

Developments in international banking and capital markets in 1985

This article continues the annual series on international banking developments expanded, as last year, to encompass wider capital market developments.

- *Much of the year's international financial flows was between investors and borrowers in developed countries and was channelled through securities markets. International bank lending fell further from its pre-eminent position seen in the 1970s.*
- *Financial innovation continued apace and included the establishment of new markets for short-term paper, while controls were relaxed in the major capital markets. Together these forces contributed to a growing integration of markets.*
- *In October US Treasury Secretary Baker launched an initiative for tackling the debt problems of certain developing countries. The proposals provide a framework based on growth-oriented adjustment policies and have been broadly welcomed, although discussions on implementation continue.*

Overview

There was continued growth in private international capital flows during 1985. International bond issues rose to record levels, but bank lending to final users grew less rapidly than in 1984, and overall the pace of growth slowed slightly (Table A). This took place against a background of widening current account imbalances among the major developed countries. The dollar fell against all major currencies and initiatives were launched in the United States to reduce the federal deficit. These developments occurred too late to prevent the current

account and government deficits in the United States increasing further in 1985, with the result that US entities again provided the major demand for international lending. Many of the smaller developed countries and those developing countries not affected by debt problems enjoyed stronger current account positions; in many cases they took advantage of competitive market conditions to lower the costs of their existing debt by repaying bank borrowings and refinancing them in the securities markets.

The developing countries' debt problems continued to hang over international banking markets. Although 1985 saw the signing of the first commercial bank multi-year rescheduling agreements (MYRAs), which place the maturity structure of the debt burden on a more sustainable basis, these have not yet stimulated significant new lending. Bank lending to developing countries grew very modestly, by only just over 2% according to figures published by the Bank for International Settlements. Overall, these countries reverted to their usual role as net borrowers from banks in the BIS reporting area.⁽¹⁾

The slow pace of banks' new lending and continued high real interest payments exacerbated the economic, political and social problems facing debtor countries. Against this deteriorating background, in October US Treasury Secretary Baker put forward a three-pronged initiative for tackling the debt problem. Baker's proposals were based on growth-oriented adjustment policies by the major debtors, combined with increased lending by the multilateral development banks (the World Bank and

Table A
Growth of international lending

\$ billions: banking flows adjusted to exclude estimated exchange rate effects

	1982	1983	1984	Nine months to end-Sept. 1985	
				1985	1985
Gross lending					
Bank lending	+229	+127	+148	+155	..
of which:					
To inside area	+190	+95	+135	+140	..
To outside area	+39	+28	+14	+11	..
Euro and foreign bond issues	+72	+72	+108	+118	+163
Total gross lending	+301	+199	+256	+273	..
Net lending					
Bank lending(a)	+95	+85	+95	+55	..
of which:					
To inside area	+55	+57	+82	+41	..
To outside area	+40	+28	+14	+11	..
Euro and foreign bond issues net of redemptions(b)	+59	+58	+90	+95	+132
Total bank and bond finance	+154	+143	+185	+150	..
minus double counting(c)	-9	-13	-28	+30	..
Total net lending	+145	+130	+157	+120	..

.. not available.

(a) BIS estimate of lending to final users.

(b) Gross issues less estimates of redemptions and repurchases.

(c) Double counting due to partial inclusion of banks' purchases of bonds in bank lending series and banks' own bond issues made for purpose of supporting their international lending.

(1) Since December 1984 the BIS reporting area has included banks in the Group of Ten countries plus Luxembourg, Austria, the Bahamas, Bahrain, the Cayman Islands, Denmark, Hong Kong, Ireland, the Netherlands Antilles and Singapore and branches of US banks in Panama.

regional development banks) and an increase in lending by commercial banks of some 2½% to 3% per annum. The proposals provide a framework which has been broadly welcomed, and discussions are continuing on the details.

South Africa declared a moratorium on its external debt at the end of August as domestic political disturbances and international pressure led to a withdrawal of credit lines. In contrast to the moratoria introduced in other countries, the South African moratorium covered short-term interbank lines as well as medium-term debt. Debt problems also spread to some other countries not previously affected.

There was again a high level of bank failures in 1985, although these were mostly due to domestic, rather than international, difficulties. In the United States 120 banks failed, of which about half were involved mainly in agricultural lending, compared with a total of 79 failures in 1984. There were also bank failures and difficulties in Brazil, Canada and Hong Kong. As the failed Brazilian banks had long-term loans from foreign banks, which are being met only in part by the Brazilian central bank, there were fears that rescheduling negotiations with Brazil might be affected. International banking markets were also involved when the tin buffer stock manager became unable to meet his obligations in October, although the magnitudes were not such as to have implications for the stability of the international banking system.

In contrast to the modest flows to developing countries, activity among countries within the BIS reporting area continued to increase. Residents of the United States were the major takers of funds, principally dollars, from the international markets. However, their net absorption from international banking markets was again equivalent to a modest proportion, roughly one third, of the US current account deficit. Overseas non-banks remained the dominant source of finance: eurobond issues, net of repayments, financed a further quarter of the deficit, and foreign purchases of US Treasury bonds probably financed slightly less than this. Arrangements of euronote facilities for US borrowers rose fivefold, but will have contributed towards financing the deficit only to the small extent that they were actually drawn.

Investors in Japan, with a strong current account surplus behind them, appeared to be the major purchasers of international bonds. Japanese borrowers were also active, being second only to US borrowers in their volume of fixed-rate bond issues. In 1985 Japanese banks replaced US banks as the largest international lenders by nationality group, although their lending was mainly financed from the international interbank market.

Intense competition between financial intermediaries in the securities markets has created pressure to innovate as a means of winning mandates and compensating for lower fees and spreads. (The main innovatory instruments are

described on page 65.) Many of these innovations have added to the means available for hedging interest or exchange rate exposures in response to the greater volatility of recent years. Other innovations have been designed to reduce the pressure on banks' capital by facilitating credit flows in a form that does not add to banks' total assets. This has raised important issues which have been addressed by central banks.

For the purposes of prudential supervision of banks it is important that all the risks to which a bank is exposed should be included when its capital adequacy is being measured. In April last year the Bank announced that it was undertaking a review of the prudential treatment of off balance sheet business. At the international level, last September the central bank Governors of the Group of Ten countries discussed the development of off balance sheet business. They endorsed the steps already being taken by bank supervisors to emphasise the importance to banks of keeping a careful watch on off balance sheet business and on the risks to which such activities expose them. The Basle Supervisors Committee addressed the supervisory issues raised by the growth in off balance sheet business in a paper published in March. The causes of financial innovation and its consequences for the conduct of monetary policy and for the stability of the financial system have been considered by a central bank study group, whose report is to be published in April.

During the 1980s, international portfolio investment flows have grown relative to GDP in most of the major industrialised countries. Current account imbalances have grown and shifted between countries. Technological developments have made it easier for borrowers to look to whichever market offers the cheapest source of funds. These investment flows have been facilitated by a series of deregulatory moves, in some cases going back to the early 1970s, and including the abolition of exchange controls in the United Kingdom and Japan in 1979–80. A further important change was the abolition of withholding tax during 1984 in the United Kingdom, the United States, Germany and France. In 1985 there was a further series of deregulatory moves designed to improve foreign access to national capital markets (see page 60).

In the United Kingdom, a series of further changes is due to take place in 1986 as a result of the restructuring of The Stock Exchange and the introduction of a new regulatory framework for the financial services industry.⁽¹⁾ In anticipation of these changes, a number of financial conglomerates are in the process of being formed, with the capacity to carry out a range of activities, possibly including banking, corporate advice, issuing, market making and investment management, within the same organisation. Foreign banks and other financial institutions have taken participations in Stock Exchange member firms. Other foreign firms will join the Exchange

(1) These changes are described in an article on pages 544–50 of the December 1985 *Bulletin*.

Capital market deregulation

A series of measures were taken in 1985 to liberalise access to the major capital markets.

Japan

(i) From 1 December 1984 foreign corporations, state and local governments and government agencies were authorised to issue euroyen bonds under the same criteria as for samurai bonds (eg a rating of A or better)—previously only foreign public borrowers could do so—and restrictions on the number and size of issues were eased; the criteria were relaxed further for both samurai and euroyen bonds from 1 April 1985. Foreign institutions were allowed to act as lead manager of euroyen bond issues from December 1984. (Euroyen bonds are sold through international syndicates of banks to investors outside Japan; 'samurai bond' is the conventional name for issues by foreign borrowers in the Japanese domestic yen-denominated bond market.)

(ii) Withholding tax on euroyen bond issues by Japanese residents was abolished from 1 April. Although some Japanese corporations had been permitted to issue euroyen bonds since April 1984, withholding tax had made it uneconomic to do so. The number of Japanese corporations able to issue euroyen bonds was significantly increased later in the year, simultaneously with a relaxation of standards for domestic issues.

(iii) From the beginning of April non-resident lenders and Japanese banks' overseas branches were permitted to extend yen loans with a maturity of one year or more to non-residents and to overseas subsidiaries of Japanese corporations.

(iv) From 17 June euroyen FRNs, zero-coupon bonds and dual-currency issues were permitted for non-resident borrowers.

(v) A market re-opened in May for bonds issued in Japan by non-resident borrowers denominated in foreign currencies (known as 'shogun' bonds).

(vi) Dual-currency samurai bonds were permitted in November, the ceiling on issue amounts was increased and the number of eligible bond rating agencies raised to five.

(vii) Late in 1985 it was announced that overseas subsidiaries of Japanese corporations were to be allowed to issue euroyen bonds under the same criteria as foreign firms.

France

(i) The French franc eurobond market was re-opened to public and private French and foreign borrowers in April. Swaps and convertible bonds were authorised, but not FRNs. Initially the book-running lead managers are expected to be French banks. While French residents may buy the eurobonds without paying withholding tax, they cannot enjoy the fiscal advantages provided by domestic

issues. New issues are subject to a calendar set by the Issuing Committee (on which the French Trésor is represented).

(ii) From 18 December a commercial paper market was permitted in France, with maturities between 10 and 180 days. Borrowers are required to have a back-up credit line, which can be provided by French or foreign banks, to at least 95% of paper outstanding.

Germany

FRNs, zero-coupon bonds, swap-related bonds and dual-currency issues were permitted in the deutschemark foreign bond sector from 1 May. Foreign-owned banks incorporated in Germany were permitted to lead manage foreign deutschemark issues, subject to reciprocity requirements. The formal calendar for foreign issues was replaced by a system whereby issuing banks have only to give notice of their intention to the Bundesbank in the previous month.

Italy

From September, issues of Italian lira eurobonds by non-residents were permitted, with the flow of issues controlled by the authorities.

The Netherlands

From 1 January 1986 Dutch guilder FRNs, CDs and commercial paper were permitted. Bond issues without sinking funds were permitted (which made it easier to arrange swaps) and the minimum original average maturity was reduced to two years. Foreign banks coming under the supervision of De Nederlandsche Bank that have fully-fledged securities departments were permitted to lead manage domestic or foreign bond issues.

United Kingdom

In March, measures were taken to facilitate the issue of short-term sterling bonds with maturities between one and five years, subject to the borrower's satisfying certain criteria.

Activity in deregulated markets

\$ millions

	1985			
	Q1	Q2	Q3	Q4
Euroyen				
Fixed-rate bond issues by non-residents	1,264	278	2,427	1,782
of which:				
Dual-currency bonds	—	—	2,183	612
Bond issues by Japanese borrowers	—	320	94	442
Floating-rate notes	—	—	63	70
Credits for non-residents	—	—	414	208
French francs				
Eurobonds	—	393	442	524
Italian lire				
Eurobonds	—	—	—	272
Deutschemarks				
Floating-rate notes	—	1,034	179	1975
Zero-coupon bonds	—	163	—	72

in their own right. This foreign presence in the London Stock Exchange will add considerably to the international integration of domestic securities markets.

The cumulative effect of the process of innovation and deregulation has been to bring about a growing integration between what were formerly discrete market sectors. This integration has taken various forms: new channels have opened up for finance to flow directly between investors and borrowers in different countries (such as eurocommercial paper and international equities—these are discussed below); instruments have spread beyond their traditional markets and have broadened into different currency sectors; dismantling of regulatory and tax barriers has given borrowers and intermediaries a greater choice of markets; and the process of securitisation of international lending has allowed a wider range of institutions to participate in the long-term credit markets. As a result, borrowing terms have moved closer in line between domestic markets and euromarkets. In the longer run the distinction between domestic markets and euromarkets may be eroded if investors and borrowers have access to the same instruments through the same intermediaries on the same terms in both markets.

The pace of innovation and liberalisation has varied between markets, however, and there have been an increasing number of examples of the intermediation of capital flows between investors and borrowers in the same country through international markets. Examples include Japanese borrowers selling eurobonds to Japanese investors, German borrowers selling Australian dollar eurobonds mainly to German investors and Swiss companies issuing euroequities apparently mainly to Swiss investors. In these ways the international markets have become an extension of the domestic.

The development of interest rate and currency swap techniques has played a key role in this integration of markets as they have enabled borrowers to look to a wider range of markets in order to meet their funding requirements. In particular, the convergence of domestic bond yields and eurobond yields in the major currencies has encouraged borrowers to look to less widely traded currencies in the search for profitable swap opportunities, leading to increased use of these currencies in international markets.

These developments have transformed international financial markets. The innovations may originally have been a response to particular circumstances, but in most cases they have become established as useful techniques in their own right. They are likely to remain in use, even if the circumstances which gave rise to them change. Furthermore, it seems possible that there has been a shift in attitude among market participants—intermediaries, borrowers and investors—to accepting and even favouring innovation as a continuing feature of financial markets. A number of intermediaries have set up 'product development groups' whose task is to research and

implement new financial techniques. Such developments suggest that the pace of innovation is likely to continue to be rapid, and, in future, changes in the economic environment may be met with new financial techniques more quickly than in the past.

A particular development which may prove to be significant for the future was the growing interest in finance through the issue of short-term paper. 1985 saw the establishment of a eurocommercial paper market and the opening of new domestic commercial paper markets in a number of countries; more are likely to follow. These markets extend to short-term financial flows the disintermediation that has already occurred in the securities markets for longer-term flows. Although a model for these markets exists in the United States, the disintermediation of international short-term finance is an unfamiliar prospect and one which may have important long-run implications for the international role of banks.

Developments in the principal markets

This section describes developments in the international capital markets using information compiled by the Bank (see page 64 of the March 1985 Bulletin, but note that figures for all instruments are now compiled by announcement date).

Floating-rate notes and fixed-rate bonds

New issues of floating-rate notes in 1985, at \$55 billion, were 60% higher than in 1984 and new issues of fixed-rate bonds 45% higher, at \$107 billion. However, borrowers took advantage of improved conditions to refinance existing debt on finer terms, and the volume of FRNs called before maturity rose from less than \$1 billion in 1984 to \$12 billion in 1985. Net of repayments the rate of growth of FRN issues was halved to 30% (Table B).

Table B
New international bond issues by country of issue; 1985

\$ billions; figures for 1984 in italics

	Total		Fixed-rate bonds		FRNs	
	Gross	Net(a)	Gross	Net(a)	Gross	Net(a)
Total	162.7	131.8	107.4	89.3	55.3	42.5
<i>108.1</i>	<i>89.7</i>	<i>74.0</i>	<i>57.5</i>	<i>34.1</i>	<i>32.2</i>	
BIS reporting area	127.1	103.7	81.8	68.8	45.2	34.9
<i>85.6</i>	<i>72.8</i>	<i>55.4</i>	<i>43.7</i>	<i>30.2</i>	<i>29.0</i>	
<i>of which:</i>						
United States	40.4	36.3	30.2	26.2	10.2	10.1
<i>24.9</i>	<i>21.4</i>	<i>19.8</i>	<i>16.7</i>	<i>5.1</i>	<i>4.7</i>	
Japan	20.0	18.7	19.0	18.2	1.0	0.5
<i>15.8</i>	<i>15.0</i>	<i>14.3</i>	<i>13.5</i>	<i>1.5</i>	<i>1.5</i>	
United Kingdom	14.9	12.9	3.2	2.3	11.7	10.6
<i>4.5</i>	<i>4.0</i>	<i>1.3</i>	<i>0.9</i>	<i>3.2</i>	<i>3.1</i>	
France	11.9	6.4	5.0	3.7	6.9	2.7
<i>8.0</i>	<i>7.0</i>	<i>3.0</i>	<i>2.3</i>	<i>5.0</i>	<i>4.7</i>	
Sweden	5.9	1.8	3.7	2.7	2.2	- 0.9
<i>6.6</i>	<i>5.3</i>	<i>2.5</i>	<i>1.4</i>	<i>4.1</i>	<i>3.9</i>	
International institutions(b)	18.5	13.4	15.7	12.4	2.8	0.9
<i>13.3</i>	<i>10.9</i>	<i>12.6</i>	<i>10.3</i>	<i>0.7</i>	<i>0.6</i>	
Other developed countries	9.3	8.4	7.8	7.2	1.5	1.2
<i>6.1</i>	<i>4.7</i>	<i>4.9</i>	<i>3.6</i>	<i>1.2</i>	<i>1.1</i>	
<i>of which:</i>						
Australia	5.7	5.1	5.3	4.9	0.4	0.2
<i>3.1</i>	<i>2.6</i>	<i>2.6</i>	<i>2.1</i>	<i>0.5</i>	<i>0.5</i>	
Other countries	7.9	6.3	2.1	0.9	5.8	5.4
<i>3.1</i>	<i>2.0</i>	<i>1.1</i>	<i>- 0.1</i>	<i>2.0</i>	<i>1.4</i>	

(a) Net figures are new issues net of Bank of England estimates of sinking fund payments and bonds and FRNs maturing or called before maturity.

(b) Including European institutions.

Table C
Floating-rate note holdings of banks in
the United Kingdom

\$ billions, at mid-months

	1983		1984		1985	
	Nov.	May	Nov.	May	Nov.	May
Japanese banks	5.8	8.6	11.8	14.4	17.7	
American banks	0.9	0.9	0.8	1.0	1.2	
British banks	0.8	0.9	0.9	1.1	2.9	
Consortium banks	0.7	0.4	0.7	0.8	0.8	
Other overseas banks	1.9	2.4	2.8	4.6	7.0	
Total	10.1	13.1	17.0	21.8	29.6	

Purchases by banks still appear to be a major factor behind the growth of the market. Although figures are not available for the whole of the BIS reporting area, data for banks in the United Kingdom show that their holdings of FRNs almost doubled in 1985 (Table C). Some \$5 billion of fixed-rate bonds were called, compared with \$2 billion in 1984.

The largest issuers of FRNs were borrowers, particularly banks, in the United Kingdom and the United States. In the past, borrowers in France and some of the smaller developed countries had been the major issuers of FRNs; not only was the volume of their new issues in many cases lower in 1985 than in the previous year, but they also called outstanding FRNs, which were then refinanced more cheaply. There were increases in fixed-rate bond issues by some borrowers who had formerly been more active in the FRN market, since combined with an interest rate swap these provided cheaper floating-rate funds than an FRN issue.

Borrowers in some developing countries around the Pacific basin enjoyed improved access to the FRN market, and to a large extent used the proceeds to prepay existing bank credits.

The volatility of exchange rates, and particularly expectations of a decline in the value of the dollar, led to the growing use of a variety of hedging features. Most of these were attached to dollar bonds, since there was a continuing demand from investors for dollar-denominated assets despite uncertainty over the future value of the currency. Features such as partly-paid bonds and warrants to purchase additional bonds in the same or a different currency allowed investors to benefit from a decline in US interest rates while limiting their exposure to an exchange rate decline. Increased interest in warrants meant that this technique spread outside its traditional use in the dollar eurobond market. A series of dollar FRN issues with warrants to buy bonds in different currencies was made after the G5 agreement to intervene to reduce the value of the dollar, emphasising the use of the warrants as a currency hedge.

The number of variations in the form of the coupon carried by FRNs continued to grow. The mismatch technique,⁽¹⁾ which had been introduced in 1984, went through periods of great popularity when the yield curve

was particularly steep. An innovation during the year was capped FRNs, which carry a coupon which varies in line with an interest rate index only up to a certain predetermined maximum level, or cap: these were introduced in dollars, where the cap was set at around 13%, and spread to deutschemark FRNs, with caps set at around 8%.

The purpose of these variations was to reduce the cost to the borrower by offering alternative attractions to the investor: the spreads on mismatched FRN issues or FRNs with warrants could be lower than on other issues as in the first case the investor hoped to add to his return from the steepness of the yield curve, and in the second case there was a possibility of gain on the warrant as a result of interest or exchange rate movements. Although capped FRNs carried higher spreads than others, to compensate the investor for the risk that interest rates might rise above the cap level, the cost to the borrower could nevertheless be reduced by selling the cap to another borrower who was more concerned to protect himself against a rise in interest rates.

In a number of countries measures were taken to liberalise foreign access to national capital markets (see page 60). The response to these deregulatory moves has varied. After an initial burst of activity in deutschemark FRNs and zero-coupon bonds when these instruments were permitted for the first time, volume fell during the summer, but recovered towards the end of the year. There was a similar pattern in issues of euroyen bonds by foreign corporations. The level of activity, initially high, quickly fell away, but revived in the second half of the year when dual-currency issues were permitted. By contrast, use of some of the newly liberalised instruments in the euroyen market was slow to start and there has been little activity overall. The French franc eurobond market has a controlled flow of new issues and so shows a fairly constant level of activity.

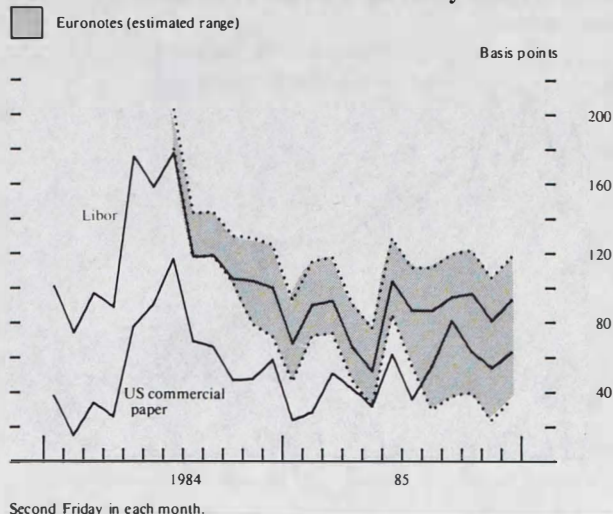
Euronote facilities

Euronote facilities are designed to allow the borrower to raise funds over a medium-term period by issuing a stream of short-term notes. During 1985 the volume of facilities arranged more than doubled to \$49 billion. Their development moved in two directions which, in different ways, reflected growing integration with other markets.

In the first half of the year the emphasis was on the development of underwritten multiple-component facilities which give access to a range of different markets, enabling the borrower to switch between them to take advantage of the cheapest source of funds, but at the expense of having to pay front-end and commitment fees. Any short-term notes issued under these facilities would normally be for fixed maturities of three or six months,

(1) The mismatch technique consists of an FRN carrying a coupon of—for example—six-month Libor reset and paid monthly. This allows the investor to take advantage of a steeply upward-sloping yield curve by funding himself at the one-month rate but receiving the higher six-month rate, without being exposed to a rise in interest rates. Most issues have offered the investor some form of protection against a downward-sloping yield curve.

Chart 1
Differentials from 3-month US Treasury bills



distributed by tender panel or a sole placement agency, with settlement taking several days. Some of the alternative forms of drawing, such as 1-5 year sterling notes, have never in fact been used and the attraction of maintaining flexibility seems to have diminished.

The yields on euronotes fell relative to those on other instruments as the result of success in developing a non-bank investor base (Chart 1). At the start of the year, few managers were able to place more than about 30% of euronote issues with non-bank investors, but by the end of the year there were several facilities under which the notes were reported to have been placed almost entirely with non-bank investors. Swiss investors in particular, attracted by short-term instruments issued by prime quality borrowers, seem to have become important purchasers. Since they tended to regard euronotes as an alternative to US Treasury bills, they were prepared to buy euronotes at yields as much as 60 basis points below the interbank bid rate at around a one-month maturity. At these levels, the yields on euronotes were still above those on US Treasury bills but lower than those on US commercial paper, encouraging US borrowers to turn to the euronote market in preference to their domestic commercial paper market.

As a result, an increasing number of euronote facilities took the form of uncommitted eurocommercial paper facilities: over the year as a whole, a third of the facilities arranged were uncommitted, but in the final quarter this proportion rose to over half. These differed from traditional note issuance facilities and multiple-component facilities in that they were not tied to specific back-up lines, and enabled paper to be issued for flexible maturities of anything from 7 to 365 days and distributed through dealers with same-day settlement. Many of these features are borrowed from US commercial paper programmes. There are, however, two main differences: in the United States, programmes are backed by firm credit lines (which eurocommercial paper programmes are not) and receive a credit rating (which is

only just beginning to happen in the euromarkets). Because eurocommercial paper programmes are not backed by bank commitments, they do not give rise to contingent exposures for banks and borrowers do not have to pay any underwriting fee.

Nevertheless, multiple-component facilities continued to be arranged. One of their attractions is that they enable funds to be drawn in the form of advances in currencies in which euronotes may not be issued. So far, euronotes have been issued only in US dollars and ECU, although similar short-term notes have been issued in the domestic Australian dollar, Singapore dollar, Hong Kong dollar, Norwegian krone and Spanish peseta markets. Commercial paper markets have recently been opened in France and the Netherlands (so far used only by domestic issuers). Since a number of facilities allow for notes to be issued in any major currency, as and when it becomes possible, the ground has been prepared for an international, multi-currency commercial paper market.

A number of supervisory authorities have taken steps to include in their measurement of capital adequacy commitments given by banks underwriting euronote facilities. In April the Bank of England included banks' underwriting commitments in their calculation of the risk asset ratio with a provisional weighting of 0.5, subject to the review of off balance sheet business set in train at the same time. In May the Japanese authorities announced proposals for a risk asset ratio in which underwriting commitments would be given a weighting of 0.3. The weighting in the French risk asset ratio for underwriting commitments given to non-banks was increased to 0.5 from January 1986. Also in January the Federal Reserve Board announced a proposal for a risk asset ratio in which underwriting commitments would be given a weighting of 0.3.

Equity-related issues

Equity-related bond issues (that is, bonds either convertible into equity or carrying warrants to purchase equity) have traditionally formed a link between the bond and equity markets. The volume of these issues fell slightly in 1985, perhaps because Japanese borrowers constitute the major part of this market and the Tokyo market performed less well than most other major stock markets during the year (Table D).

During 1985 there was increasing use of eurobond syndication and marketing techniques to distribute equity issues in bearer form. At present the market for bearer participation certificates (BPCs) is confined almost

Table D
International equity-related issues

\$ billions	1984	1985
Convertibles	8.5	7.3
Equity warrants	3.4	4.3
Total	11.9	11.6
Euro-equity issues	0.2	1.1

entirely to Switzerland. In 1985 virtually all the issues were for Swiss companies: of \$1.1 billion of euroequity issues during 1985 almost all were for Swiss companies, raised in Swiss francs, and managed by banks with a strong distribution capacity in Switzerland.

Euroequity issues in bearer form appeal to issuers because they are presumed to attract a distinct, 'eurobond', type of investor who would not normally purchase registered equity. Another attraction to issuers is the extent to which they are subject to less rigorous disclosure requirements.

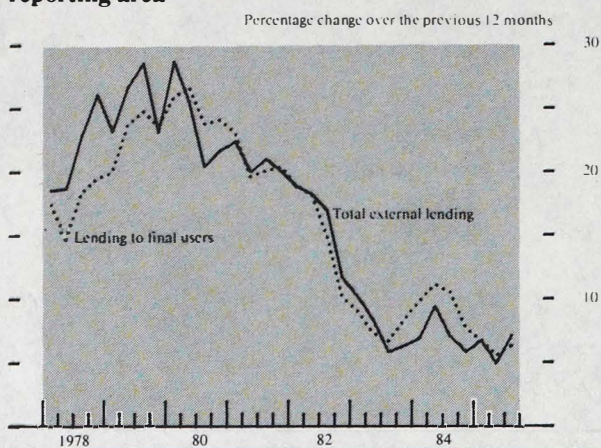
At least four other types of international activity in equities have been growing. First, there has been a trend for conventional equity issues to be made simultaneously in two or more established and regulated domestic markets along the lines established by British Telecom and Reuters. Second, issues have been targeted at a single foreign equity market, conforming to the regulatory requirements of that market. Third, overseas managers have been incorporated into the syndication of a domestic issue, thereby facilitating targeting at institutional investors in the country of that manager. Finally, equities have been distributed internationally through private placements.

Banks' international business

The preceding discussion of market developments in 1985 relates to capital flows taking the form of negotiable instruments. Banks are major purchasers of these securities. But they also lend directly to customers in non-negotiable forms—such lending includes syndicated credits, which make it possible to finance international loans which are too large for individual banks to accommodate. Thus statistics of lending collected from banks in national centres and aggregated by the Bank for International Settlements (BIS) are complementary to the international capital market data. There is some overlap between the two series because the BIS data include purchases of overseas securities by banks in some but not all of the reporting countries. The BIS statistics, which were briefly described in the March 1985 Bulletin (page 64), form the basis of this section of the article. They are available only to end-September 1985 and analysis therefore focuses mainly on developments in the twelve months to that date. Statistics of the international business of banks in the United Kingdom in the fourth quarter of 1985 are assessed separately on pages 43–44.

Banks' international lending, which expanded rapidly during the 1970s as they played a major role in recycling the surpluses generated by the oil price rises, decelerated in 1982 and 1983 when debt problems of certain major borrowers became acute. The deceleration reduced the share of banks' lending in total international intermediation. There was a modest pickup in the pace of banks' lending to final users in 1984. But this was not

Chart 2
Growth in external lending of banks in the BIS reporting area



continued in 1985 and bank lending fell further from the position of pre-eminence in international intermediation established in the seventies. Banks' participation in total private international lending, as shown in Table A, is understated by the omission of the purchases of bonds by banks located in some countries from the statistics providing the geographical detail of their lending.⁽¹⁾ But after allowing for this, a further fall in the importance of bank-intermediated flows is apparent. In the first nine months of 1985, identified bank lending accounted for under half of the funds raised, on a net basis, on international markets. This compares with 61% in 1984 and 86% in 1981, the year before the debt problems of major borrowing countries began significantly to affect the volume, direction and form of international lending flows.

As in 1984, new bank lending went largely to borrowers in developed countries in the BIS area. The pace of spontaneous lending to outside-area countries rose very modestly and international banks remained highly selective in their lending to developing countries. The falls in interest rates and the dollar over the year were favourable to developing countries. In contrast, lower oil prices had a mixed impact, beneficial for the oil importers and adverse for the oil exporters, although the effect of the sharp end-year fall has yet to be felt fully. Peru's ceiling on debt repayments, South Africa's moratorium, and Brazil's failure to reach full agreement with the IMF were among the developments increasing banks' caution and selectivity. On the other hand, banks in the major centres reacted positively to the Baker initiative to increase their lending to major debtors over the medium term, providing other conditions are met.

Business within the BIS reporting area (Tables E, F and G)

In the period immediately after Mexico's moratorium in August 1982, BIS-area banks and, on the evidence of IMF statistics, other banks not reporting to the BIS, adopted a

(1) The Bank of England is collecting geographical information on holdings of bonds by banks in the United Kingdom with effect from end-December 1985 (see Table 14 and the additional notes to the statistical annex). This will fill a considerable part of the statistical gap.

Innovation in financial markets

The main example of an innovation designed to facilitate credit flows is the *note issuance facility* (NIF—also known as RUF, TRUF, SNIF and so on). This is a medium-term facility which enables the borrower to issue a series of short-term notes (known as euronotes). The facility is usually backed or underwritten by a commitment from a group of banks to ensure that the borrower will have access to funds when they are required. The first NIFs were arranged in 1981, but the strongest growth has taken place since 1984: \$33 billion of NIFs were arranged in 1985, bringing the total of underwritten NIFs in place to about \$60 billion. The underwriting banks are exposed to two kinds of risk: a liquidity risk, that they might be called upon to provide funds at short notice, and a credit risk, that the circumstances in which the borrower needs to call upon them might be those in which the borrower's creditworthiness has deteriorated.

A more recent development has been the *eurocommercial paper facility*: like a NIF this provides for the borrower to issue short-term paper, but it is not backed by a commitment from banks and usually allows for more flexible maturities. This type of facility first developed at the end of 1984; during 1985, at least \$16 billion of eurocommercial paper facilities were arranged.

Other innovations are designed to facilitate hedging. There are three main groupings:

Financial futures are the longest established of the techniques described here.⁽¹⁾ Interest rate futures were introduced in Chicago in 1975 and in London in 1982 with the opening of the London International Financial Futures Exchange (LIFFE). The range of contracts available has steadily increased, although the eurodollar interest rate contracts remain the most used in both the United States and the United Kingdom with open interest at the end of 1985 of approaching \$200 billion in the two countries together. In addition to financial futures contracts traded on exchanges, forward rate agreements (FRAs) have been developed, principally in London, as a form of over-the-counter financial future. They serve the same purpose as exchange-traded contracts, but offer more flexibility of amount, date and currency. Although developed as an interbank instrument, FRAs are increasingly being used by non-banks.

Swaps are a technique whereby two parties agree to exchange two streams of interest payments.⁽²⁾ The two streams may be in the same currency but on different interest rate bases, known as interest rate swaps (eg one stream of fixed-rate payments and one stream at Libor); they may be both at fixed rates but in different currencies, known as currency swaps; or they may be in different currencies and on different interest rate bases, known as cross-currency interest rate swaps (eg one stream of fixed-rate payments in Swiss francs, and one stream in dollars at Libor). In interest rate swaps the principal on which the streams of payments are based does not change hands, although there may be an exchange of principal in currency swaps.

Swaps in the present sense of the term started to be arranged in volume in 1982. The market grew rapidly in 1984 and 1985, and by the end of 1985 there were estimated to be about \$200 billion of swaps outstanding,

with the volume of interest rate swaps considerably greater than for the other types. Originally, swaps were usually combined with new eurobond issues as borrowers raised funds in the market in which they had a comparative advantage and swapped the proceeds into the form which met their requirements. Subsequently, however, swaps have increasingly come to be used as a trading instrument in their own right, with a number of banks and securities houses making a market in them; this was helped by the introduction of standardised terms in 1985 by the International Swap Dealers Association and the British Bankers Association. A particular development in 1985 was the growth in asset-based swaps which enable investors to transform the interest or exchange rate characteristics of their assets rather than, as with conventional swaps, of their liabilities.

Swaps give rise to contingent credit exposure between the two parties: there is the risk that, if one party failed, the other might make a loss in replacing the stream of payments it had been expecting to receive. The size of this exposure fluctuates over the lifetime of the swap and as current interest or exchange rates vary in relation to the rates used in the swap.

An *option* gives its holder the right, but not the obligation, to buy (call option) or sell (put option) a financial instrument at a predetermined price within a given period. Because the holders of options are not obliged to buy or sell the underlying assets, they are able to take advantage of a favourable movement in prices, while their loss in the event of an unfavourable movement is limited to the premium paid to buy the option initially. This asymmetrical quality makes it very difficult for the writers, or sellers, of options to hedge their exposure, since they cannot know in advance whether the options will be exercised. They may hedge their exposure by themselves buying options similar to those they have sold. If they choose to hedge themselves in the market for the cash instrument underlying the options, then they must constantly adjust the size of their hedging, depending on their current estimate of the probability of the options' being exercised.

Currency options have been traded between banks for some time but have grown in volume since currency options started to be traded on the Philadelphia Stock Exchange in 1982, as this made it easier for banks to hedge options they had written. Currency options were introduced on LIFFE and the London Stock Exchange in 1985. Interest rate options have grown up more recently and are still at a lower volume than currency options.

The international bond markets have long provided instruments with the same characteristics as options. Convertible bonds and equity warrants are in effect options for the investor to buy stocks. Bond warrants give the investor the option to buy a bond at a predetermined price. Capped FRNs (that is, FRNs with a predetermined maximum level for their coupon) amount to a stream of interest rate options, stretching out to longer maturities than are traded on exchanges and available in currencies such as deutschemarks for which there are no exchange-traded interest rate options. In this case it is the borrower who is buying the option from the investor, usually in return for a higher spread.

(1) See the December 1985 *Bulletin*, pages 559-63, for a fuller description.

(2) In this context, 'swap' does not refer to the traditional short-term swaps carried out in the foreign exchange markets.

Table E
International business of banks in the BIS reporting area^(a)

\$ billions: changes exclude estimated exchange rate effects

	Year to end-September			1984				1985			Outstanding at end-Sept. 1985
	1983	1984	1985	Q1	Q2	Q3	Q4	Q1	Q2	Q3	
External business analysed by location of bank											
Total external lending	+94	+120	+150	+33	+45	-9	+52	+55	+8	+35	2,347
of which:											
United Kingdom	+22	+28	+23	+14	+12	-5	+3	+9	+1	+10	533
Other Europe	+14	+39	+71	-1	+5	+10	+35	+17	+15	+4	662
United States	+37	+18	+4	+2	+21	-15	+7	—	+1	-4	408
Japan	+15	+18	+34	+11	-4	+11	+4	+13	+1	+17	166
Total external deposits	+75	+157	+153	+43	+54	-1	+50	+57	-3	+49	2,311
of which:											
United Kingdom	+27	+37	+35	+17	+17	-4	+6	+13	+3	+13	584
Other Europe	+11	+40	+61	-2	+10	+8	+33	+11	+9	+8	655
United States	+28	+48	+27	+8	+21	-6	+8	+10	+1	+8	345
Japan	+4	+16	+27	+12	-2	+9	+4	+10	-1	+14	157
Net external assets (+)/liabilities (-)	+20	-36	-2	-10	-10	-8	+2	-2	+12	-14	+35
of which:											
United Kingdom	-6	-10	-12	-4	-5	-2	-3	-4	-3	-3	-51
Other Europe	+3	-1	+10	+1	-5	+2	+3	+6	+6	-4	+7
United States	+9	-31	-23	-6	—	-9	-1	-10	-1	-12	+63
Japan	+12	+2	+7	-1	-2	+1	—	+3	+1	+3	+9
Direction of external business											
Lending within the BIS area and to non-reporting 'offshore centres'	+63	+97	+129	+32	+39	-9	+45	+56	—	+27	1,695
Lending outside the BIS area	+19	+26	+17	+2	+5	+1	+6	-2	+6	+7	603
of which:											
Latin America	+5	+8	+1	+3	+2	+1	—	—	—	+1	216
Other non-oil developing countries	+8	+3	+8	-1	+1	+1	+4	-1	+2	+3	127
Oil exporters	+3	+4	-1	—	—	-3	+1	-1	-2	—	107
Eastern Europe	-3	—	+5	—	-1	—	+1	-1	+3	+2	57
Developed countries	+6	+11	+5	—	+3	+2	—	+1	+2	+1	96
Deposits within the BIS area and from non-reporting 'offshore centres'	+80	+120	+143	+39	+42	-10	+47	+63	-4	+38	1,871
Deposits from outside the BIS area	-10	+27	+14	+3	+11	+6	+10	-4	+3	+6	383
of which:											
Latin America	+5	+8	+2	+1	+3	+3	+3	—	—	-1	68
Other non-oil developing countries	+4	+9	+3	+2	+5	-2	+3	-1	—	+1	104
Oil exporters	-21	+1	+2	-2	+1	+3	—	+1	-1	+2	152
Eastern Europe	+4	+6	+2	+2	—	+1	+1	-3	+2	+2	25
Developed countries	-3	+3	+6	—	+1	—	+2	—	+2	+2	34
Net supply (-)/use (+) of funds within the BIS area and non-reporting 'offshore centres'	-17	-23	-14	-7	-4	—	-1	-7	+4	-10	-177
Net supply (-)/use (+) of funds outside the BIS area	+29	-1	+3	—	-6	-5	-4	+2	+3	+1	+220
of which:											
Latin America	—	-1	-1	+2	-1	-3	-3	—	—	+2	+148
Other non-oil developing countries	+4	-6	+5	-3	-5	+3	—	—	+2	+2	+23
Oil exporters	+24	+3	-3	+2	-1	-6	+1	-1	-1	-2	-45
Eastern Europe	-7	-5	+3	-2	-2	-1	—	+2	+1	—	+32
Developed countries	+8	+8	-1	—	+2	+2	-2	+2	—	-1	+62
Domestic business of BIS-area banks in foreign currency (b)											
Lending to:											
Banks	+7	+18	+39	+25	-19	+17	-9	+22	-22	+47	396
Non-banks	+10	+11	+12	+8	—	+2	+4	+8	+2	-1	145
Deposits from:											
Banks	+13	+19	-47	+22	-13	+14	-8	+21	-17	-51	393
Non-banks	+2	+4	+9	+4	-3	—	+5	—	+3	—	63
Net supply (-)/use (+):											
Banks	-6	—	-8	+3	-6	+3	-1	+1	-5	-4	+3
Non-banks	+7	+8	+5	+4	+3	+2	-1	+8	-1	-1	+82

(a) With effect from end-December 1983 the BIS reporting area was expanded from fifteen to twenty-four countries.

(b) Excludes business of banks in the United States entirely; excludes business of banks in Japan with respect to non-bank detail.

more cautious attitude towards the expansion of all their international business. The modest recovery in total final lending in 1984 was specifically in lending to final users in the reporting area. This geographical concentration of lending continued in 1985, despite some pickup in spontaneous lending to developing countries.

In the twelve months to end-September 1985, 73% of total final lending went to BIS-area residents and the percentage would be even higher if banks' securitised lending were fully covered in the statistics. In the second half of the 1970s the comparable figure was under 40%. A notable feature of the lending in 1985 was the low proportion, about 20%, of direct cross-border lending to final users.

Most of the new international loans by BIS-area banks were to non-bank residents of their own countries, in the form of foreign currency and domestic currency loans funded by external borrowing. The result was that the cross-border risks taken on in 1985 were largely interbank. Funding of the US deficits explains a substantial part of this pattern. American banks again borrowed heavily from other banks in the reporting area, using the funds for on-lending to non-banks, including the Federal Government, in the United States. Thus, banks in the United States reduced their net external interbank claims to finance purchases of domestic assets. However, US banks were not alone in funding domestic lending from euromarket borrowing.

Table F
Net cross-border supply of funds from countries within the BIS reporting area

\$ billions: net supply of funds (-)/use (+)

	Changes (excluding estimated exchange rate effects)				Outstanding net supply (-)/use (+) at end-Sept. 1985	
	Year to end-Sept. 1984		Year to end-Sept. 1985		Banks	Non-banks
	Banks	Non-banks	Banks	Non-banks		
By residents of:						
Austria	+ 1.5	+ 0.3	+ 0.2	+ 0.2	+ 1.9	+ 2.8
Belgium	+ 1.1		+ 1.0		+13.6	
Luxembourg	- 0.9	- 0.7	- 0.9	- 1.8	- 8.3	+ 1.9
Canada	- 0.4	- 0.9	- 0.3	- 1.0	+20.0	- 0.3
Denmark	+ 0.2	- 1.2	+ 0.6	- 1.5	- 0.4	+10.4
France	+ 0.6	+ 1.1	- 1.7	+ 0.2	- 5.3	+10.9
Germany(a)	- 1.7	- 2.6	- 8.6	- 2.9	-13.5	+26.8
Ireland	- 0.1	+ 0.3	+ 0.2	-	+ 3.1	+ 4.3
Italy	+ 4.1	- 2.3	- 0.6	- 1.7	+16.5	+14.9
Japan	- 2.1	- 1.4	- 7.0	- 1.9	- 8.7	+ 4.8
Netherlands	- 3.3	- 2.2	- 1.8	+ 0.3	- 7.7	- 3.7
Sweden	- 0.2	- 1.5	+ 1.6	- 0.7	+ 8.1	+ 6.6
Switzerland	- 1.7	- 2.4	- 0.6	+ 0.3	-26.0	-16.8
United Kingdom(b)	+ 9.8	- 2.0	+11.4	+ 2.2	+50.7	+ 1.9
United States	+30.5	+13.0	+23.2	+11.9	-63.0	-85.3
Total (c)	+36.5	- 0.3	+ 2.1	- 1.1	-35.4	- 4.9

(a) Excluding positions of banks in the Federal Republic of Germany *vis-à-vis* the German Democratic Republic.

(b) The omission of banks' overseas investments from the lending statistics exaggerates the extent to which banks in the United Kingdom are net users of funds. At end-September 1985 banks in the United Kingdom held overseas securities equivalent to 78 per cent. of the net use identified in this table.

(c) From end-December 1983 includes Finland, Norway and Spain and 'offshore' banking centre reporters. For bank positions: the non-bank data do not include the 'offshore centres', and the category includes items not allocated to individual countries on confidentiality grounds.

The cross-border lending to final users which did take place in 1985 was also mainly to the United States. Non-banks in the United States continued their eurodollar borrowing and have reduced their net external claims on BIS-area banks by just under \$25 billion in the past two years. Net borrowing by US residents—bank and non-bank—in the twelve months to end-September 1985 was equivalent to just over 30% of the US current account deficit during that period. This compares with a figure of over 45% of the lower deficit incurred in the preceding twelve months.

The mounting US deficits experienced since 1982 have significantly reduced the net claims of US residents on BIS-area banks. At the same time, residents of the United States remained easily the most important net suppliers of cross-border funds at end-September 1985 (Table F). The effect of continuing large Japanese current account surpluses—a significant counterpart to the US deficits—is

Table G
Interbank lending within the BIS reporting area^(a)

\$ billions: changes exclude estimated exchange rate effects; figures in italics are percentages

	Transactions in year to end-September			Outstanding at end-Sept. 1985
	1983	1984	1985	
Cross-border interbank lending	+ 51	+85	+117	1,379
<i>Interbank lending as a percentage of all cross-border lending</i>	<i>86</i>	<i>87</i>	<i>91</i>	<i>81</i>
Lending to resident banks in foreign currency ^(b)	+ 16	+18	+ 39	396
Total international interbank lending	+ 67	+103	+156	1,775
<i>Interbank lending as a percentage of international lending</i>	<i>78</i>	<i>81</i>	<i>87</i>	<i>79</i>

(a) Including the 'offshore' reporters from 1984 onwards.

(b) Excluding lending by banks in the United States and Japan.

not so readily apparent in the data on net supply, despite the large increase in international lending by Japanese banks. While the United States has reduced its net claims on BIS-area banks by \$79 billion in the past two years, Japanese residents have increased theirs by only \$12½ billion and were, at end-September 1985, net suppliers of only \$4 billion. Much of the explanation lies in direct funding of the US budget deficit by non-banks in Japan. While this occurred, much of the expansion of international lending by Japanese banks was financed by borrowing from the international interbank market.

Interbank business dominates banking flows within the BIS area and at end-September 1985 interbank loans accounted for just over 80% of international claims on inside-area countries. As lending to final users rose in 1983 and 1984, the ratio of interbank to total lending also increased. This was perhaps unsurprising given the increasing concern among depositors about the exposure of international banks to the major debtor countries and the banks' heightened awareness of the risks associated with cross-border lending. Any less even distribution of non-bank deposits between banks would suggest the need for more interbank lending to finance a given level of lending to final users. In 1985, as discussed earlier, interbank lending assumed an even more dominant role in total cross-border lending and accounted for more than 90% of all such transactions. The same was true in the case of intra-centre international lending. From these figures it would seem that there is as yet no sign in the aggregate published data of the reduced use of the interbank market thought likely as banks make use of options, futures and forward rate agreements as alternatives to hedging through interbank transactions.

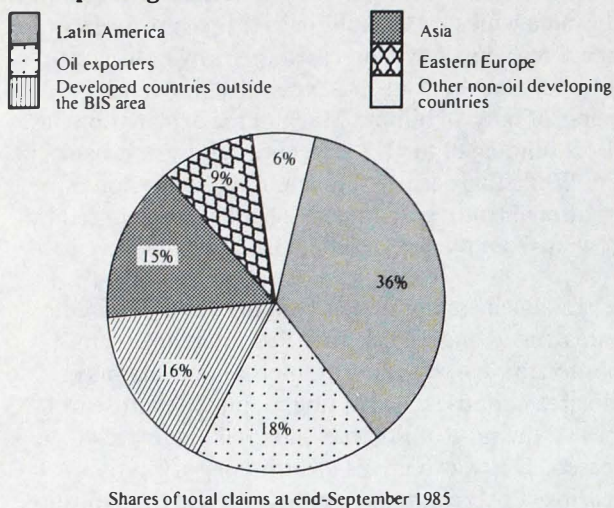
Business with countries outside the BIS area and the offshore centres (Tables E and H and Chart 3)

The developments discussed below took place before the unveiling of the Baker initiative. They occurred in the context of mixed experiences in the positions of the major debtor countries, despite continued non-bank flows to the developing countries as a whole.

Several statistical considerations complicate analysis. The first is that, with developing countries gaining increasing access to the bond markets, particularly the FRN sector, and with banks' holdings of securities incompletely captured in the geographical analysis of claims, the under-estimation of bank lending has become greater. A particular problem in the case of the statistics of banks' lending to Latin America is that the known unspontaneous lending to the area was considerably greater than new lending apparent from the banking data. This may perhaps have been because some banks' claims were transferred to export credit agencies, written off, or sold to non-banks.⁽¹⁾ A third complication is that bonds issued by some countries have financed the repayment of bank loans ahead of schedule.

(1) See, for example, Terrell, HS and Mills, RH, *US banks' lending to developing countries: a longer-term view*, Federal Reserve Board of Governors, International Finance Discussion Paper No 255.

Chart 3
Claims of BIS reporting banks on countries outside the reporting area



Comparisons of the rate of lending in 1984 and 1985 are affected by the periods studied. Using the twelve-month periods to end-September, lending was weaker in the year to September 1985 than in the preceding period. However, a comparison of the first three quarters of 1984 and 1985 suggests the opposite, in large part because some 1984 borrowing needs were anticipated in the final months of 1983 when market conditions were judged favourable. On balance, there was perhaps little change in the underlying pace of lending between 1984 and 1985. Whatever conclusion is reached on comparisons of the rate of total lending to outside-area countries, the pace of lending undertaken by commercial banks in addition to their participation in rescheduling packages, usually identified as 'spontaneous' lending, definitely quickened in 1985. The upturn can be traced to the third quarter of 1984 and, after a fall in the first quarter of 1985, the rate of lending accelerated. This trend is accentuated if account is taken of the increased FRN issues by these countries. Combined BIS and OECD statistics enable the nature of the new 'spontaneous' lending to be examined rather more carefully.⁽¹⁾ They show that since the end of 1983 a rising proportion of banks' lending to outside-area countries has been officially guaranteed or insured. The implication is that banks' exposure to these countries has risen by less than their identified lending.

The statistics indicate that new 'spontaneous' lending remains highly selective. Lending to Asian countries and the re-emergence of Eastern European countries as borrowers from international banks account for the rise in such lending. Claims on the developed countries outside the BIS area rose much less rapidly than in 1985, mainly because of a slowdown of Australian borrowing. With most new money facilities fully drawn down, identified lending to Latin America rose by less than 1% in the twelve months to end-September 1985. Allowance for the factors outlined above would imply further

growth, but of very modest dimensions. One feature was that, while lending to Brazil and Mexico fell, claims on smaller countries in the area rose.

Claims on Eastern bloc countries rose by 10% in the year to end-September 1985, after no growth in the previous twelve-month period. A large proportion of the new lending was booked in London and the borrowers negotiated fine terms. The Soviet Union was the largest borrower, accounting for just under 60% of total funds raised by the group. Only around one fifth of total lending to the Soviet Union was provided under syndicated credits announced in 1985, and in the first half of the year they drew heavily on previously undisbursed commitments made by BIS-area banks.

Three countries, China, South Korea and India, accounted for the large rise in borrowing by non-oil developing countries in Asia. Recorded claims on Malaysia, one of the area's major borrowers, fell in the year to end-September 1985, but in this period the country completed two FRN issues. The lending to China was not apparent in the statistics of new syndicated credits but, as with the Soviet Union, the country drew heavily during the first half of the year on funds earlier committed by BIS-area banks. It had a record trade deficit in 1985.

Despite falling oil prices and their shrinking market share, the oil exporters collectively reduced their borrowing from BIS-area banks in 1985. Indeed, they were again net suppliers of funds, although on a scale very much reduced from that of 1974-77 and 1979-81. Kuwait and the UAE were principally responsible for the reduction in aggregate borrowing. Saudi Arabia's borrowing was essentially unchanged, but with their current account in considerable deficit official foreign assets continued to fall. Algeria was the largest borrower.

Outside-area countries reverted to their more customary role as net takers of funds from BIS-area banks in the first nine months of 1985. This reflected the modest increase in their borrowing and a deceleration in the rate of

Table H
Business of BIS reporting area banks with non-oil developing countries in Latin America

\$ billions: changes exclude estimated exchange rate effects

	Transactions in year to end-September			Transactions in nine months to end-Sept. 1985	Outstanding at end-Sept. 1985
	1983	1984	1985		
Total lending	+5.2	+7.7	+0.9	+1.1	216
<i>of which, to:</i>					
Argentina	+0.5	-0.6	+2.1	+1.7	28
Brazil	+2.1	+5.8	-0.5	-0.4	77
Mexico	+1.4	+3.5	-1.9	-0.6	72
Total deposits	+4.8	+8.3	+1.8	-1.1	68
<i>of which, from:</i>					
Argentina	+0.6	-0.6	+0.7	+0.5	9
Brazil	+1.4	+4.3	+0.6	-0.8	17
Mexico	+2.8	+4.4	-0.1	-0.4	22
Total net lending	+0.4	-0.6	-0.9	+2.2	148
<i>of which, to:</i>					
Argentina	-0.1	—	+1.4	+1.2	19
Brazil	+0.7	+1.5	-1.1	+0.3	61
Mexico	-1.4	-0.9	-1.8	-0.2	51

(1) Statistics on external indebtedness: bank and trade-related non-bank external claims on individual borrowing countries and territories at end-June 1985, BIS/OECD, January 1986. This series was described in the March 1985 *Bulletin*, page 64. There have since been revisions to eliminate differences in reporting populations which previously complicated comparisons between periods.

Table J
International banking analysed by centre

	End-September 1985			Total(a)	Share of total market		
	Foreign currency lending to:		Domestic currency lending to non-residents		1983	1984	1985
	Non-residents	Residents					
				\$ billions			
Gross lending	1,708	541	639	3,003			
<i>of which:</i>					Percentages		
United Kingdom	497	198	36	732	26.6	24.9	24.4
United States	15	..	393	408	15.4	15.0	13.6
Japan	109	147	57	313	8.6	9.1	10.4
France	128	49	24	200	7.0	6.6	6.7
Luxembourg	96	19	2	117	4.2	3.7	3.9
Swiss trustee accounts	..	..	..	115(b)	3.4	3.7	3.8
Belgium	83	27	4	113	3.3	3.3	3.8
Germany, Federal Republic	23	2	53	79	2.5	2.3	2.6
Netherlands	52	9	16	77	2.6	2.4	2.6
Switzerland	32	8	34	74	2.8	2.3	2.5
Canada	41	25	3	70	2.6	2.6	2.4
Italy	34	19	2	55	1.6	1.7	1.8
'Offshore' banking centres	..	..	..	533	18.1	18.9	17.7

not available.

(a) The three components do not sum to the total, which also includes Swiss trustee accounts.

(b) July 1985.

depositing. The considerable buildup in deposits by Latin American countries came to an end in the first quarter of the year. Drawdowns by Brazil and Mexico, whose total foreign exchange reserves fell during the same period, explain the overall reduction in the area's deposits with BIS-area banks in the first three quarters of 1985.

Analysis of business by centre and bank nationality (Table J and Chart 4)

The major international banking centres can be classified according to the size of their international business relative to their domestic transactions. Among the larger centres, London stands out as having international business many times larger than the domestic market. In contrast, New York and Tokyo are large international centres—although even together not as large as London—which conduct significantly greater volumes of domestic business. Frankfurt exhibits the American and Japanese structure, but with a much less important international dimension. Paris and the smaller European centres conform to the London pattern.

There is also a considerable difference in the nature of the transactions of the various centres, notably in their currency composition. London is by far the largest eurocurrency centre. In contrast, New York books business almost exclusively in its domestic currency and foreign currency transactions are very small. Similarly, the international business of banks in Germany mainly involves cross-border transactions in deutschemarks rather than euro-business. Banks in Japan occupy middle ground somewhere between London, and New York and Frankfurt, with foreign currency business accounting for around two thirds of their outstanding external loans at end-September 1985.

London and New York remain by some distance the largest centres of international banking, but both again lost market share in 1985. With dollar-denominated business accounting for such a high proportion of business in both centres, particularly of course in New York, the dollar's depreciation was an important factor.⁽¹⁾ Business booked in London was also affected by a further contraction in the balance sheets of American banks in London. In contrast, banks located in Japan continued to expand international operations rapidly, increasing their market share to 10½% at end-September 1985.

The statistics show a widening geographical dispersion of international banking assets in 1985, indicating a changing balance and increased competition between financial centres.

Despite the strong growth in international loans booked in Tokyo, the share of lending conducted from the three principal centres fell for the second year in succession, from a peak of over 50% in 1983. In 1985 the major counterpart rise was in the share of the smaller European centres, notably Belgium, Luxembourg and West Germany. If Swiss trustee business is included, these smaller centres now collectively account for almost 30% of the international banking market. The further considerable growth in Swiss fiduciary accounts was a prominent feature of the latest period. Their international lending is 50% greater than other overseas lending by banks in Switzerland, and larger than the international business of all but five of the other banking centres.

Data published for the first time in 1985 and since updated⁽²⁾ present the international business of most BIS-area banks on the basis of the banks' nationalities of ownership rather than their countries of location. The statistics show that during 1985 Japanese-owned banks

Chart 4
International claims of banks in the BIS area analysed by nationality of ownership



Shares at end-September 1985

(1) It should be noted that the valuation effect of the dollar's appreciation between 1982 and 1984 was to exaggerate the size of New York, and of London (because of the importance of euro-dollar business there), relative to centres for which non-dollar business is more important.

(2) *The nationality structure of the international banking market and the role of interbank operations*. BIS, May 1985; and *International banking developments—third quarter 1985*, part II 'The nationality structure of the international banking market'. BIS, January 1986.

worldwide replaced American banks as the largest international banking presence. During the first three quarters of the year Japanese-owned banks accounted for over half of the total rise in BIS-area banks' lending. Before allowance for exchange rate movements, American-owned banks' international balance sheets actually fell during the period, as their reassessment and rationalisation of overseas operations continued. At end-September 1985 Japanese-owned banks, which are the major bank group in London and the principal foreign owners of International Banking Facilities in the United States, held over one quarter of the total international assets booked by BIS-area banks.

Analysis by currency (Table K)

Although the dollar remained the single most important currency for international lending in 1985, its share in the external lending (and within this total the eurocurrency lending) of BIS-area banks fell again, although by considerably less than in 1984. Actual dollar lending is greater than that identified in the statistics. Banks' purchases of FRNs and bonds, which are largely denominated in dollars, are not fully incorporated in the lending figures, and there is no currency detail for the business of the 'offshore' centres, which is thought to be mainly conducted in dollars. Despite the understatement and the dollar's continued dominance in stock terms—66% of outstanding external loans at end-September—it is clear that borrowers, and particularly banks, revealed a greater preference for non-dollar loans last year. This was true even though US borrowers, who customarily prefer their own currency, were prominent in the market.

In the international bond and FRN markets, the amount raised, net of repayments, in dollars fell from 64% of the total in 1984 to 58% in 1985. The dollar share remains higher in the securities markets than in bank lending, partly because of the differences in borrowers in the two markets and partly because of the increasing use of hedging devices attached to bonds, designed to protect investors from a fall in the value of the dollar.

Table K
Currency shares of external lending by BIS area banks^(a)

Percentages: estimated exchange rate effects are excluded

Increases in year to end-September	US\$	DM	Sw. Fcs	Yen	£	Other ^(b)
1981	67.3	9.6	7.9	3.9	3.8	7.5
1982	78.6	3.7	3.3	2.7	2.0	9.7
1983	47.2	15.0	2.4	7.6	4.8	23.0
1984	38.5	10.1	7.5	12.4	9.7	21.8
1985	36.7	12.0	4.7	17.9	6.4	22.3
Stock outstanding at end-Sept. 1985	66.2	10.7	5.6	5.0	3.1	9.3

(a) Excluding the lending of the 'offshore' banking centres for which currency detail is not available; the dollar share may therefore be understated.

(b) Including ECU and unallocated items.

Interpretation of statistics on the currency denomination of borrowing is, however, complicated by the growing use of currency swaps, since in many cases the proceeds of the borrowing are immediately swapped into different currencies. In the fixed-rate bond sector, Japanese borrowers accounted for more than half of the 35% rise in new dollar issues. Many of the dollar bonds issued by Japanese entities were so-called 'sushi' bonds targeted at Japanese investors.

The demand for yen-denominated loans was particularly apparent in the international banking statistics. Nevertheless yen loans still account for only 5% of total external lending, which emphasises that the internationalisation of the yen is in an early stage of development; the euroyen market is at present essentially an interbank market only.

The other principal feature of the year was the further large increase in lending in ECU and minor currencies (shown jointly as 'other' currencies in Table K). The stock of banks' ECU claims is still small in relation to total outstanding eurocurrency claims. But the rapid growth of ECU business since the end of 1982 has established it as an important sector of the euro-banking market, and ECU-denominated assets at end-September 1985 were considerably greater than euro-assets in sterling, French francs and Dutch guilders. A BIS study⁽¹⁾ has concluded that the stimulus to ECU market growth came from lending opportunities: demand was mainly from Italy and France. ECU fixed-rate bond issues were also important in 1985, and a sign of their popularity is that, net of repayments, they exceeded by value those in deutschmarks.

Currency diversification was also a feature of the fixed-rate bond sector. In addition to increased yen and ECU borrowing, there was a surge in issues in less widely-traded currencies, such as Australian and New Zealand dollars and Danish kroner; these were largely driven by swap opportunities. Liberalisation of the French franc and Italian lira eurobond markets added to the range of currencies in use.

With the exception of a small number of ECU facilities, euronotes are all issued in dollars. In the case of syndicated credits a growing proportion of new credits have carried multi-currency options, allowing the borrower to draw funds in any of a range of agreed currencies. FRNs are still predominantly a dollar instrument. However, the range of currencies in which they were issued widened in 1985 with the liberalisation of the deutschmark and yen markets and will widen further in 1986 with similar liberalisation of the Dutch guilder market.

(1) 'The role of the ECU in international banking activity'. BIS, *Fifty-Fifth Annual Report*, June 1985, pages 127-33.