The London dollar certificate of deposit

Introduction

London dollar certificates of deposit were first issued in 1966, by the London branch of a United States bank. Simultaneously a London investment bank started to make a secondary market. Other international banks soon followed in issuing these certificates. Over a hundred London banks have now issued them, and there are about $9,500 million (£3,900 million) outstanding. Their issue, in fact, preceded the issue of sterling certificates of deposit, which did not appear until October 1968. Articles reviewing the development of the sterling certificate market appeared in the December 1972 and September 1973 issues of the *Bulletin*. This article describes the background to the issue of dollar certificates in London and the development of primary and secondary markets in this paper. It then considers certain aspects of the growth of these markets.

Essentially a London dollar certificate of deposit is a negotiable receipt for a U.S. dollar deposit with a London bank. It is in bearer form, and a number of London houses have formed a secondary market in this paper. A certificate thus gives the holder the advantage of liquidity compared with a straightforward term deposit. It may also give the issuing bank the advantage of being able to borrow at a finer rate of interest, particularly for the medium term.

The market in dollar certificates of deposit is a relatively small adjunct of the euro-currency market in London; the total of $9,500 million of certificates currently in issue must be viewed against U.K. banks' total dollar deposit liabilities of about $90,000 million, or their total foreign currency deposit liabilities of about $120,000 million.

Because dollar certificates are defined as foreign currency securities, permission from the U.K. exchange control must be obtained before a bank can issue them. Dealers in the secondary market equally need to obtain permission to borrow euro-dollars with which to finance the purchase of certificates for their own books. Borrowing is now allowed for periods of up to six months. Dealers normally finance their operations by borrowing rather than by using investment currency because of the uncertainty of movements in the investment currency premium. Other U.K. residents wishing to acquire dollar certificates would normally use investment currency. Because they are bearer securities, all certificates bought by U.K. residents, or those which are physically held in this country on behalf of non-residents, have to be placed in the custody of an authorised depositary.

Primary issuers

Of the 140 banks with U.K. exchange control permission to issue dollar certificates, about 130 currently do so. Analysis of issues by groups of banks shows that the proportions have not varied greatly during the last five years (see Table A). The main issuers are the American banks in London (now 47% of the total), the other foreign banks (18%), and the group shown in the table as "other British banks", which largely comprises the British overseas banks (16%).

Short-term certificates (up to one year) are available on tap in multiples of $1,000, with a minimum of $25,000, although such

Table A

London dollar certificates of deposit: analysis of outstanding issues by banks

$ millions

End:	1969	1970	1971	1972	Sept. 1973
Total issued	3,689	3,960	4,826	8,101	9,554
of which *per cent*					
Clearing banks	–	–	*2*	*2*	*2*
Accepting houses	*2*	*3*	*3*	*5*	*3*
Other British banks	*13*	*21*	*19*	*17*	*16*
Commonwealth banks	*1*	*1*	*6*	*6*	*8*
American banks	*55*	*48*	*47*	*48*	*47*
Other foreign banks	*24*	*21*	*16*	*14*	*18*
Consortium banks	*5*	*6*	*7*	*8*	*6*

small amounts would not command the best rates. They are normally issued for exact terms of one to twelve months – the most popular seem to be of three and six months. Issues for broken dates may be made in special circumstances; such intermediate maturities can also be obtained through the secondary market.

The maximum term permitted by the authorities is five years, but longer effective terms have, on occasion, been arranged by means of forward contracts. A bank could, for example, obtain funds for eight years by issuing an initial certificate for, say, three years and, at the same time, contracting to issue a further certificate, or series of certificates, at specified terms, to cover the remaining five years. The original purchaser would also guarantee to take up these forward issues.

Medium-term issues (over one year) are mostly made in tap form to individual depositors, usually in amounts above $250,000, although amounts of $100,000 are not uncommon. There have also been some issues in the form of tranches, which are 'managed' issues on the lines of a public offer for sale. Amounts offered are usually between $15 million and $25 million, in denominations of $10,000, issued with the aim of obtaining a wide distribution among the financial world. So far only a few operators have handled tranche issues on behalf of issuing banks, and the amount of such issues has been in the region of $300 million.

Opportunities may arise for investors to switch dollar funds profitably between medium-term certificates and euro-bonds of the same maturity. The secondary market in short euro-bonds is not as developed as that in certificates, and discrepancies do occur in the adjustment of rates between the two markets.

Banks themselves take up a considerable proportion of the certificates in issue. In September 1973 they held about $2,900 million, or 30%. To this extent the secondary market has facilitated the movement of inter-bank funds. As a rule, banks would not buy their own paper; such a practice would not be approved in the market, nor would it be encouraged by the authorities. An analysis of holdings by groups of banks is shown in Table B.

Apart from the banks, the only other identified domestic holdings are those by the discount houses and certain other dealers who help to make up the secondary market. Together they held about $315 million in September 1973. Certificates held by the banks in London on behalf of overseas customers at that date, in

Table B

Holdings of London dollar certificates of deposit by groups of banks

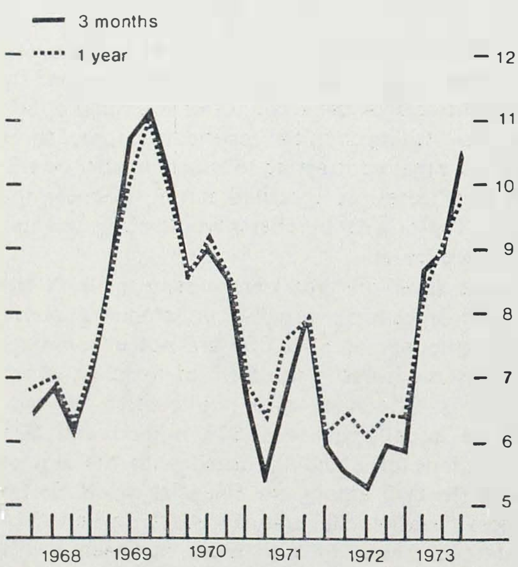
$ millions: *percentage of total in italics*

	Oct. 1971		Oct. 1972		Mar. 1973		Sept. 1973	
British banks:								
Clearing banks	10		8		32		48	
Accepting houses	204		399		325		430	
Other British banks	235		685		770		677	
	449	*37*	1,092	*43*	1,127	*38*	1,155	*40*
Commonwealth banks	91	*7*	208	*8*	223	*8*	334	*11*
American banks	142	*12*	490	*19*	709	*24*	571	*20*
Other foreign banks	94	*8*	219	*9*	347	*12*	271	*9*
Consortium banks	437	*36*	539	*21*	530	*18*	587	*20*
	1,212	*100*	**2,548**	*100*	**2,936**	*100*	**2,918**	*100*

so far as they can be identified, amounted to some $4,250 million. This leaves a gap of about $2,070 million of unidentified holdings, most of which are assumed to be foreign-owned. Part of this amount may be held with authorised depositaries other than banks. Only a small part is thought to be physically held abroad.

Chart A

London euro-dollar interest rates [a]



a End-period middle market rates.

Interest rates

Certificates are paid for on issue at full face value and the interest rate is stated on them. On those of up to one year interest is paid on the maturity date; on longer-term issues interest is paid around the anniversary of the date of issue and at maturity.

Issuing banks fix their interest rates each morning, but rates will be adjusted during the day according to the size of particular deposits and changes in international money market conditions, especially those in the United States. Chart A shows the movement of the three-month and one-year rates during the last five years. Because of their fundamental similarity, interest rates on dollar certificates of deposit move very much in line with ordinary euro-dollar deposit rates. Indeed since the tight money period of 1969–70, rates quoted for certificates have been similar to those available in the inter-bank euro-dollar deposit market.

Maturity structure

Periodic enquiries by the Bank of England into the maturity structure of the euro-currency business of U.K. banks have produced such information about both issues of certificates and holdings by the banks. Such enquiries, because they give merely 'snapshots' of a continually changing scene, pose problems of interpretation, but do provide some guide to developments in the market.

Table C

Maturity analysis: London dollar certificates outstanding

$ millions: *percentage of total in italics*

	Oct. 1971		Oct. 1972		Mar. 1973		Sept. 1973	
Less than 8 days to maturity	137	*2*	146	*2*	399	*4*	293	*3*
8 days to less than 1 month	629	*14*	873	*12*	1,266	*14*	1,412	*15*
1 month to less than 3 months	1,541	*36*	2,189	*31*	2,203	*25*	2,334	*24*
3 months to less than 6 months	974	*23*	1,803	*25*	1,947	*22*	2,176	*23*
6 months to less than 1 year	569	*13*	862	*12*	1,385	*16*	1,155	*12*
1 year and over	477	*11*	1,290	*18*	1,650	*19*	2,184	*23*
	4,327	*100*	**7,163**	*100*	**8,850**	*100*	**9,554**	*100*

Table C shows the maturity structure of issues at the times of the most recent enquiries. This information relates to the period remaining to final maturity at the reporting date, not to the original terms. Taken together, the figures emphasise the importance of the shorter-term maturities, but they do not necessarily establish that any one particular term is the most popular. For example, a large figure in the "3 months to less than 6 months" category might merely reflect an earlier hump of six-month issues. It is fairly clear, however, that the relative importance of longer-term certificates has grown, because the proportion of certificates with one year or more to run has increased from 11% in October 1971 to 23% in September of this year.

Banks' holdings of certificates seem to have had a fairly stable maturity pattern, as can be seen from Table D.

Table D

Maturity analysis: U.K. banks' holdings of London dollar certificates

$ millions: *percentage of total in italics*

	Oct. 1971		Oct. 1972		Mar. 1973		Sept. 1973	
Less than 8 days to maturity	29	*2*	65	*3*	131	*4*	79	*3*
8 days to less than 1 month	103	*9*	315	*12*	362	*12*	362	*12*
1 month to less than 3 months	336	*28*	636	*25*	718	*25*	660	*23*
3 months to less than 6 months	343	*28*	573	*22*	622	*21*	742	*25*
6 months to less than 1 year	166	*14*	409	*16*	486	*17*	409	*14*
1 year and over	235	*19*	550	*22*	617	*21*	666	*23*
	1,212	*100*	**2,548**	*100*	**2,936**	*100*	**2,918**	*100*

The secondary market

The secondary market in London facilitates the marketability of dollar certificates of deposit, and, as has been seen, a prime attraction of certificates is the facility they provide to realise funds before the original maturity date of the deposit, should holders find that their own, or external circumstances, have changed.

Secondary market dealers act partly as brokers, acquiring certificates for their clients directly from issuing banks. They also act as principals, buying and selling for their own 'books', for the most part trading in secondary paper. However, if a particular maturity is not available in the market, they will obtain it for their own account from an issuing bank. One of their functions is to arrange to break down large amounts into convenient smaller amounts for their clients. This helps to broaden the market.

The market is made up of about twenty dealers although only seventeen of these are currently active.[1] These seventeen include ten members of the London Discount Market Association, as well as several dealers based abroad. Most are members of the International CD Market Association, which was set up in 1968 to standardise dealing practices in the secondary market and to ensure that the market's customers obtained the highest standards of service. Day-to-day market practices are discussed below.

Market practices

Dealing practices in the dollar certificate market are governed by arrangements for settlement which reflect those of the foreign exchange market. Certificates are issued by London banks, or the

1 These seventeen dealers are as follows:

Members of the London Discount Market Association:
Alexanders Discount Co. Ltd*
Allen, Harvey & Ross Ltd*
Cater, Ryder & Co. Ltd*
Clive Discount Co. Ltd*
Gerrard & National Discount Co. Ltd
Gillett Bros Discount Ltd*
Jessel, Toynbee & Co. Ltd*
King & Shaxson Ltd*
Smith, St Aubyn & Co. Ltd*
The Union Discount Company of London Ltd*

Others:
A. G. Becker International Ltd*
Goldman Sachs International Corp.
McDunn, Sillcox Ltd
Nesbitt, Thomson Ltd*
Western American Bank (Europe) Ltd
White, Weld & Co. Ltd*
Wood Gundy Ltd*

* Also members of the International CD Market Association.

London branches of foreign banks, against the payment of clearing house funds in New York at their head office, branches, or New York correspondent banks. Settlement is normally on the second working day and this is the value date. Delivery of certificates may be made on this date, at the discretion of the issuing banks, without necessarily waiting for advice that such payment has been received.

Dealers, as principals, quote both buying and selling rates — the spread currently varying between 1/16% and 1/8% for maturities up to one year and between 1/8% and 1/4% for longer maturities. Dealers who wish to discourage business for a particular maturity may widen the spread: their quotations would then be nominal only, made merely to keep their names in the market. A quote of, for example, "8 1/8 — 8" would indicate a buying rate of 8 1/8% and selling rate of 8%. Quotes are made on the basis of yield to maturity, and so the quote of 8% would indicate a yield to maturity of 8% per annum on the sum invested by the buyer. A 360-day year is employed for the market's calculations,[1] and this would be reflected in the purchase price and proceeds of deals.

As with similar 'fixed interest' paper traded in the traditional money markets, dollar certificates can be most profitably traded when there is a (normal) rising yield curve, by the practice known as 'riding the yield curve'. Issuing banks may in favourable circumstances operate one form of this by taking deposits at short term in order to finance the purchase of longer-dated higher-yielding paper: they will aim to roll over the short-term certificates until the maturity of the longer certificate is reached — making their turn on the difference between short and long yields. The practice, which can also be described as time arbitrage, relies on the view that short-term interest rates will not rise above longer rates in the intervening period, or at least not for long enough to make it unprofitable.

On the other hand, investors will seek an opportunity of making a capital gain. This may be possible in conditions of stable interest rates if the slope of the yield curve is steep enough, but falling interest rates provide the ideal conditions. For example, a company treasurer with surplus funds for, say, three months, and expecting rates to decline in a month or so, might buy a six-month certificate with the expectation of selling in three months time and making a profit.

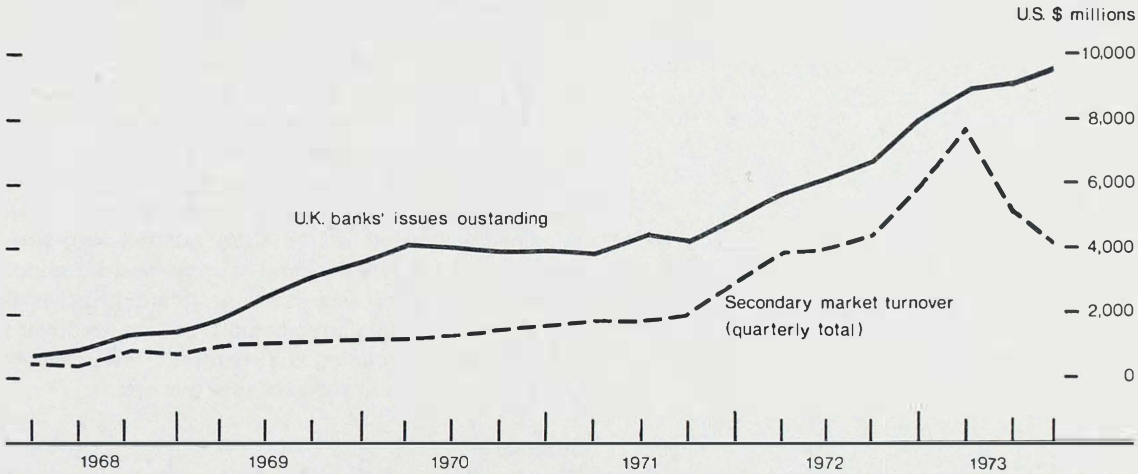
Growth of the markets

The value of London dollar certificates outstanding has grown rapidly — see Chart B. The total has increased from $1,360 million in September 1968 — the first year in which full statistics were available — to $9,550 million in September 1973. This represents a sevenfold increase in five years. However, the whole euro-currency market has grown equally fast, and the proportion of certificates of deposit outstanding to the total of U.K. banks' euro-currency liabilities has not changed much over the period, ranging between 6% and 9%. In September 1973 the proportion was 8%. The peak was attained during 1969 when London issues outpaced the rate of growth of the euro-dollar market as a whole. U.S. monetary controls at this time, and in particular Regulation Q interest rate ceilings, effectively curbed the issue of certificates

1 The formula used in dollar certificate calculations is set out in various publications produced by market members, and by the International CD Market Association.

Chart B

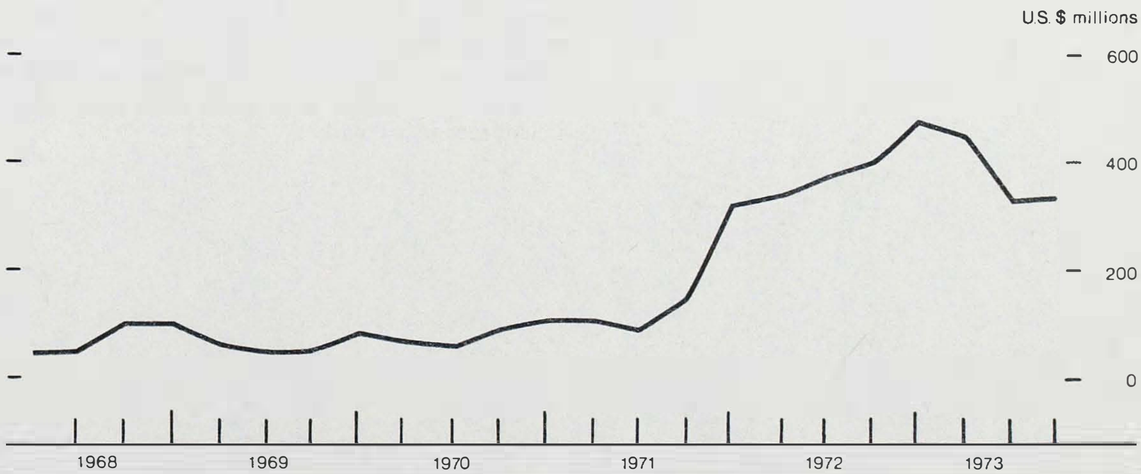
London dollar certificates of deposit: size of the market[a]



a Turnover is recorded as the sum of purchases and sales by dealers.

Chart C

Secondary market holdings of dollar certificates of deposit



by banks in the United States, and American banks in London helped to fill the gap.

Turnover in the secondary market has had a rather more varied pattern, reaching a peak in the first quarter of this year. The course of holdings of certificates by secondary market dealers is shown in Chart C.

The principal reason for the changes in secondary market business would seem to be changing opportunities to make capital gains on trading. Thus, the figures show that activity is highest when traders are faced with a normal (rising) yield curve and expect, or are experiencing, falling interest rates.

Euro-dollar rates were falling quite sharply for much of the first quarter of 1968 and hence turnover was comparatively brisk. By contrast it was rather depressed in 1969 and 1970 as rates moved upwards. In the final quarter of 1971 interest rates again began to fall and turnover picked up markedly. Euro-dollar rates continued to fall in the first half of 1972, while in the second half they remained fairly steady. These conditions were certainly favourable to trading in certificates. The very active first quarter of this year is harder to explain in such terms. Interest rates were moving upwards and continued rising after the devaluation of the dollar — the yield curve also began to flatten in March. It is possible that the increase in activity was associated with a general desire for greater liquidity at a time of currency uncertainties. In the second quarter euro-dollar rates rose further and there was a flat yield curve: in these conditions turnover fell sharply. Activity remained depressed in the third quarter also; euro-dollar rates reached double figures and a downward-sloping yield curve appeared. Business was, however, more brisk in September as dealers and investors anticipated falls in euro-dollar interest rates in the wake of declining U.S. domestic rates and of the strengthening of the dollar in the exchange markets.

Summary

The London dollar certificate of deposit must be seen in perspective as only part of the London euro-currency market, accounting for less than 10% of the whole. Its fortunes are inseparable from those of the larger market. The secondary market in certificates is moreover only one among London's many parallel money markets, and a large proportion of its dealers, particularly the discount houses, are active in several markets simultaneously. None the less, dollar certificates of deposit have advantages over straightforward term deposits and their rôle is likely to develop, aided by the existence of an efficient secondary market.