

# Developments in international capital and banking markets in 1987

*This article<sup>(1)</sup> continues the annual series on developments in international capital and banking markets. The article has a short overview, followed by sections on capital markets and international banking developments. There are features on multiple-option facilities and offshore banking centres.*

- *Activity in international capital markets slowed in 1987 while banks' international lending remained strong. There was a shift in the pattern of borrowing from eurobond issues to syndicated credits.*
- *The equity market crash accelerated a shake-out of excess capacity in the eurobond market, led to increased tiering of interest rates in international bond markets and reinforced the shift away from securitised financing.*
- *The Japanese retained their major presence in international financial markets as intermediaries, investors and borrowers. The yen increased its share of cross-border banking business.*

## Overview

International capital flows in 1987 were dominated by the persistent large current account imbalances between the major economies; borrowing by developing countries, from banks and in the international capital markets, remained weak. However, the pattern of capital flows between the major countries was more complex than might have been expected on the basis of aggregate surplus or deficit figures. Thus Japan, with a current account surplus of \$87 billion in 1987, was a substantial borrower on the capital markets and of short-term funds through the banking system. This borrowing seems in many cases to have been used for investment in financial assets. In Germany, on the other hand, banking and other short-term outflows offset inflows of portfolio investment in the first half of 1987, although this pattern was largely reversed in the second half of the year.

During most of 1987, the private sector financed a smaller proportion of the US current account deficit than in the previous year. The main exception was in the third quarter when the dollar was generally stronger and, as a result, official intervention more modest; the banking sector accounted for the greater part of the financing of the current account imbalance. In the fourth quarter, on the other hand, the increase in foreign official holdings of US assets financed half the current account deficit.

International banking developments continued to be affected by debt problems among developing countries. International banks substantially increased their provisions against lending to developing countries.

Rescheduling agreements were reached with a number of the major debtors, but negotiations were often prolonged and difficult to complete. There was progress with schemes to convert debt into equity, turnover in the secondary market for developing country debt rose substantially and, earlier this year, Mexico launched a scheme under which banking debt could be swapped for bonds.

There were virtually no signs of any revival in spontaneous lending to non-oil developing countries either by banks or through bond issues. However, the extent to which banks provided new money was hidden by debt sales, debt/equity swaps, write-offs and the transfer of loans to export credit agencies (all of which serve to reduce the recorded figures for outstanding lending).

The stock market crash in October overshadowed developments towards the end of 1987. In certain areas the impact was immediate; for example, issues of fixed-rate bonds with equity warrants fell sharply and portfolio investment flows were also severely curtailed. Elsewhere, the crash served to accentuate developments which were already taking place. There had already been evidence of greater caution earlier in 1987. For example, there were fewer innovations in international capital markets, while rising interest rates and problems in the perpetual floating-rate note sector had led to some switching back towards syndicated lending, albeit not in the same form as previously. Although one of the effects of the stock market crash may have been to close the eurobond market to the less well rated names, there is

(1) Prepared jointly by the Bank's International Banking Group, Financial Statistics Division, and International Financial Markets Group, International Division.

little to suggest that these companies' demand for finance could not be met by the banks. Moreover, if pricing of credit is now more likely to reflect the risks involved—as recent trends in the bond market (but not the credit markets) suggest—the crash may have had some beneficial consequences. The shake-out of excess capacity in the eurobond market had begun before the crash and, to the extent that the previous situation of low profitability was unsustainable, the crash may have hastened a development which was bound to occur at some stage.

The sharp increase in syndicated credits announced in 1987 might suggest a move back towards bank intermediation. However, this increase has yet to become evident in the figures of actual lending to final users produced by the Bank for International Settlements (BIS), which have averaged around \$60 billion a quarter since mid-1986. The BIS' proposals for convergence on capital adequacy may make banks more cautious about cross-border lending generally, especially interbank lending, and may leave some banks with a need to increase their capital. There were signs of a lower level of international banking business in the fourth quarter of 1987, notably by Japanese banks, but it is too early to say whether this heralds an overall slowdown in the rate of growth of the international interbank market in 1988. In any case, with little diminution in the major current account imbalances in prospect, international banking and capital market flows are bound to continue to play a substantial role in financing those imbalances.

### International capital market developments

Overall activity in the international capital markets in 1987 amounted to \$334 billion, only 4% higher than in 1986, thus representing an appreciably slower rate of growth than in recent years (Table A). Following a buoyant first quarter, eurobond market activity was stagnant during the second and third quarters as higher interest rates and further dollar weakness dampened financing. In the fourth quarter, activity declined sharply, under the influence of the stock market crash (the structural implications of which are analysed in a following section). There were marked changes in the pattern of financing over the year. After an active first quarter, issues of fixed-rate bonds declined. By contrast,

**Table A**  
Gross new activity by market sector

\$ billions

	1985	1986	1987	Percentage change 1986-87
Fixed-rate bonds	108.6	173.7	163.6	- 5.8
of which:				
Straights	97.0	147.0	120.3	- 18.2
Equity-related	11.6	26.7	43.3	+ 62.2
FRNs	55.9	47.8	12.0	- 74.9
Euronote facilities	50.3	71.1	70.0	- 1.0
Syndicated credits	19.0	29.8	88.0	+195.3
<b>Total</b>	<b>233.8</b>	<b>322.4</b>	<b>333.6</b>	<b>+ 3.5</b>

Source: Bank of England International Capital Market System (ICMS) database.

announcements of euronote facilities remained steady over the year and there was a sharp increase in the announcement of syndicated credits, which by the last quarter accounted for some 38% of total gross financing activity in the capital markets compared with 19% in the first quarter.

### Market activity by sector

#### The international bond market

Issues of fixed-rate bonds amounted to \$164 billion during 1987, slightly below the level recorded in 1986. The volume of activity peaked during the first quarter of the year at \$57 billion, weakened in the following two quarters and then fell sharply to under \$23 billion in the fourth, mainly reflecting the effects of the collapse in equity prices on equity-linked issues.

The strength of fixed-rate funding activity in the first quarter reflected the reductions in interest rates in most major countries and the continuing problems in the floating-rate note (FRN) market as borrowers sought alternative sources of funds. The weakness of the dollar and upward pressures on interest rates were the main reasons for the decline in the issue of *straight fixed-rate bonds* thereafter. These factors affected dollar-denominated issues most strongly in the second and third quarters, while adverse interest rate expectations also led to some reluctance by investors to purchase fixed-rate bonds in most major non-dollar currencies. The main exceptions to these trends were issues in Swiss francs and Australian dollars. In the case of the Swiss franc, currency appreciation, stable interest rates and the tendency of the currency to serve as a 'refuge' during periods of volatility stimulated the market in the third quarter. The Australian dollar sector was, until the fourth quarter, one of the fastest growing sectors in the eurobond market, reflecting the availability of high coupons and attractive swap opportunities.

The stock market crash, together with the ensuing weakness of the dollar, accounted for the further decline in dollar-denominated issues in the fourth quarter. Other currency sectors were unable to offset this decline, although currency appreciation and lower interest rates did result in an increase in issues in Swiss francs, yen and sterling. The first quarter of 1988 has shown some recovery in the volume of eurobond issues denominated in dollars. Some high coupon sectors, such as the Canadian dollar sector, have also shown signs of buoyancy.

Until the fourth quarter of 1987, the decline in the issue of straight fixed-rate bonds was partly offset by the rapid growth in *equity-related bonds*, most of which were denominated in dollars (Table B). Issues, which were mainly by Japanese institutions, doubled in the second quarter to \$16 billion and rose further in the third, mainly reflecting the buoyancy of the stock market in Tokyo, but then fell sharply in the fourth to only \$2.6 billion.

**Table B**  
**Equity-related bond issues**

\$ billions at quarterly rates

	1985	1986	1987				
	Year	Year	Year	Q1	Q2	Q3	Q4
Equity warrants	1.1	4.8	6.4	3.7	10.3	10.5	1.2
Convertibles	1.8	1.9	4.4	4.1	5.4	6.7	1.4
<b>Total</b>	<b>2.9</b>	<b>6.7</b>	<b>10.8</b>	<b>7.8</b>	<b>15.7</b>	<b>17.2</b>	<b>2.6</b>
<i>of which:</i>							
Japan	1.9	3.4	7.1	3.3	10.7	12.5	1.7
United States	0.4	0.9	1.2	1.2	2.1	1.4	0.2
United Kingdom	0.2	0.4	0.8	1.2	0.8	1.1	0.2

Source: Bank of England ICMS database.

The Japanese dominated this market during 1987 as issuers, bookrunners and investors: in effect, they conducted part of their domestic financial intermediation in the international arena. Over 75% of Japanese equity-linked issues were in equity-warrant form (the remainder were convertibles). Warrants proved popular with investors because they offered a highly leveraged investment on the Tokyo stock exchange with low initial cost. Many corporate borrowers in Japan found dollar-denominated equity-related bonds attractive because they could make issues with very low coupons and, through the use of swaps or forward rate agreements, obtain yen debt at a negative cost. The preference for warrants over convertibles reflected, *inter alia*, the ease with which such swaps could be undertaken. There were concerns that some Japanese firms were using cheap debt obtained through such issues for speculative financial investment. In September, Tateho Chemical Industries, which had previously made a number of equity-warrant issues, admitted that it had made substantial losses in the Japanese government bond futures market. The primary and secondary markets for equity-related issues virtually collapsed in the immediate aftermath of the stock market crash. Nearly all of the fourth quarter issues were made before mid-October; most issues still at the planning stage at that time were postponed. The market did, however, pick up towards the end of the year and the recovery persisted into the first quarter of 1988.

For much of 1987, activity in the *floating-rate note* market was adversely affected by the collapse of the perpetual FRN market at the end of 1986, though the increasing competition provided by substitutes such as euronotes may also have been important. New issues, which had averaged some \$12 billion per quarter in 1986, fell to a quarterly average of \$3 billion in 1987. Although FRNs tend to be popular with investors when interest rates are expected to rise, the increase in dollar interest rates in the second quarter did not result in any surge in new issue activity. After a low of \$1.7 billion in the second quarter, new issues recovered slightly in the third, and rose more substantially in the fourth to a total of \$5 billion, of which almost half was issued in yen—an important departure in a market that has traditionally been dollar denominated. The increase in FRN activity reflected somewhat higher borrowing by central

governments and agencies as well as by several Japanese utilities. In addition to new issues of FRNs, a large volume of repackaged FRNs,<sup>(1)</sup> amounting to \$4.8 billion, emerged during the year.

#### Euronote facilities and syndicated credits

In 1987, \$70 billion of *euronote facilities* were announced, almost the same as in 1986. The amount of paper outstanding rose to some \$56 billion at the end of October, before falling back slightly to \$53 billion by the end of the year—still a substantial increase on the end-1986 level of \$33 billion.

Eurocommercial paper (ECP) and eurocertificates of deposit were the largest sectors of the euronote market in 1987, accounting for \$45 billion, or two thirds of announcements. The continued growth of the ECP market during the year was partly due to borrowers' preference for these programmes compared with note issuance facilities (NIFs), as costs were generally lower and the distribution of paper through dealers acting as agents was reported to be more efficient. Investors also seemed to prefer to hold short-dated paper, fearing capital losses on fixed-rate bonds in the event of rising interest rates. However, there was no marked increase in total draw-downs of notes immediately following the stock market crash. This may have been because of a flight to quality borrowers (such as sovereigns) on the part of investors, which led to a pronounced tiering in the market. Growth in the stock of euronotes outstanding resumed in the first quarter of 1988.

The total volume of *syndicated credits* announced in 1987 was \$88 billion, a sharp increase on the \$19 billion and almost \$30 billion recorded in 1985 and 1986, respectively. Volumes rose particularly strongly in the second half of the year, accompanied by a sharp rise in sterling-denominated facilities. As in 1985 and 1986, OECD borrowers were the most active in this market, accounting for about 85% of syndicated lending. Prior to 1982, developing and Eastern European countries had accounted for a larger share and more of the lending had been sovereign risk.

The main reasons for the strong growth in lending in 1987 were the buoyant pace of economic activity in certain OECD countries, the continuing boom in mergers and takeovers, and the restructuring of traditional lines of credit into multiple-option facilities. US and UK borrowers accounted for over a half of all syndicated credits. The increase was most dramatic for UK firms, whose borrowing rose from a little over \$1 billion in 1986 to \$31 billion last year. This high level partly resulted from the size of a few credits, including those by BP in the first quarter (\$5 billion) and Eurotunnel and British Airways in the third [£5 billion (\$8 billion) and \$2 billion, respectively]. It also reflected heavy borrowing by UK companies involved in takeovers or financing capital expenditure. Such companies made increasing use of

(1) Not included in the new issues statistics.

## Multiple-option facilities

During 1987, there was a trend back towards bank intermediation in the international capital markets. It would, however, be wrong to characterise this trend as necessarily representing a return to traditional bank lending. Many institutions in the corporate sector decided to establish multiple-option facilities (MOFs) to replace or complement existing lines of credit; a number of credits were also obtained as back-up facilities for commercial paper activities.

The syndicated MOF is a particularly flexible form of financing which can incorporate a number of fund-raising options that can be used at the borrowers' discretion, such as commercial paper issuance, bankers' acceptances and short-term cash advances, as well as a committed credit. A MOF need not contain all these options and the actual structure of the agreement can be tailored to the needs of the borrower; some credit facilities which have consisted of only a committed loan and a bankers' acceptance facility have been termed multiple-option facilities. Such limited facilities do not represent a move away from traditional banking practices.

Both commercial and investment banks have participated in the arrangement of MOFs; members of the syndicate may be chosen according to whether they possess a specialist capacity in a particular area or because of their knowledge of the borrower. A core group of banks may provide funds under a committed credit while other banks could provide the uncommitted options. Tender panels may be incorporated into the structure of the MOF to enable the borrower to achieve competitively priced funds.

When the euronote market was first established, borrowers typically obtained funds through utilising note issuance facilities (NIFs). More recently borrowers tapping the short-term note market have done so through issuing eurocommercial paper (ECP), which is placed by dealers on a 'best efforts' basis. At times of financial volatility, however, borrowers may find that their dealers are unable to place ECP at favourable rates, and this increases the importance to borrowers of having access to alternative committed sources of finance. The MOF can potentially offer both greater flexibility and insurance to the corporate borrower. Since the fall in equity prices last October, borrowers, as well as lenders, have had doubts about liquidity in securities markets, and this has further reinforced the appeal of such financing structures.

The multiple-option facility can facilitate borrowers' attempts to raise funds through the use of short-term securities as well as through loans. If dealers are

### Total multiple-option facilities (mandated or signed)

\$ millions	International loans	Multiple-loan facilities(a)	Multiple-option funding facilities(b)
1984	134,559	—	1,500
1985	96,729	250	7,118
1986	145,827	5,487	5,724
1987	257,473	32,170	7,898

Source: International Financing Review Database (c)

(a) A multiple-loan facility involves at least two different types of committed debt. A typical example comprises a revolving credit with advances and acceptances.

(b) A multiple-option funding facility (MOFF) contains a euronote issuance facility plus one type of uncommitted note eg an ECP option.

(c) The coverage and compilation of these data differ from those of the BIS and the Bank of England International Capital Market System database used in the main article.

unable to place commercial paper at predetermined rates, the borrower has the option of drawing on the revolving credit. In the United States the domestic commercial paper market with back-up credit lines is well established and, therefore, financing structures such as MOFs appeal less to US corporates than to European institutions.

The MOF incorporates a number of contingent fund-raising mechanisms, and these have in the past raised important issues for bank supervisors with respect to the setting of capital adequacy guidelines. Recent proposals published under the auspices of the Bank for International Settlements have sought to remedy this within a general framework for promoting capital convergence.

The trend towards establishing MOFs was particularly strong in the UK corporate sector during 1987 as concerns grew over liquidity of securities markets. MOFs also became popular among French corporates towards the end of last year. A number of French institutions decided to take advantage of the opportunity to obtain competitively priced funds and moved away from more expensive traditional forms of bank lending. The MOFs obtained by UK and French borrowers have typically had a maturity of between five and seven years.

In the fourth quarter, margins on drawings were generally low, in response to the strong competitive pressures that were experienced in the international bank lending market. Some companies were reported to have obtained MOFs toward the end of last year where drawings were priced at Libor flat. The banks which arranged these facilities do not appear to have been compensated with large management or facility fees. Some highly-rated French corporates have obtained programmes where the utilisation fee has been very low. There is, of course, a danger that tightly-priced MOFs will be drawn most heavily when market liquidity is tight, and at a time when the pricing of the MOF will be furthest out of line with prevailing market conditions.

multiple-option facilities (MOFs), (see the note on page 212). Although most credits have traditionally been denominated in dollars, sterling credits were of comparable importance in the third quarter.

Competition between banks, in particular to arrange and participate in MOFs, led to very low margins and fees. Margins were often reported to be only a few basis points above Libor. In the fourth quarter, MOFs for some European companies were reported to have been priced as low as Libor. Banks were thought to be willing to accept these narrow margins mainly for relationship reasons.

#### Review of activity by borrowers

The OECD countries continued to dominate the international capital markets in 1987 (Table C), accounting for some 89% of total borrowing, a similar proportion to that recorded in the previous year, while borrowers from developing countries and Eastern Europe were again notable by their absence.

**Table C**  
**Borrowing activity by country grouping**

\$ billions at quarterly rates

	1985	1986	1987
OECD	48.5	71.3	74.4
of which:			
United States	14.8	16.1	13.4
Japan	5.1	10.6	13.2
United Kingdom	4.6	5.8	12.8
International institutions	4.9	4.9	4.8
Eastern Europe	1.0	0.8	0.6
Developing countries	4.0	3.6	3.6
<b>Total</b>	<b>58.4</b>	<b>80.6</b>	<b>83.4</b>

Source: Bank of England ICMS database.

Total activity by US borrowers was below the previous year's level, partly reflecting a fall in bond issuance. Euromarket investors proved reluctant to hold dollar-denominated debt and after the stock market crash shifted towards deposits and domestic bond markets. In addition, investors were concerned about the impact of merger and acquisition activities in the United States on the credit standing of many potential US issuers. As a consequence, borrowers found some domestic markets to be a cheaper source of funds.

Japanese borrowers remained active, especially in the first three quarters of the year. Although the total amount of Japanese borrowing through eurobonds in the year as a whole was slightly below last year's level, this was mainly a result of the collapse in equity-related bond issues in the fourth quarter. By contrast, activity by UK borrowers more than doubled during the year and did not weaken in the fourth quarter. This partly reflected a number of large syndicated credits, as noted above. It also included an increase in the volume of mortgage-backed FRNs and several non-sterling bond issues by building societies, following the new powers granted to them under the Building Societies Act (which enabled them to borrow in foreign currencies, provided the proceeds were immediately swapped into floating-rate sterling).

#### Structural developments and the impact of the stock market crash

The stock market crash not only dominated developments in international capital markets in the fourth quarter, but also reinforced some trends that were already in train and may have initiated new ones.

The stock market crash accentuated the decline in eurobond activity which had already been apparent in the second and third quarters, as various shocks had led investors to question the overall liquidity of the market. A primary effect of the crisis was to render the eurobond market as a whole relatively unattractive to investors and hence to borrowers, as the former moved to lower-risk instruments that provided greater liquidity. Euromarket margins *vis-à-vis* domestic markets widened, while borrowers of less than top quality were unable to issue eurobonds, whether straight, equity-linked or floating-rate. As a consequence, issue volumes declined. Some have suggested that the loss of channels of intermediation may lead to credit rationing and a higher cost of capital, with potential macroeconomic consequences. This depends on the degree to which syndicated lending and euronotes (and domestic bond markets), which have remained relatively attractive to investors, can provide substitutes. Evidence to date suggests that this has to some extent been the case. In any case, a resurgence of price rationing of credit need not be a wholly undesirable development. In the past, concerns have been expressed about the effects of strong competition<sup>(1)</sup> on pricing of risks which might arise from such factors as credit quality, price volatility and illiquidity. The greater tiering in eurobond and euronote markets as well as increased margins and more expensive pricing of futures and options may be an indication of some reappraisal of the risks.

The eurobond market appears to be undergoing a shake-out of excess capacity among intermediaries. This began before the crash, with the volume of new issues falling off as rising interest rates prompted mounting investor concern over the liquidity of eurobonds. For some participants competition drove profit margins below levels necessary in the long run. Against these pressures, demand for bonds as inventories, both for trading purposes and to profit from declining interest rates, could not continue to be supported by new firms entering the market. The stock market crash and the decline in issuing activity proved a catalyst for the withdrawal of several participants, and this process can be expected to continue until an adequate level of profits is restored.

The pace of innovation, which had been modest in 1986, slowed further in 1987, with the growth of syndicated multiple-option facilities being the principal development. The collapse in equity prices provided a test for recent financial innovations. There were some problems in specific markets such as stock index options and futures (indeed in the US domestic market, trading strategies

(1) A recent result of such intense competition has been the easing of the rules of the Swiss banks' underwriting cartel.

using futures and options have been blamed by some observers for aggravating the equity market crisis); trading ceased temporarily in equity-related products such as warrants. There was, however, an increase in secondary market activity in swaps. The experience of most instruments in the aftermath of the collapse in equity prices was generally reassuring and systemic problems were contained, although it should be noted that the change in volatility of interest and exchange rates was not as great as that of equity prices. The decline in eurobond issues and the resurgence of interest rate tiering led many borrowers to shift their demand for funds back to the syndicated loans markets, though domestic bond markets also benefited. Indeed, many of the borrowers in the credits market in the fourth quarter were second-tier corporates that might previously have issued eurobonds. The collapse in equity prices thus intensified the shift towards greater bank intermediation which had been apparent since the end of 1986. Growth of lending in the syndicated credits market was, as noted, characterised by strong competition, while the crash had little impact on pricing. This resulted—in contrast to the bond market—in very low spreads over Libor, suggesting that risks may be, to a certain extent, underpriced.

An important question is whether the shift from securitisation implied by the decline of the eurobond market and the pause in innovation is likely to be cyclical or lasting. There is a general tendency during periods of economic instability for banks, which are superior analysts of credit quality compared with bond investors and who have more secure sources of funds, to take a larger proportion of intermediation. Issues of fixed-rate bonds have tended to be concentrated during periods of bullish financial market conditions and falling interest rates, and the latest such period has coincided with the upturn in the current trade cycle. Moreover, the growing importance of multiple-option facilities in new syndicated loans still represents only a partial shift towards bank lending, given that it implies a role for securitised instruments, albeit with a back-up line of credit.

Part of the answer depends on the impact the fall in equity prices has had on the factors which supported the growth of securitised borrowing. According to the Cross Report<sup>(1)</sup> three factors contributed to the growth of securitisation. First, the supply of new technology to financial institutions increased the speed of access to information and reduced the costs of transactions. It seems unlikely that recent events will have any noticeable impact on the pace of technological progress. Second, securitisation was fuelled by a major change in the credit standing of banks *vis-à-vis* corporations, which left many banks with no comparative advantage in the cost of funds. The reduction in the credit standing of banks was largely driven by the deterioration in the debt position of developing countries. This has not changed materially since the crash though there has been a gradual improvement in capitalisation and provisioning of some banks. On the other hand, if there were to be a recession, corporations, facing

deteriorating credit ratings and uncertain cash flows, would be more likely to draw down bank lines of credit, thereby contributing to the reintermediation of credit flows. The third factor behind the growth of securitisation was the ability of investment banks and securities houses to compete aggressively for business because they faced capital and other regulatory requirements which were less constraining than those faced by commercial banks. It is here that the aftermath of the crash has produced a situation which is more clearly to the advantage of the banks. Securities houses have suffered losses on their capitalisation. In addition, some national regulatory authorities may in future impose tighter regulations on capital ratios in the securities industry.

It may be important to distinguish between trends in international and domestic markets in assessing the prospects for securitisation. While domestic security markets seem resilient—subject to the factors noted above—it is possible that the shake-out in the euromarkets will lead to a decline in the share of bond financing there. Signs of illiquidity in the eurobond markets, in particular for small issues and specialised instruments in which markets were always thin, were already apparent before 19 October, and investor concerns were intensified by the crash. These tendencies suggest that, rather than a reversal of securitisation as a whole, there may be a return to large and liquid bond issues, to domestic markets and to security issues with bank back-ups. As a result, there may be only a partial shift in the locus of intermediation back to banking.

Much depends, however, on the ease with which banks can take on a role as principal suppliers of credit. Although it strengthened banks' deposit bases, the stock market crash worsened their prospects for raising external capital, lowered the quality of some banks' assets and impaired the prospects for fee income at a time when banks had already been weakened by their lending to developing countries and (in the United States) problem loans in the farming, energy and real estate sectors. The recent agreement on capital convergence will impose additional requirements on some banks. Banks could therefore be faced with potentially conflicting objectives. They are likely to face increasing demand for loans, including demand from less highly rated borrowers, but at the same time need to strengthen capital positions, when stock markets are likely to find equity issues unattractive and the FRN market remains dormant.

Although changes in financial market behaviour and underlying economic conditions were the key influences on euromarket activity during 1987, regulatory developments both in the euromarkets themselves and in related domestic markets also had an impact. Among the most important were the liberalisation of lead management regulations, the proposed withholding tax in Germany and the proposed abrogation by the United States of its double-tax treaty with the Netherlands Antilles. Threatened imposition of withholding taxes led

(1) *Recent Innovations in International Banking*, Bank for International Settlements, 1986.

to sharp initial falls in the prices of eurobonds in the relevant currencies, while liberalisation of lead management in the German market is likely to stimulate use of the deutschemark. The capital adequacy guidelines agreed by BIS-area central banks in December may dampen euromarket activity by increasing banks' costs, but could benefit other market sectors. For example, as banks may not be required to deduct all holdings of other banks' capital from their own capital, the perpetual and dated FRN markets could eventually experience a recovery. Continuing deregulation in Japan is likely to give a fillip to activity but could also bring issuance back to the domestic markets.

## International banking developments

Banks' international lending<sup>(1)</sup> remained strong through 1987, growing by \$731 billion, compared with \$665 billion in 1986 (Table D). As usual, most of the business was between banks within the reporting area. Lending to final users (which excludes double counting resulting from the redepositing of funds between reporting banks, but includes an estimate of banks' own use of external funds for domestic lending) was also buoyant. The Japanese again played a major role as intermediaries in 1987 with banks in Japan undertaking 38% of new lending. There was particularly strong growth in interbank business between Japan and other Far East financial centres.

Following a move by Citibank in May, major banks in the United States and the United Kingdom substantially increased their provisions against lending to developing countries, many continental banks having already done

so. In the United Kingdom, the banking supervisors circulated to the banks a matrix of factors against which banks could judge the adequacy of provisions. Although agreements, which included the provision of new money, were reached between banks and a number of the major debtors, negotiations were often prolonged and generally banks remained reluctant to provide new money to debtor countries. Brazil imposed a moratorium on interest payments to commercial banks which continued for most of the year. This led banks to cut back on trade lines; but the strengthening of their balance sheets in the past few years, in terms of both capital and provisions, meant that they were better placed to withstand non-payment of interest.

In 1987, there was further progress with schemes to convert debt into equity. Gross turnover in the secondary market in developing-country debt rose substantially, to an estimated \$15–20 billion (the greater part of this was swaps of debt rather than outright sales for cash). Earlier this year, the Mexican scheme was launched under which banking debt could be swapped for 20-year floating-rate bonds. There was a limited response to this scheme, with the majority of banks unwilling to exchange debt for credit-enhanced bonds at significant discounts. Despite increased activity in these areas, schemes such as the Mexican debt-for-bonds swap may lead to only a small reduction in the claims of banks on middle-income countries. Nevertheless, they help to broaden the range of techniques available to banks away from the simple provision of new money. As a result of continuing problems with the major debtors, banks remain very cautious about cross-border lending to most countries outside the BIS-reporting area; even for 'non-problem' borrowers the spreads are often seen as inadequate.

**Table D**  
**Growth of international lending**

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

	1982	1983	1984	1985	1986	1987
<b>Gross lending</b>						
Bank lending	229	127	152	297	665	731
of which:						
To inside area	190	95	138	269	638	710
To outside area	39	28	13	24	14	7
Euro and foreign bond issues	72	72	108	164	222	176
of which:						
To inside area	64	66	99	146	201	160
To outside area	7	6	9	18	21	15
<b>Total gross lending</b>	<b>301</b>	<b>199</b>	<b>260</b>	<b>462</b>	<b>886</b>	<b>906</b>
<b>Net lending</b>						
Bank lending(a)	95	85	90	105	165	255
of which:						
To inside area	55	57	77	77	138	235
To outside area	40	28	13	24	14	7
Euro and foreign bond issues net of redemptions(b)	59	58	83	125	156	104
Total bank and bond finance minus double counting(c)	154	143	173	230	321	359
	- 9	- 13	- 28	- 55	- 76	- 44
<b>Total net lending</b>	<b>145</b>	<b>130</b>	<b>145</b>	<b>175</b>	<b>245</b>	<b>315</b>

(a) BIS estimate of net international bank credit: excluding double counting resulting from the redepositing of funds between reporting banks, but allowing for the banks' own use of external funds for domestic lending.

(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) This analysis of international banking developments focuses on statistics collected from the banks in the BIS-reporting area, and from banks in the United Kingdom. Throughout this section international banking business refers to all banking transactions in foreign currency—cross-border and with local residents—and cross-border transactions in domestic currency. The BIS-reporting area comprises banks in Austria, Belgium, Canada, Denmark, Finland, France, Federal Republic of Germany, Ireland, Italy, Japan, Luxembourg, Netherlands, Norway, Spain, Sweden, Switzerland, United Kingdom, United States and those engaged in international business in the Bahamas, the Cayman Islands, Hong Kong and Singapore, all offshore banking units in Bahrain, all offshore banks operating in the Netherlands Antilles and branches of US banks in Panama.

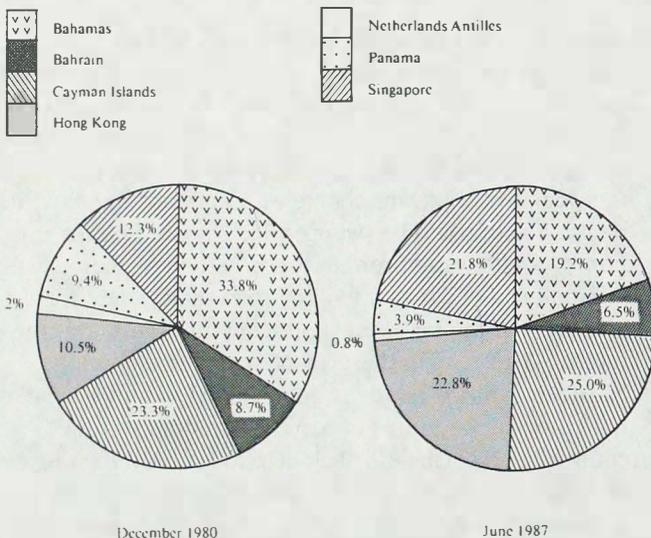
## The interbank market

International interbank business between banks within the reporting area remained buoyant in 1987. It was \$547 billion, compared with \$530 billion in 1986 (Table E). Interbank transactions played a major role in recycling capital flows associated with external current account imbalances between the developed countries. Banks' purchases of securities were often financed in the interbank market and the market was also used to hedge against interest rate and exchange rate movements. These factors varied in importance between different financial centres, but a notable aspect of interbank business in 1987 was the acceleration of activity between banks in Japan and those in other reporting countries. Having accounted for 55% of interbank business within the BIS-reporting area in 1986, banks in Japan accounted for two thirds of interbank business in 1987. Much of this activity was with banks in Hong Kong and Singapore, where the Japan

## Offshore banking centres

Offshore banking centres are countries or territories where the volume of cross-border lending and deposit-taking substantially exceeds the value of cross-border trade. Those discussed here are: The Bahamas, Bahrain, the Cayman Islands, Hong Kong, the Netherlands Antilles, Panama and Singapore. These centres compete with established financial centres by being able to provide finer deposit and lending rates, principally because there are no reserve requirements on business denominated in foreign currencies; additional advantages include low or non-existent income and corporation taxes.

### Offshore lending: market shares



The offshore centres' market share has remained at around one fifth of BIS-reporting banks' external assets since 1980 despite the development of 'offshore' banking in both the United States and, more recently, Japan. The *US International Banking Facilities* (IBFs) were set up in December 1981 to repatriate the eurodollar market by enabling US-resident banks to conduct dollar-denominated business with non-residents without the need for reserve requirements and deposit insurance. They were also not subject to (the later abolished) domestic interest rate controls. The *Japan Offshore Market* (JOM) was established in December 1986 along the same lines as the IBFs and has grown rapidly. At end-December 1987, the IBFs accounted for 7% of BIS-area banks' external assets and the JOM, 5%.

Outstanding lending from *Hong Kong* has grown from \$38 billion at end-1980 to \$266 billion at end-1987. Most of this growth has occurred since September 1986. The dominant feature of the past fifteen months has been interbank lending to Japan, which grew from \$27 billion at end-September 1986 to \$125 billion at end-1987; this followed the opening of the JOM. Borrowing by Japanese non-banks increased to \$21 billion at end-1987, well in excess of borrowing by non-banks in any other country.

Prior to the opening of the JOM, Hong Kong's most important interbank business had been with the United

Kingdom and Singapore, with interbank lending to each of around \$18 billion at end-1987. In addition to Singapore, there are strong banking connections with other offshore centres, in particular The Bahamas and the Cayman Islands. Both non-banks and banks in China and South Korea do substantial business with Hong Kong; at end-1987, they had borrowed \$9 billion and \$6 billion respectively.

*Singapore's* market share expanded from 12% at end-1980 to 22% at end-June 1987. Surges in growth occurred during 1981 and the final quarter of 1986. The link between the JOM and Singapore's growth may, however, not be as close as it is for Hong Kong; between September 1986 and September 1987, total interbank lending from Singapore grew by \$34 billion compared with \$81 billion for Hong Kong.

Among the Caribbean centres, the *Cayman Islands* have steadily increased their market share since 1980 and were the largest offshore centre in terms of external assets, with 25% of the offshore market, at end-June 1987. Conversely, *The Bahamas* have suffered a decline in fortunes since 1980 when it was by far the largest offshore centre with a 34% market share. External assets fell in three of the seven years to end-1986. According to US statistics, The Bahamas became increasingly dependent on business with US banks over this period. As other business declined, lending from The Bahamas to banks in the United States increased, rising from 13% of lending at end-1980 to over a half at end-1986.

Lending from the *Netherlands Antilles* and *Panama* peaked at end-1982 at \$12 billion and \$43 billion respectively. The subsequent decline in the Netherlands Antilles' external assets was particularly sharp, the nadir being reached at end-September 1986, by which time they were at less than half their end-1982 volume. Much of this fall was connected with changes in US withholding tax and its double taxation treaty with the Netherlands Antilles, reducing the advantages to US residents of funding in that centre. Subsequently, there has been a slight recovery to \$7 billion at end-June 1987. Panama's external assets fell to \$31 billion at end-September 1985 and remained at that level until mid-1987: some two thirds of its external lending has been to Latin America. A subsequent sharp decline was due to deterioration of the political climate and to some centralisation of loan portfolio administration elsewhere.

*Bahrain's* external assets reached \$55 billion at end-1984 and have since fluctuated around \$50 billion. Nearly half of this lending is to Arab countries, a fifth to Western Europe, and most of the rest to North America and other offshore centres. Bahrain's importance as an offshore centre stemmed largely from its proximity to its principal (Arab) market, the establishment of an offshore market in Saudi Arabian riyals and its position in an intermediate time zone between London and Tokyo. This last factor has declined in importance in recent years with the advent of global dealing. The Middle East has also experienced sharply reduced oil revenues and banks in Bahrain, as elsewhere, have had problems with non-performing loans in the region.

**Table E**  
**Interbank lending between banks in the**  
**BIS-reporting area**

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

	Flows			Outstanding at end-1987
	1985	1986	1987	
Cross-border interbank lending	183	451	485	2,780
<i>Interbank lending as a percentage of all cross-border lending</i>	89	92	88	84
Lending to resident banks in foreign currency(a)	49	79	63	552
International interbank lending	231	530	547	3,332
<i>Interbank lending as a percentage of all international lending</i>	86	83	77	77

Source: BIS.

(a) Excludes lending by banks in the United States. Includes lending by banks in Japan to resident non-banks.

Offshore Market has opened up significant arbitrage opportunities.

#### Lending to final users

Lending to final users was \$255 billion in 1987 compared with \$165 billion in 1986. Much of this was accounted for by Japanese residents' direct borrowing from the euromarkets. These figures for actual lending to final users do not fully reflect the revival in syndicated credits described earlier. This is partly because there is a lag before announced credits are drawn down by the borrower; only then do they feed through into lending data. Moreover, many of the credits were either a rearrangement of existing facilities or precautionary facilities which may never be drawn down.

BIS-area banks' new cross-border lending to non-banks doubled from \$40 billion in 1986 to \$80 billion in 1987. In recent years, non-banks have been net suppliers of funds to BIS-area banks, but in 1987 they were net takers of \$22 billion. This reflected both an increased rate of lending to non-banks and slower growth in non-banks' deposits. Both these phenomena were particularly marked in the fourth quarter. Most of the geographically identifiable business was within the BIS-reporting area. Here, lending to non-banks was \$59 billion in 1987 (an increase of 15%) compared with \$38 billion during 1986. Slower growth in new deposits with BIS-reporting banks meant that non-banks became net borrowers of \$19 billion in 1987, having been net providers of \$26 billion in 1986.

Within the BIS-reporting area, non-banks in Japan were the most significant borrowers, borrowing \$27 billion direct from banks overseas and a further \$57 billion in foreign currencies from banks in Japan during 1987. Much of this borrowing was in foreign currency either to finance foreign investments or to swap into yen; euroyen borrowing also rose sharply. Non-banks in Germany were, unusually, also net borrowers, with particularly heavy borrowing in the fourth quarter. In contrast, non-banks in the United Kingdom and, to a lesser extent, the United States were net providers of funds to BIS-reporting banks.

Non-banks outside the United Kingdom were an important source of funds for UK banks, much of which

was used to fund foreign currency demand from non-banks within the United Kingdom. The position of non-banks outside the United Kingdom has changed in the past two years, on the basis of outstandings, from being net users of UK banks' funds amounting to \$15 billion at end-1985 to being net providers of \$27 billion at end-1987. Non-banks in the BIS-reporting area were the main source of funds during 1987, providing over three quarters of the net increase in deposits by non-banks (though this was a smaller percentage than in 1986). Non-banks in the United States were by far the largest providers of funds, followed by non-banks in Germany. Non-banks in Japan were the principal overseas non-bank borrowers from UK banks.

#### Analysis by centre

The United Kingdom remained the world's largest centre for international banking business in 1987 (Table F), even though its share of total outstanding international assets has fallen two percentage points over the last two years (to 22% at end-1987). The only major centre to experience growth in its share of business in 1987 was Japan. The opening of the Japan Offshore Market in December 1986 contributed to the expansion of Japan's share of total outstanding international assets to 18% at end-1987 from 15% at end-1986. In 1987, Japan accounted for 38% of new international lending (the United Kingdom accounted for 13%).

In *London*, the growth of total international business slowed in 1987 to 9% compared with 14% in 1986. However, the structure of international business of banks in the United Kingdom remained largely unaltered through the year. They were net takers of funds, with

**Table F**  
**International banking analysed by centre**

\$ billions; figures in italics are percentages

	End-December 1987			Total(a)	Percentage share of total		
	Foreign currency lending to:		Domestic currency lending to non-residents		End-Dec.		
	Residents	Non-residents			1985	1986	1987
<b>Gross lending</b>	<b>980</b>	<b>3,005</b>	<b>1,152</b>	<b>5,285</b>			
<i>of which:</i>							
Belgium	48	155	10	213	3.7	3.8	4.0
Luxembourg	38	179	3	220	4.0	4.0	4.2
France	73	220	47	340	6.8	6.2	6.4
Germany, Federal Republic	4	58	148	210	3.1	3.9	4.0
Italy	37	59	5	100	2.1	2.0	1.9
Netherlands	15	91	24	131	2.5	2.4	2.5
Switzerland	16	64	66	146	2.5	2.6	2.8
Swiss trustee accounts	..	..	..	149(b)	3.7	3.2	2.8
United Kingdom	267	803	72	1,143	24.5	23.0	21.6
Canada	23	49	4	76	2.2	1.9	1.4
Japan:							
'Offshore' market	16	123	69	208	..	2.3	3.9
Other	374	165	220	760	10.4	12.5	14.4
United States:							
International banking facilities	..	40	237	277	6.2	5.8	5.2
Other	..	11	221	232	6.6	5.5	4.4
'Offshore' banking centres	..	874	5	879	17.8	17.1	16.6

.. not available.

Source: BIS.

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

(b) End-September 1987.

non-banks outside the United Kingdom and the UK interbank market being the main source of funds. Lending was predominantly to unrelated banks overseas and to own offices. There was a marked increase in the rate of growth in foreign currency lending to UK non-banks (much of which was to non-bank financial institutions), although this was heavily concentrated in the first half of 1987. The repayment of loans by non-banks towards the end of 1987 may have been partly a result of the stock market crash; there was a substantial reduction in UK holdings of portfolio investments abroad in the fourth quarter and this would have reduced the value of loans needed for hedging.

Japanese banks in London continued to show strong growth, even though the growth of their international lending slowed to 8% last year (compared with 30% in 1986). Lending by Japanese banks in London to their own offices overseas grew much less rapidly in 1987 compared with 1986 and they cut back their business with the UK interbank market. At the end of 1987, Japanese banks' share of total international claims had fallen slightly from the peak of 37% reached in the first quarter of 1987, although they still hold, by a clear margin, the largest share among bank nationality groups. The growth in British banks' international lending from London accelerated slightly to 5% in 1987, while US banks' lending grew by 7%. For the latter, this was the first growth in their international lending since 1983, and was principally to own offices overseas and to non-banks in the United Kingdom.

In 1987, Japan remained in the paradoxical position of being a net borrower of funds though the banking system despite its current account surplus (Table G). International activity by banks in Japan was boosted by the Japan Offshore Market (which accounted for over half of the growth in cross-border lending by banks in Japan in 1987) and by the growing volume of Japanese domestic

financial activity taking place in international markets. Net inflows via the banking system into Japan more than doubled in 1987, to \$51 billion, compared with \$23 billion in 1986. As already noted, non-banks in Japan were particularly heavy net borrowers. There were quarterly fluctuations in these flows. Banks in Japan, which are usually net borrowers in the third quarter on account of window dressing, were net lenders in that quarter of 1987. This position was reversed in the fourth quarter when the growth in cross-border lending by banks in Japan fell sharply while their foreign currency borrowing continued at a high rate. In 1987, banks in Japan were net borrowers of \$24 billion (compared with \$21 billion in 1986). At end-1987 the external assets of banks in Japan stood at \$577 billion, having overtaken those of banks in the United States for the first time in the third quarter of 1987.

Banks in the *United States* exhibited the more usual pattern of banking flows for a country with a balance of payments deficit and continued to play an important role in financing the country's current account deficit. Banks' net borrowing increased from \$24 billion in 1986 to \$50 billion in 1987. Nevertheless, these flows exhibited strong quarterly fluctuations, with banks in the United States being net lenders in the second quarter. In 1986, borrowing by banks was partly offset by non-banks in the United States, whose net deposits abroad were \$6 billion. In 1987, these fell to \$0.5 billion.

In the *Federal Republic of Germany* both banks and non-banks continued to be net exporters of funds, although on a much smaller scale than in 1986. In 1987, net banking outflows from Germany fell to \$3 billion compared with \$49 billion in 1986. These outflows were concentrated in the first half of 1987. In the second half of the year, they were reversed, with banks in Germany running down their external lending and German non-banks becoming heavy borrowers, notably in the fourth quarter.

**Table G**  
Net cross-border banking flows

\$ billions; flows exclude estimated exchange rate effects  
Net borrowing/lending (-)

	Outstanding at end-1984	Flows			Outstanding at end-1987
		1985	1986	1987	
<b>By residents of</b>					
<b>United States</b>					
Banks	- 86.1	35.2	23.5	49.8	23.5
Non-banks(a)	- 88.7	8.4	- 6.1	- 0.5	-84.5
Total	-174.8	43.6	17.4	49.5	-61.0
<b>Germany, Federal Republic</b>					
Banks	- 6.8	-13.1	-27.8	- 4.1	-74.2
Non-banks(a)	24.9	- 2.7	-21.0	1.3	18.3
Total	18.1	-15.8	-48.8	- 2.8	-55.9
<b>Japan</b>					
Banks	0.1	-12.1	21.0	24.4	15.1
Non-banks(a)	5.3	- 0.8	2.3	26.5	37.1
Total	5.4	-12.9	23.3	50.9	52.2
<b>United Kingdom</b>					
Banks	41.9	15.1	9.5	6.5	52.0
Non-banks(a)	- 0.3	- 1.5	3.2	- 3.1	- 2.3
Total	41.6	13.6	12.7	3.4	49.7

Source: BIS.

(a) Net external flows vis-à-vis BIS-area banks.

#### Analysis by currency

The currency composition of cross-border business during 1987 was marked by continuing strong growth of lending in yen (Table H). Over the year, yen-denominated lending accounted for 29% of new lending by the industrial countries (compared with 16% in 1986). There was a

**Table H**  
Currency shares of external lending  
by BIS-area banks<sup>(a)</sup>

Percentages; flows exclude estimated exchange rate effects

	Flows			Outstanding at end-1987
	1985	1986	1987	
US dollar	30.5	58.8	47.5	51.7
Deutschemark	16.2	6.9	9.0	13.6
Yen	24.1	16.4	29.4	13.3
Swiss franc	10.1	2.8	0.4	6.3
Sterling	4.0	4.5	3.4	3.7
ECU	7.7	1.9	2.4	2.4
Other	7.4	8.7	7.9	9.0

Source: BIS.

(a) Excludes the lending of the 'offshore' banking centres for which currency detail is not available.

marked increase in the euroyen business of banks in Japan, which accounted for 56% of cross-border business in 1987, compared with 35% in 1986. The growth of this business largely reflected arbitrage opportunities with Hong Kong and Singapore which have increased since the opening of the Japan Offshore Market. At the same time cross-border euroyen claims of banks in the industrial countries expanded by a quarter, and by end-September 1987 exceeded those in euro Swiss francs for the first time. New US dollar denominated lending accounted for 48% of total lending in 1987, compared with 59% in 1986. The dollar's share of outstanding lending fell six percentage points in 1987 to account for 52% of lending at end-year.

**Table J**  
**Net borrowing from BIS reporting banks by selected country groups**

\$ billions; flows exclude estimated exchange rate effects

	Flows			Outstanding at end-1987
	1985	1986	1987	
<b>Latin American non-OPEC developing countries</b>				
Borrowing	1.7	1.6	- 7.1	225.7
Deposits	0.4	0.8	7.4	80.0
Net borrowing	1.3	0.8	-14.5	145.7
<b>Asian non-OPEC developing countries</b>				
Borrowing	8.3	2.5	7.5	117.2
Deposits	2.4	13.1	14.1	109.0
Net borrowing	5.9	-10.6	- 6.6	8.2
<b>Oil exporters</b>				
Borrowing	0.2	0.4	2.3	127.4
Deposits	7.6	-22.0	18.9	169.6
Net borrowing	-7.4	22.5	-16.6	- 42.2
<b>Eastern Europe</b>				
Borrowing	5.7	3.4	1.7	84.0
Deposits	2.8	-0.1	- 0.7	31.9
Net borrowing	2.9	3.5	2.4	52.1

Source: BIS.

**Business with countries outside the BIS-reporting area**  
Reversing their traditional role as net takers of funds from BIS-area banks, countries outside the BIS-reporting area were net providers of funds in 1987 (Table J). This reflected both the continuing decline in new lending and the sharp rise in these countries' deposits. New lending was \$7 billion during 1987 compared with \$14 billion in 1986. Non-oil developing countries are shown as having made net repayments of loans in 1987. However, published figures for bank lending to these countries are becoming increasingly difficult to interpret because of debt sales, debt/equity swaps, transfers and write-downs. These factors are impossible to quantify but their effect is generally to reduce the figure shown for the outstanding stock of bank lending to particular countries, thereby tending to understate new bank lending to developing countries.

The most striking feature of the banking flows of countries outside the BIS-reporting area was the sharp increase in their deposits with BIS-area banks, which rose by \$56 billion during 1987, having been drawn down by \$2 billion in 1986. This increase was spread amongst most country groupings, except for Eastern Europe. Non-oil developing countries' deposits increased by \$24 billion during 1987 (\$7 billion of this was accounted for by Taiwan), reflecting the significantly improved external current account positions of a number of these countries. Strengthening oil prices allowed OPEC countries to build up their deposits by \$19 billion during 1987 (they had fallen by \$22 billion in 1986). These developments resulted in outside-area countries being net providers of over \$43 billion to BIS-area banks in 1987.