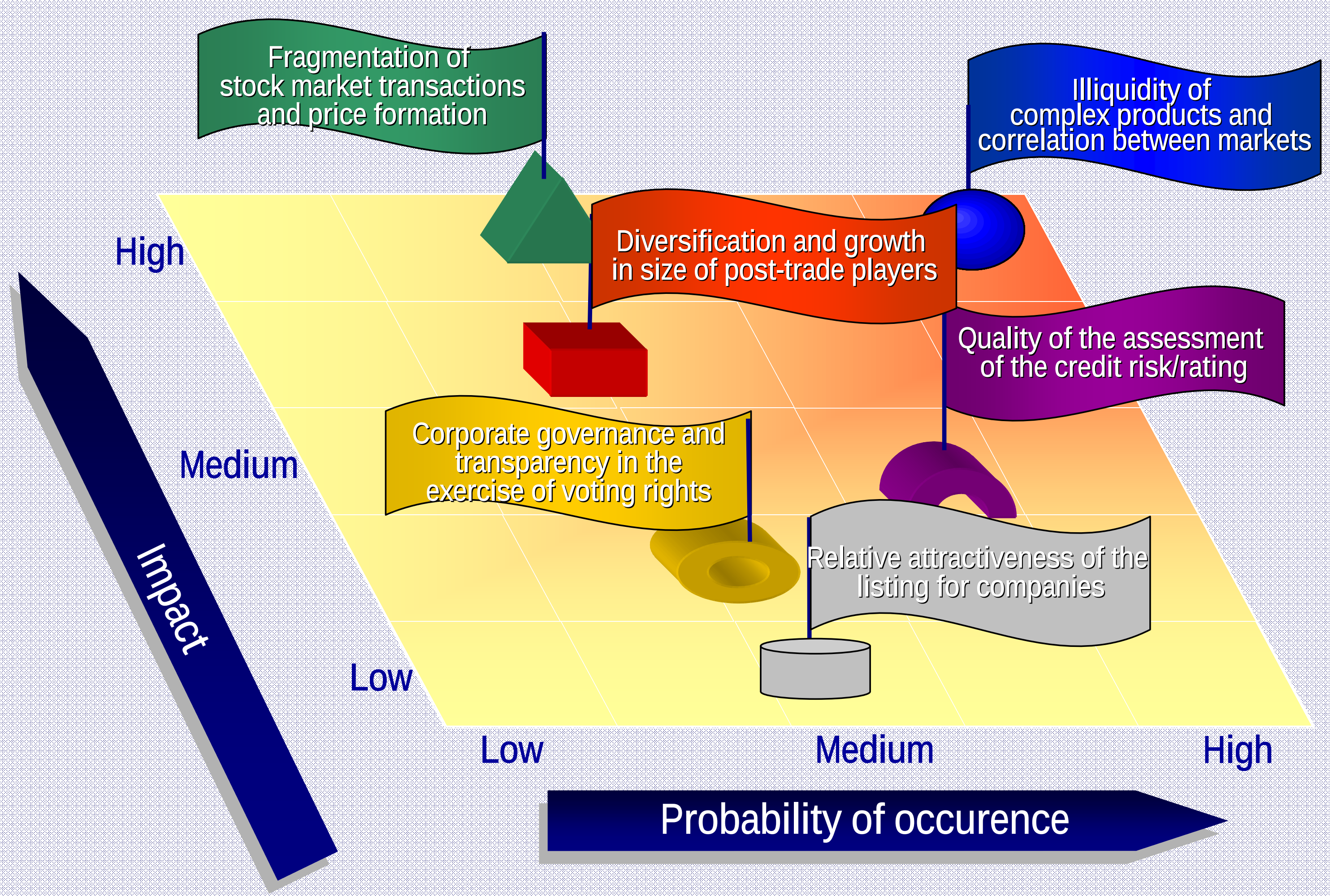
This increasing diversification of players and integration of market infrastructures is the subject of many controversies. Some question the economic efficiency of this new configuration in terms of price-setting process. Others invoke the risks incurred by players as the scope of their activity diversifies, particularly in the area of securities clearing. Finally, the intermediated holding of securities and increasing recourse to international banks for the booking and collateralisation of transactions render increasingly important the question of applicable law and competence of competing jurisdictions for the securities concerned.

* * *

In summary, the analysis of trends highlights six major issues for wholesale financial markets:

- the quality of the process of direct and indirect credit assessment by investors;
- the potential lack of liquidity for increasingly complex or specialised products, its impact in the event of a market reversal and the growing correlation between different market segments;
- the relative attractiveness of listing for companies;
- the role of investors in corporate governance and the necessary balance between the level of activism, stability and transparency in the holding and management of ownership rights in listed companies,
- efficiency and transparency of price-setting mechanisms in the event of a fragmentation of the European landscape of stock exchanges and competing trading venues;
- the legal and economic impact of the diversification of players in the post-trade industry and the concentration of clearing and settlement infrastructures.

Map of trends for wholesale financial markets for and risks for intermediaries, listed companies and institutional investors



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