

Developments in international banking and capital markets in 1988

This article⁽¹⁾ continues the annual series on developments in international banking and capital markets. The article has a short overview, followed by sections on developments in international banking and capital markets. There is a feature on mortgage-backed securities.

- *There was a slowdown in the rate of growth of international banking business in 1988.*
- *Banks in Japan continued to dominate international banking business, though Japanese banks in London have not increased their share of business there any further. Both the yen and the dollar were less important in international lending flows in 1988 than in 1987.*
- *Primary activity in international capital markets was buoyant, reflecting the strength of investment in industrial countries, the continuing surge in mergers and the strong issuance of equity-related bonds by Japanese borrowers.*
- *Competition among intermediaries remained intense, as reflected in low profit margins despite the boom in issuance. Tighter regulation is claimed to have raised costs.*

Overview

The international banking markets in 1988 were characterised by a slowdown in the rate of growth of international business after buoyancy in the two preceding years. Gross lending slowed from \$760 billion in 1987 to \$495 billion in 1988 (Table A). This slowdown was common to most banking centres and also to lending to banks and non-banks both inside and outside the BIS reporting area. The Basle proposals for convergence on capital adequacy had been widely expected to lead banks to concentrate more on profitability than on growth and this is likely to have been one factor behind the slowdown in lending, especially interbank lending where margins are low. At times during the year, differentials between domestic and euromarket interest rates were not sufficient to stimulate cross-border business. Another possible influence may have been deregulation in certain centres which encouraged business to go back 'onshore'. As far as lending to developing countries is concerned, many banks have been seeking to restructure their balance sheets and sell or swap debt in the secondary market. This type of activity appears as a fall in the recorded lending figures, as the stock of lending falls by the amount of the discount involved. Activity in the secondary market is estimated to have been around \$40-50 billion in 1988, about double the level of the previous year; some four fifths of trading was in Latin American debt.

Lending to non-banks in 1988 was surprisingly muted in view of the high rate of announcements of syndicated credits both in that year and in 1987 (the majority of which

were either merger-related or multiple-option facilities). However, the syndicated credits figures are for announcements of facilities arranged and there is often a lag between announcement and take-up. Moreover, many of the multiple-option facilities are likely to have been precautionary or replacements of existing lines of credit. There were a few signs later in the year that some of the takeover-related credits were being reflected in the banking figures and more of this lending may come through in early 1989. Certainly this is one of the more profitable areas for the banks at the moment and, in the

Table A
Estimated net lending in international markets 1983-88

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

	1983	1984	1985	1986	1987	1988
1 Gross international bank lending	126	152	297	654	760	495
2 Net international bank lending	85	90	105	195	300	225
3 Gross new bond issues(b)	74	109	165	222	181	219
4 less redemptions and repurchases	14	25	39	59	71	82
5 Net new bond issues	60	84	126	162	110	138
6 Net new euronote placements	—(a)	6(a)	10(a)	13	23	20
7 Total international financing (2+5+6)	145	180	241	370	433	383
8 less double counting	13	28	55	83	53	67
9 Total net international financing	132	152	186	287	380	315

Source: BIS, Bank of England and Euroclear.

(a) Bank estimates.

(b) On a completions basis.

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

UK figures at least, domestic lending in foreign currency to non-banks was relatively buoyant in 1988.

Although in gross terms activity in the international banking markets was lower in 1988 than in 1987, this was not always true of net cross-border flows, and in some cases banking flows continued to play an important role in financing payments imbalances—though, as last year, not always in the way expected. In the United Kingdom, short-term banking inflows—notably in sterling—were the major identified counterpart to the current account deficit. On the other hand, banks in Japan remained in the paradoxical position of being net borrowers despite Japan's surplus.

Among individual banking centres, London has continued gradually to lose share of international business and—at the end of December 1988—had virtually the same share as Japan. The other gainers have been the offshore banking centres (as a group), notably Hong Kong. These gains partly reflect the opening of the Japan offshore market; another factor has been the rapid growth of domestic foreign currency business in Japan. The continental European centres have also in general lost share over the past two years. It is worth pointing out that the figures on which these shares are calculated relate only to on-balance-sheet business. It may be that if off-balance-sheet business—which has been a rapidly-growing area in recent years—were taken into account any loss of share by London would be less significant. The section beginning on page 256 looks in more detail at developments in the banking market in London since the end of 1985.

In contrast to the slowdown in the growth of international bank lending, primary activity in international capital markets was buoyant. Gross bond issues recovered from the low levels recorded in the fourth quarter of 1987 following the stock market crash, and the sector showed some resilience to higher interest rates in the second half of the year. Indeed the increases in interest rates provided a boost to the floating-rate sector. Demand for new euronote programmes was, however, relatively stable, perhaps reflecting the maturity of the market. Net new bond issues increased from \$110 billion in 1987 to almost \$138 billion in 1988 (Table A), while net new euronote placements declined from \$23 billion to \$20 billion over the same period. Overall, total net international financing declined from \$380 billion in 1987 to \$315 billion in 1988, as the strength of bond issues was offset by weaker bank lending (Table A).

The main factors underlying the growth in capital markets were the strength of investment among the industrial countries and the surge in merger activity among corporations. In addition, there was a sharp increase in equity-related issues for Japanese borrowers in the first half of the year, partly reflecting the strong recovery in

equity prices in Japan during this period. More generally, investors remained cautious over equity (except in Japan) and borrowers found it cheaper to issue debt rather than equity. In addition several banks, seeking to meet the Basle agreement on capital convergence, chose to issue subordinated debt rather than equity.

The proportion of straight fixed-rate international bond issues denominated in dollars has declined in recent years, from over 50% in 1982 to just 25% in 1987, although it rose slightly in 1988. The dollar's share was particularly high in the third quarter. In the fourth quarter, however, concerns over 'event risk' (the potential for deterioration in the credit quality of obligations issued by US corporations in the case of highly leveraged takeovers or buyouts) adversely affected the eurodollar sector. Some investors continued to show a preference for bonds in currencies offering high coupons (despite the potential exchange rate risk) and issuers in these currencies made extensive use of swaps. In the eurobond markets more generally, a large proportion of all bonds were swapped and swaps have become a key component of the markets. Although primary activity in the bond markets was strong, there was a decline in the volume of secondary market trading, thought to reflect greater caution among investors as they held rather than traded bonds.

Competition among intermediaries in the capital markets remained very strong. Some sectors suffered from over-capacity, underwriting margins were low and the decline in secondary market trading further affected profitability. Additional regulatory requirements, especially the need to meet the requirements of the Financial Services Act, were claimed to have raised costs. Although swap transactions are reported to have provided good returns, the large increase in the arrangement of private placements reported during the year may suggest that some firms are now placing more emphasis on improving profitability, by arranging specially-tailored deals, than on gaining market share in terms of public issues.

International banking developments

Despite the continuing substantial payments imbalances and a buoyant world economy, the growth of total international bank lending⁽¹⁾ slowed down considerably in 1988 to 9%, after two years of growth of the order of 20%. The slowdown occurred in lending to non-banks (who may have been relying more heavily on the capital markets) as well as in interbank lending within the BIS reporting area (Table B). Activity involving banks in Japan continued to dominate the figures, and Japan further increased its share of the international banking market.

One factor behind the slowdown in the rate of growth of international lending was that claims on countries outside

(1) This analysis of international banking developments focuses on statistics collected from banks in the BIS reporting area, and from banks in the United Kingdom. Throughout this and the following section, international business refers to all banking transactions in foreign currency—cross-border and with local residents—and cross-border transactions in domestic currency.

Table B
Growth of international lending

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

	1983	1984	1985	1986	1987	1988	Percentage change in 1988
Gross lending	126	152	297	654	760	495	9.0
<i>of which:</i>							
To inside area	88	139	269	627	737	486	10.4
<i>of which:</i>							
<i>Banks</i>	<i>71</i>	<i>108</i>	<i>231</i>	<i>521</i>	<i>558</i>	<i>358</i>	<i>9.9</i>
<i>Non-banks</i>	<i>17</i>	<i>30</i>	<i>38</i>	<i>106</i>	<i>179</i>	<i>128</i>	<i>11.9</i>
To outside area	28	13	24	14	11	7	1.0
Unallocated	10	—	4	13	12	2	2.0
Net lending(a)	85	90	105	195	300	225	9.4
<i>of which:</i>							
To inside area	47	77	77	168	277	216	14.4
To outside area	28	13	24	14	11	7	1.0

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

the reporting area are reported as having risen by only \$7 billion. These countries' deposits again rose relatively rapidly so that they were, as in 1987, net providers of funds. Non-oil developing countries were the group which were shown as having repaid debt in 1988, to an amount of \$8.9 billion. Some Asian countries such as South Korea and Taiwan were genuinely repaying banking debt, but among some problem debtors the fall will be more a reflection of balance-sheet adjustments by the banks in the form of sales and swaps of debt in the secondary market. Such transactions tend to lead to a recorded fall in lending in the figures, as the stock of lending falls by the amount of the discount on the debt. In some cases, debt may be sold or transferred to institutions or countries that fall outside the reporting system, and in some cases the statistics will show a fall equivalent to the full amount outstanding.

The interbank market

The most significant slowdown in the growth of business in 1988 occurred between banks in the reporting area, where claims rose by only \$358 billion compared with \$558 billion in 1987. Even so, interbank business still

Table C
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-Dec. 1988
	1986	1987	1988	
Cross-border interbank lending	441	496	351	3,068
<i>of which:</i>				
<i>Between banks in Japan and in other reporting countries</i>	<i>247</i>	<i>334</i>	<i>319</i>	<i>1,270</i>
Between banks in the United States and other reporting countries except Japan	70	74	14	630
Between banks in Europe	78	61	38	741
Other	46	28	-19	426
<i>Interbank lending as a percentage of all cross-border lending</i>	<i>87</i>	<i>83</i>	<i>84</i>	<i>68</i>
Memorandum items				
Lending to resident banks in foreign currency(a)	79	63	7	542
International interbank lending	520	558	358	3,610
<i>Interbank lending as a percentage of all international lending</i>	<i>79</i>	<i>73</i>	<i>72</i>	<i>66</i>

Source: BIS.

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

accounted for nearly three quarters of total international business within the reporting area (Table C).

The Basle proposals on capital adequacy may have focused banks' attention on profitability and discouraged them from expanding their interbank business in 1988 on the scale of the preceding two years. At times during the year, banks took advantage of arbitrage opportunities and placed funds with banks overseas and also used the interbank market to fund domestic loan demand; this was a major reason behind the sharp increase in the third quarter of \$142 billion in interbank business between banks in Japan and those in other centres. However, at other times, when interest differentials were less favourable, activity was much more muted. Interbank business between banks in the United States and other reporting countries except Japan actually fell by \$38.4 billion in the first quarter. The build-up of business between banks in Japan and those in the Far Eastern centres—notably Hong Kong—which had been such a feature of 1987 was much less evident in 1988. Nevertheless, cross-border interbank business involving banks in Japan accounted for 90% of the total of such business, compared with two thirds in 1987.

Lending to non-banks

Somewhat surprisingly in view of the announcements of syndicated credits discussed above, lending to non-banks was also less buoyant in 1988 than it had been in 1987. The BIS measure of lending to final users, which includes an estimate of funds raised in the international markets for domestic use, also showed slower growth in 1988 than in 1987. The slowdown affected both cross-border claims on non-banks within the reporting area and domestic lending in foreign currency. However, the growth of deposits by non-banks also slowed slightly, so that they were again net takers of funds.

Non-banks in Japan in particular, who had dominated non-bank borrowing in 1987, were less active, as were borrowers in the United States. On the other hand there was a significant increase in cross-border borrowing by non-banks in the United Kingdom, some of which may reflect credits connected with takeovers. More of the announced syndicated credits related to takeovers may yet be reflected in the actual lending figures, but the slow rate of growth of lending generally confirms the judgement that many other announced credits were precautionary or replacements of existing lines.

Analysis by centre

Although the slowdown in the rate of growth of banking business occurred in almost all the major centres, Japan continued to increase its share of international banking business and accounted for over 40% of new international lending. Thus by the end of 1988, Japan's share of international banking business had risen to 21.0%, virtually the same as that of the United Kingdom (20.9%)—see Table D. The decline in the United States' share was halted in 1988; indeed there was a small

Table D
International banking analysed by centre

\$ billions; figures in italics are percentages

	End-December 1988			Total(a)	Percentage share of total		
	Foreign currency lending to:		Domestic currency lending to non-residents		End-Dec.		
	Residents	Non-residents			1986	1987	1988
Gross lending	1,020	3,171	1,223	5,505			
<i>of which:</i>							
Belgium	44	134	9	187	3.8	3.8	3.4
Luxembourg	34	186	3	223	4.2	4.2	4.1
France	71	233	43	347	6.4	6.6	6.3
Germany, Federal Republic	4	61	145	210	4.0	4.0	3.8
Italy	41	59	3	104	2.1	1.9	1.9
Netherlands	18	100	23	140	2.5	2.5	2.5
Switzerland	16	62	55	133	2.7	2.8	2.4
Swiss trustee accounts	171(b)	3.4	3.4	3.1
United Kingdom	266	807	77	1,149	23.8	22.1	20.9
Canada	24	44	4	72	2.0	1.5	1.3
Japan:							
'Offshore' market	41	200	131	372	2.3	4.0	6.8
Other	380	189	213	783	12.9	14.6	14.2
United States:							
International banking facilities	..	54	255	309	6.0	5.4	5.6
Other	..	12	234	246	5.7	4.5	4.5
'Offshore' banking centres	..	980	6	1,020	17.7	18.0	18.5

.. not available.

Source: BIS.

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

(b) End-October 1988.

increase. However, continental European centres in general lost share in 1988.

Although claims of banks in *Japan* grew less rapidly in 1988 than in 1986 or 1987, they nevertheless rose by more than 20%. Growth was concentrated in the offshore market, whose international assets have risen to \$372 billion in the two years since the market was established in December 1986. Japan remained a net borrower of funds through the banking system despite the continuing substantial current account surplus (Table E). Although net borrowing by banks was on much the same

Table E
Net cross-border banking flows

\$ billions; flows exclude estimated exchange rate effects

Net borrowing/lending (-)

	Outstanding at end-1985	Flows			Outstanding at end-Dec. 1988
		1986	1987	1988	
By residents of United States					
Banks	- 51.5	23.5	47.9	13.5	34.5
Non-banks(a)	- 77.6	- 6.1	4.5	5.8	-73.5
Total	-129.1	17.4	52.4	19.3	-39.0
Germany, Federal Republic					
Banks	- 23.3	-27.8	- 4.1	- 8.7	-77.0
Non-banks(a)	28.8	-21.0	1.9	0.2	17.0
Total	5.6	-48.8	- 2.2	- 8.5	-60.0
Japan					
Banks	- 15.3	21.0	24.6	23.3	38.7
Non-banks(a)	5.8	2.3	26.2	13.6	50.5
Total	- 9.5	23.3	50.7	36.9	89.2
United Kingdom					
Banks	36.0	9.5	6.2	27.6	78.6
Non-banks(a)	- 2.3	3.2	-2.9	3.6	1.8
Total	33.7	12.7	3.3	31.2	80.4

Source: BIS.

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

scale as in 1987, non-banks borrowed only about half the amount they borrowed then; domestic foreign currency borrowing was also on a much smaller scale. The greater strength of the dollar in the middle of 1988 may have reduced Japanese perceptions of the need to borrow to hedge foreign currency investments, especially after the cost of dollar borrowing increased, even though outward portfolio investment by Japanese residents was on much the same scale as in 1987. Cross-border borrowing was particularly heavy in the third quarter when part of heavy domestic credit demand was met through the international banking markets.

Inflows into banks in the *United States* were less important in financing the US current account deficit than in 1987, although the quarterly pattern varied. Net borrowing by non-banks in the United States was only slightly larger than in 1987; in gross terms both deposits and borrowing were well below the rates of 1987.

After the first quarter, banks in *Germany* reverted to their more normal position of being net suppliers of funds: in general, business increased more rapidly in the second half of the year than in the first. The non-banks' position was almost flat; their deposits with banks abroad rose more rapidly than in 1987, which might have been the result of the withholding tax (which was implemented at the beginning of 1989).

Analysis by currency

The most striking feature of the currency composition of cross-border lending in 1988 was the small share of the dollar; it accounted for only 38% of the total (Table F). However the yen's share of lending also fell back and the major counterpart to the fall in the dollar's share was an acceleration in lending in sterling (especially in the second quarter), in ECU and in deutschemark. After a pause between the end of 1985 and mid-1987, activity in ECU picked up and was particularly buoyant in the first three quarters of 1988; banks in the United Kingdom accounted for nearly half the increase in the year as a whole. In the case of sterling, eurosterling lending by banks in the industrial countries accounted for three quarters of the rise in sterling claims in 1988, in contrast with 1987 when banks in the United Kingdom accounted for the greater part.

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

Percentages; flows exclude estimated exchange rate effects

	Flows			Outstanding at end-Dec. 1988
	1986	1987	1988	
US dollar	58.8	48.0	38.3	52.5
Deutschemark	6.9	8.7	13.8	12.7
Yen	16.4	29.7	23.5	14.5
Swiss franc	2.8	0.5	-1.7	4.9
Sterling	4.5	3.3	9.2	4.2
ECU	1.9	2.0	5.0	2.5
Other (b)	8.7	7.8	11.9	8.8

Source: BIS.

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

(b) Includes total non-dollar positions of banks in the United States for which no currency breakdown is available.

International banking business in London

As was the case with other centres, the rate of growth of international business transacted in London slowed further in 1988; claims rose by 4½% compared with 9% in 1987 and 14% in 1986. This contrasts with growth in sterling domestic business, notably lending to industrial companies and persons, which rose rapidly in 1988. Over these three years, business in London grew less rapidly than in other centres, so that London's share of the international banking market as a whole fell from 24.5% at end-1985 to 20.9% at end-1988. Although the fall in London's share of business is largely balanced by an increase in Japan's share, London continues to have by far the largest share of foreign currency lending to non-residents, the major component of international lending. The major contribution to the increase in Japan's share came from lending to residents in foreign currency; the fall in London's share of this market was entirely a result of banks reducing low-margin interbank business. London has also increased its share of lending to non-residents in domestic currency, though this is small in absolute terms.

There have also been changes in the structure of the banking market in London since the end of 1985; unrelated banks overseas are now less important as a source of funds and, in 1988, there was a fall in net lending to banks' own offices overseas. Foreign currency lending within the London interbank market has fallen in the past two years by \$16 billion but foreign currency lending to non-banks in the United Kingdom has been buoyant, having risen by \$31 billion since 1986. On the other hand, non-banks overseas are now net suppliers of funds, largely as a result of relatively slow growth of lending. There has also been a sharp increase in the net supply of funds from other market sources, notably CD issues, though the net position also reflects little growth in the banks' holding of investments after the end of 1986 (Table G). In general, the trends are common to the major nationality groups, though to varying degrees and from different starting points.

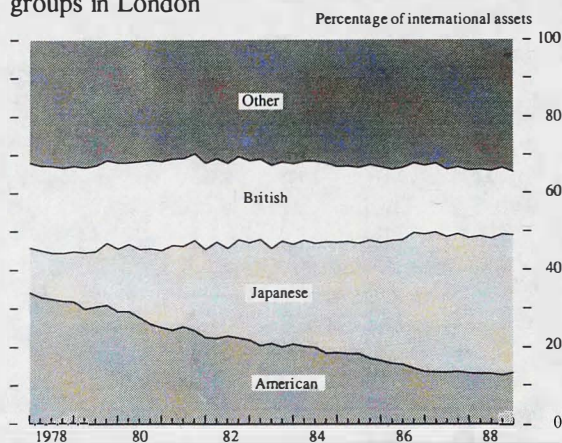
Table G
Net sources/uses of international funds of banks in London

\$ billions; net lending/borrowing (-) at end of period

	1985	1986	1987	1988
Own offices overseas	53.1	67.8	85.0	59.0
Other banks overseas	-76.0	-66.1	-54.7	-29.3
Non-banks overseas	29.4	14.0	2.6	-8.9
Other market sources	-51.8	-60.0	-87.7	-102.9
Banks in the United Kingdom	17.2	13.6	4.5	4.2
Non-banks in the United Kingdom	26.5	26.8	32.5	41.7
Total	-1.6	-3.8	-17.9	-36.2

In 1988, there were substantial net inflows into the United Kingdom through the banking system. A large part of these inflows was in sterling as overseas residents took advantage of high interest rate differentials, though the bulk of the inflows occurred in the second quarter. Lending and deposit-taking in foreign currency by banks

Chart 1
International market shares of major bank groups in London



in the United Kingdom both grew less rapidly than in 1986 and 1987. Non-banks in the United Kingdom were also net borrowers from banks in the BIS area in 1988 as they stepped up their borrowing; some of this may reflect take-up of syndicated credits.

Japanese banks remain the largest nationality group in London, with 36.4% of international assets at end-1988 (Chart 1), a share that has remained broadly unchanged since the end of 1986. However, the share of total international business of Japanese banks transacted in London has fallen from nearly 34% at end-1985 to a little over 26% at mid-1988. This fall partly reflects rapid growth of domestic foreign currency business in Japan itself, but the growth of the offshore market and the opening up of arbitrage opportunities with the Far Eastern centres may be a further factor.

The Japanese banks illustrate some of the changes in the structural pattern of the banking market mentioned above. They cut back their foreign currency business in the London interbank market in 1987 and—to a lesser extent—in 1988, and lending to their own offices overseas, which has traditionally been a major reason for their presence in London, actually fell in 1988 when they were net takers of funds from that source. On the other hand, other banks overseas, which have traditionally supplied the Japanese banks in London with funds, were net users in 1988 as lending to them rose rapidly. Japanese banks remain net lenders to non-banks overseas, as much because they have not shared in the increase in deposits from non-banks abroad as because of a more rapid rise in lending. They also rely more heavily on CD issues than the other groups, accounting for nearly half of the CDs issued by banks in London that are held by overseas residents. Foreign currency lending to non-banks in the United Kingdom has risen only moderately, and Japanese banks have not increased their share of the market (23% at end-November 1988) in the period since 1986 as a whole; to some extent this reflects a fall in lending to securities dealers which had been built up prior to 'Big Bang' in October 1986. Lending in foreign currency to the wholesale distribution sector remains an important outlet

and Japanese banks have nearly two thirds of all this lending. They have also increased their share of lending to 'other' financial companies and to property companies, though the level of the latter remains low.

Some fall-off in the rate of growth, if not an absolute decline, in Japanese banks' business had been widely expected as a result of the Basle convergence proposals. The reduced participation in the London interbank market and the fall in lending to their own offices, which would be low-margin business, may reflect increased emphasis on profitability rather than growth. However, Japanese banks generally appear to have had little difficulty in improving their capital ratios on the Basle formula and other factors—such as deregulation in Japan itself and the establishment of the offshore market—may also be influencing their strategy in London, as Japanese banks worldwide have continued to increase their share of total banking business.

The most rapid growth in the London market in the past two years has come from the *other overseas* group, notably from banks from European Community countries; the latter group has increased its share of international business from 12.2% at end-1985 to 16.5% at end-1988. They are also, as a group, active in the sterling market, taking over half the increase in sterling deposits from overseas in 1988. Other overseas banks have traditionally been net takers of funds from banks overseas and net lenders to non-banks, both in the United Kingdom and overseas, and to other banks in London. Since the end of 1985, unrelated banks have become relatively less important as a source of funds, their place being taken by own offices. The *other overseas* group reduced its business with the London interbank market in 1988 and non-banks abroad are now net suppliers of funds. Perhaps the most striking development in 1988 has been the growth of lending in foreign currency to UK non-banks, where *other overseas banks'* share has increased from 27% to 29% in the two years to end-November 1988. They have also increased their share of total lending (including sterling) in this period, unlike the Japanese or American banks. Compared with other nationality groups, they are relatively more important in lending to manufacturing industry and also to construction, though lending to the 'other' financial services sector and to business and other services (including property companies) is also important.

After a fall in business in 1986, the decline in the share of *American banks* in international business in London has now been stemmed and they have broadly maintained their share since the end of 1986. As with the Japanese banks, lending to their own offices remains their most important function in London, although this has diminished in importance as a net use of funds over the period since 1985 as a whole. American banks are also now net takers of foreign currency funds from the London interbank market; their lending to it fell in 1987 but recovered a little in 1988. Lending in foreign currency to non-banks in the United Kingdom has been a growth

area, especially in 1987; most has gone to securities houses and American banks now account for nearly 70% of lending in foreign currency to this section. Elsewhere lending has fallen in many cases, especially to manufacturing industry. In addition, the American banks are major participants in the London foreign exchange markets, and also in the markets for instruments such as swaps. The figures for their share of on-balance-sheet business therefore probably understate the extent of their influence in the London market.

As with the American banks, the *British banks'* international business has also grown only slowly since the end of 1985 and their share has fallen from 20.6% then to 17.1% at the end of 1988. Unlike the other groups, they have increased their net lending to their own offices abroad over the past three years, though overall this is a less important activity for them than for the foreign banks. Other banks overseas have become a less important net source of funding. Claims on non-banks overseas have fallen in each of the past three years, which probably reflects a generally cautious attitude to cross-border business, so that non-banks overseas are now a net provider of funds to the British banks. However, the growth of British banks' lending in foreign currency to non-banks in the United Kingdom has broadly kept pace with that of other groups and they have maintained their share of this market. Compared with the other nationality groups, the British banks direct foreign currency lending more to manufacturing industry than to the financial sector and have gained share here at the expense of the American banks.

International capital market developments

The international bond market

Issuance of fixed-rate bonds, at \$203 billion, recovered strongly in 1988 after the difficulties experienced in the fourth quarter of 1987 when the stock market crash and the fall in the dollar brought issues almost to a halt. Issues of floating-rate notes doubled to \$23 billion. Repayments of bonds rose to almost \$79 billion, so total net issues amounted to \$147 billion, well above the level recorded in 1987 but below that for 1986.

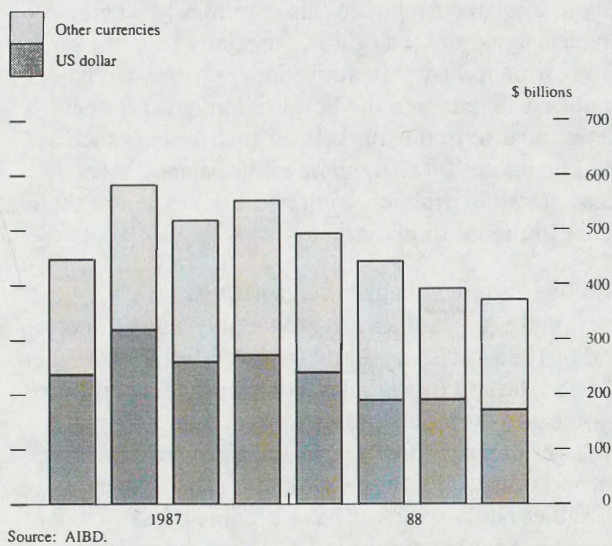
Table H
Announced^(a) international bond issues

\$ billions	1986	1987	1988
Fixed-rate bonds			
Straights	144.8	117.0	159.9
Equity-related bonds	26.7	43.3	42.0
of which:			
Warrants	19.2	25.7	29.9
Convertibles	7.5	17.6	12.1
Bonds with non-equity warrants (currency, gold, debt)	2.2	3.3	1.2
Total fixed-rate bonds	173.7	163.6	203.1
Floating-rate notes	47.8	12.0	23.2
Total gross new issues	221.5	175.6	226.3
Repayments	59.2	71.1	78.8
Total net new issues	162.3	104.5	147.4

Source: Bank of England ICMS database, BIS.

(a) The differences in totals between this table and Table A reflect the difference between announcements and completions.

Chart 2
Straight fixed-rate bonds: secondary market turnover



Turnover in the secondary market fell in 1988 (see Chart 2), indicating some change in investor behaviour from trading to buy-and-hold strategies. Nevertheless, many investors remained concerned over liquidity, resulting in a preference for quality issuers and attempts by underwriters to enhance liquidity by bringing larger issues to market (the average size of straight dollar-denominated eurobonds rose from \$155 million in 1987 to \$172 million in 1988). There was a sharp contrast between large issues, which retained a high degree of liquidity, and the rest of the market where liquidity was reportedly low.

An important feature of the bond markets in 1988 was the further broadening and deepening of the swaps market, offering high quality borrowers greater scope to reduce their cost of funds. A large proportion of all bond issues were thought to have been swapped, although because some swaps were unpublicised and other issues were swapped in stages, it is difficult to give a precise figure. Currency swaps from high-yielding currencies such as the Canadian dollar and the Australian dollar into US dollars, and then often into another currency, were particularly common. According to data from the International Swap Dealers Association (ISDA) there was strong growth in the volume of interest rate swaps in the first half of 1988—up 25% compared with the previous six months. There was also a rise in the proportion of interest rate swaps in non-dollar currencies, especially the yen and the deutschmark. The swaps market witnessed a number of innovations (such as delayed-rate swaps, mark-to-market swaps and swap insurance facilities) which broadened the range of opportunities and extended the network of counterparties to borrowers.

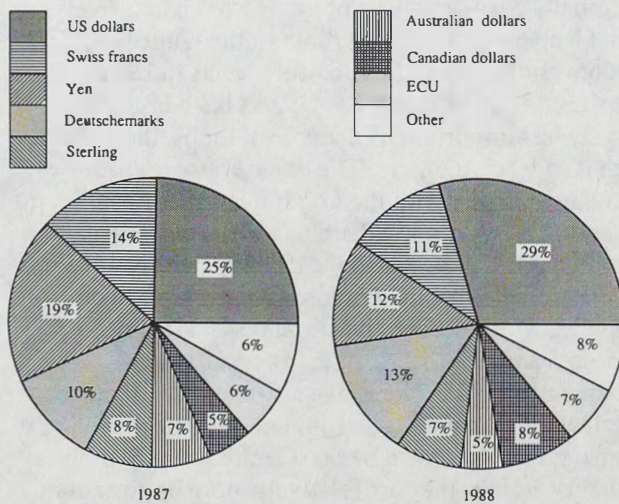
There were numerous private placements in 1988 (estimated by market sources to have reached some \$40 billion) many of which involved swaps. Japanese institutional investors were reported to be the main subscribers. The Bank's database recorded some

\$20 billion of private placements in 1988. If the higher market estimates are correct, then the data presented here understate activity in the bond markets.

Straight fixed-rate bonds

Straight fixed-rate dollar-denominated issues amounted to \$47.2 billion, which, although above the level for 1987, was well below that recorded in 1986. Despite unease over the dollar, there was strong demand for short-dated issues in the first half of the year. US corporations, however, who have traditionally been the largest issuers of fixed-rate eurodollar bonds, found it cheaper to issue in the US domestic market. Many of these issuers returned to the eurobond market in the third quarter, with the result that the dollar's share rose sharply. In the fourth quarter both euromarket and US domestic issuance were weakened by concerns over 'event risk' (sudden declines in the perceived credit quality of outstanding bonds following leveraged buyouts), which affected US corporations. The yankee market (bond issues by foreigners in the US market) remained active throughout the year, but received a particular boost when these concerns over event risk emerged.

Chart 3
Currency composition of straight fixed-rate international bonds



There was a record level of issuance—DM 36.4 billion (\$20.9 billion)—of deutschmark-denominated foreign bonds in 1988. The German government's earlier announcement of a plan to impose a 10% withholding tax from January 1989 on interest income from domestic bonds caused a decline in the price of domestic and international bonds. However, after an initial period of uncertainty, it led to an increase in issuance in the international deutschmark sector by foreign subsidiaries of German corporations who were exempted from the tax. Issues in the straight euroyen sector fell to ¥2,433 billion (\$19.2 billion), mainly because of a lack of attractive swap opportunities. They were partly replaced with specially-tailored issues designed to meet the specific fiscal and accounting requirements of Japanese investors

and issuers, most of which required prior placing in Japan and resembled private placements. Many of these included redemption prices linked to particular financial indices such as those on the Tokyo stock market. Issues in Swiss francs were particularly strong in the first quarter as investors were attracted by the stability of the currency, but volumes fell throughout the remainder of the year, mainly because Swiss interest rates remained unusually low in relation to those in other capital markets. Total issues amounted to Sw.Fcs. 25.5 billion (\$17.8 billion).

Some investors, especially retail investors from continental European countries, continued to show a strong preference for high coupons during 1988, thus underpinning issuance in the Canadian dollar, Australian dollar, ECU and sterling sectors. A high proportion of issuers in these currencies were non-resident borrowers who issued bonds in anticipation of greater currency depreciation than that implied by covered interest parity. In this respect, investors' focus on high nominal coupons appeared to reflect widely differing expectations of currency risk. The Canadian dollar sector (US\$13.2 billion) was buoyant: funding opportunities remained favourable for most of the year, reflecting the strength of the currency in relation to the US dollar. Issuance in Australian dollars (US\$7.3 billion) was strong in the first half, but declined in later quarters, reflecting saturation of investors' portfolios and exchange rate concerns. The ECU also benefited both from its stability and from favourable swap opportunities.

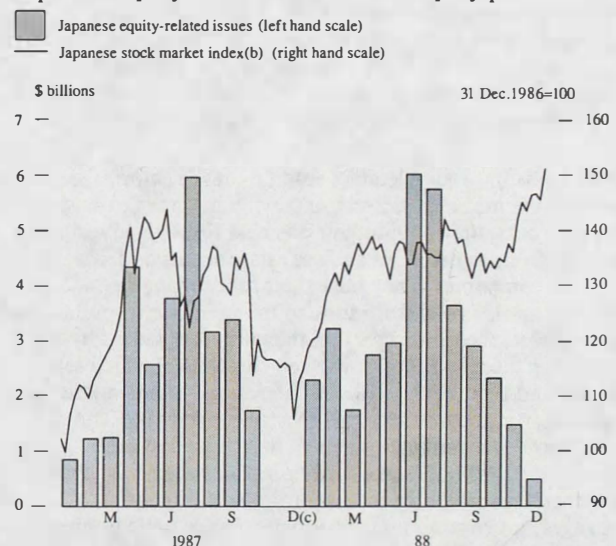
There was an increase in the amount of new straight fixed-rate issues in sterling, as eurosterling activity rose from £5.5 billion (\$8.9 billion) in 1987 to over £6.4 billion (US\$11.7 billion) last year. In the first half, a combination of low and declining interest rates and the strength of the currency contributed to a large volume of fixed-rate issues by both UK and foreign borrowers. The rise in short-term interest rates in the second half reduced the level of activity (while stimulating it in the FRN sector—see below). A significant proportion of euro-issues were by UK institutions, usually of long-dated stock and sold to UK institutional investors. UK investors needed to find alternative means of matching their longer-term assets and liabilities in view of the cessation of net gilt issues. Although many of these issues were structured as eurosterling issues, their pricing and distribution characteristics were in a number of cases similar to those of domestic bonds. There was also a revival of the dormant bulldog market (the market for foreign borrowers issuing in the domestic sterling market) following relaxation of the regulations governing issue size and grey market trading, with long-dated issues for Portugal and the European Investment Bank.

Equity-linked bonds

Total issues of *equity-linked bonds* amounted to \$42 billion, much the same as in 1987. Some 70% were bonds with equity warrants attached, most of which were

issued in US dollars by Japanese corporations, which swapped the proceeds into yen. The rapid rise in the Japanese stock market in the first half of the year was the main reason for the recovery of this sector, issues having virtually ceased towards the end of 1987 after the stock market crash. However, in the summer an excess supply of paper and uncertainty surrounding the future direction of the stock market unsettled the market, resulting in an

Chart 4
Japanese equity-related issues^(a) and equity prices



(a) Source: Bank of England ICMS database.

(b) FT- Actuaries world index.

(c) No issues were made in November or December.

excess supply of paper. To alleviate these problems, the major Japanese securities houses agreed to a temporary moratorium on new equity-warrant bond issues. As a consequence, the volume of issues declined in the third quarter. It also fell sharply in the fourth, reflecting the continuing effects of the earlier oversupply of paper as well as an increase in the post-swap yen cost of funds relative to domestically issued yen convertible bonds.

Floating-rates notes (FRNs)

Issues of FRNs rose from \$12 billion in 1987 to \$23.2 billion last year, but remained well below the levels attained in both 1985 and 1986. The market was buoyant owing to rising interest rates and the call of several sovereign FRNs, both of which provided support to secondary market prices and encouraged primary issuance. The year also saw the first perpetual issue since 1986 when National Westminster Bank launched an issue using the variable rate note (VRN) structure. Institutions in the United Kingdom accounted for a large proportion of FRN issues and the sterling sector accounted for about half of all FRNs. Most UK FRN issues took the form of sterling-denominated mortgage-backed securities for specialist mortgage lenders (see the note on page 260). In addition, building societies issued subordinated notes for the first time, having been granted the necessary authority earlier in the year. Both types of borrowing slowed considerably towards the end of the year, owing to the decline in new mortgage commitments.

The sterling mortgage-backed securities market

The first sterling mortgage-backed issue was introduced in 1985, but this sector of the sterling capital market only came to prominence at the beginning of 1987. In 1987 there were nine mortgage-backed issues for a little over £1 billion and last year there were a further nineteen issues for £3.3 billion taking the amount outstanding to more than £4 billion. In the first quarter of this year there were two issues together worth £250 million. This expansion largely reflected the buoyancy of the housing market and, in particular, the growth of lending by specialist mortgage lenders, which, unlike banks and building societies, are almost entirely reliant on the capital markets to finance mortgage lending. Sales of sterling mortgage-backed securities (MBS) have emerged as an important source of funding for some of these lenders.

The specialist mortgage lenders entered the UK mortgage market in the mid-1980s. Because they do not have extensive retail networks, they obtain their business through advertising and through intermediaries such as estate agents and insurance companies. They raise their funds from the wholesale markets and from time to time remove from their balance sheets the mortgages that they have originated by transferring them to note issuing vehicles (NIVs) which sell MBS to fund them. Principal and interest payments on the on-sold mortgages are then used to service the MBS. The ability to offload mortgage assets in this way allows the primary lender to undertake further mortgage lending. This in turn generates further fee income, from administration of mortgages and commissions on any insurance policies linked to the mortgages (insurance companies are major shareholders in some of the specialist mortgage lenders). The differential between the rate charged to homeowners and the yields paid on the MBS accrues initially to the NIV but can be paid back to the parent originator as fees and/or dividends. A number of mortgage lending arms of foreign banks, and one UK bank, the Trustee Savings Bank, have recently set up NIVs to securitise mortgages.

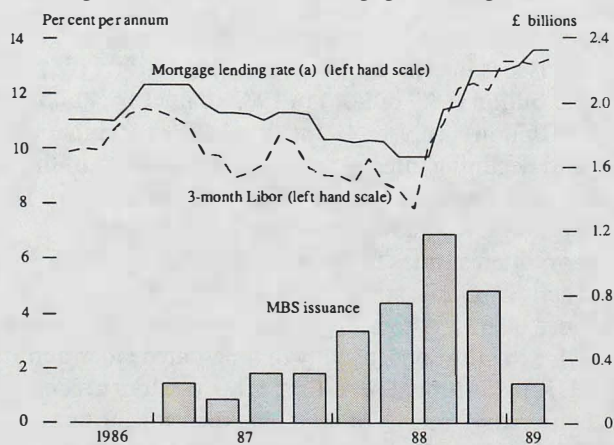
As most UK mortgages are made at floating rates of interest, most MBS issues to date have offered floating rates of interest (at a quarterly reset spread over three-month sterling Libor) in order to avoid a fixed/floating-rate mismatch. So far, only two fixed-rate bond issues, which involved complex swap arrangements, have been introduced. Because most of the underlying mortgages have 25–30 year maturities, most MBS have correspondingly long stated nominal maturities. However, the actual maturity of the MBS is invariably shorter than this because, in the event of early repayment of the mortgages by homeowners, the NIV is usually obliged to make a principal payment on the outstanding MBS. Because they are made at floating rates of interest, repayment rates on UK mortgages have been relatively stable with respect to interest rate movements (in contrast to the unstable repayment rates common in other countries with fixed-rate mortgages). Experience suggests that the average life of MBS will be between 5 and 8 years. In most of the earlier MBS issues principal repayments were distributed *pro rata* among all note holders. Issues made more recently have tended to include sinking funds which draw lots selecting individual bonds for redemption.

The credit quality of MBS is very high, with all issues having been awarded AAA or AA ratings by the established rating agencies. These high ratings reflect a number of factors. First, the default rate on UK mortgages has historically been very low. Second, the position of the mortgagees is protected

because mortgagors are generally obliged to purchase building and life insurance policies. Third, the MBS structure incorporates additional insurance on the whole pool of mortgages. This protection can be provided in one of two ways. The first involves using a highly-rated insurance company to cover a part of the losses on the pool of mortgages which would result from defaults by borrowers after all steps have been taken to enforce payment; the second method has a two-tranche structure which distinguishes between senior and junior claims, with the latter receiving a higher return for the greater risk since they bear the initial impact of any default on the principal.

The main impetus for the growth of the securitised mortgage market has come from deregulation and increased competition in the UK mortgage market since the early 1980s which led to a shift from administered to market-determined mortgage rates. Until the early 1980s, it would not have been possible to securitise mortgages at yields greater than those available on competing assets such as gilts and bank deposits because the administered mortgage rate tended to be below the yields available on such assets. In the more competitive market of the 1980s, the mortgage rate has generally been set at a premium of 1% to 2% above three-month sterling Libor so that it has become profitable to repackage UK residential mortgages into securities that offer a sizable spread over Libor (see the chart). More recently, the increase in UK interest rates has resulted in a slowdown in new mortgage commitments. It has also coincided with a narrowing of the differential between mortgage rates and Libor, and has therefore reduced the profits which can be derived from the securitisation of mortgages.

Sterling MBS issuance and mortgage lending rates



Source: Bank of England.

(a) Building societies/banks' average mortgage lending rate.

The prospects for the MBS market are linked to the level of activity in the UK housing market in general. Developments in the market will also depend on the extent to which banks and building societies decide to securitise some of their mortgage assets and on investor demand for the securities. As is often the case with innovative structures, euromarket investors were initially reluctant to purchase MBS. Many of these investors were deterred by the uncertain final maturity and the complex structure relative to conventional unsecured eurobonds. Most MBS were initially purchased by London-based banks as liquid alternatives to conventional mortgage lending. More recently, the investor base has diversified geographically as well as functionally.

A number of French corporations and state-owned banks issued perpetual subordinated capital notes during 1988. The banks' main reason for raising such funds was their need for additional capital to meet the BIS rules on capital convergence, given the restrictions on raising capital from private sources or the government. The structures generally involved repackaging outstanding issues of perpetual FRNs with zero-coupon US Treasuries to produce synthetic dated FRNs which were then placed privately with investors. The tax advantages associated with the structures meant that the cost of raising capital was lowered, enabling the issuers to offer investors a generous margin over Libor. For banks, however, there has been uncertainty about the capital status of the issues under the BIS rules.

Borrowers and underwriters

The main borrowers in the eurobond market were industrial corporations, which accounted for some 40% of total bond issues. Financial institutions increased their share of total bond issues in both the fixed and floating sectors to almost 38% in 1988, spurred on by desire to issue subordinated debt to build up their capital ratios. The volume of bond issues by sovereign borrowers fell in 1988 (and their share declined to 13.1%), as many governments experienced a reduction in their foreign borrowing requirements owing to improved balance of payments or budgetary positions.

Japanese securities houses and banks continued to dominate the underwriting of eurobonds—partly reflecting the importance of the equity-warrant bond market. Certain US investment banks increased their market share, partly reflecting their expertise in swaps and derivative instruments. In 1988 there was also an increase in the number of bookrunners in the eurobond market, which would imply intensified competition in this sector.⁽¹⁾ The strength of competition manifested itself in a variety of ways, including a continuing drive to market innovations, the development of capability in swaps and highly competitive pricing by lead managers. The strength of competition has almost certainly contributed to low profitability in primary market activity, and the decline in secondary market trading has limited the scope for offsetting this by earning trading profits. There is now some evidence that investment houses are placing greater emphasis on improving profitability rather than gaining market share—the increase in the number of private placements is one indication. But some firms also withdrew from the sector last year to concentrate on other markets where their expertise was greater, contributing to the retrenchment which occurred in the London financial markets.

Euronote facilities and syndicated credits

The total volume of *euronote* programmes announced in 1988, at \$77.1 billion, was only slightly higher than that

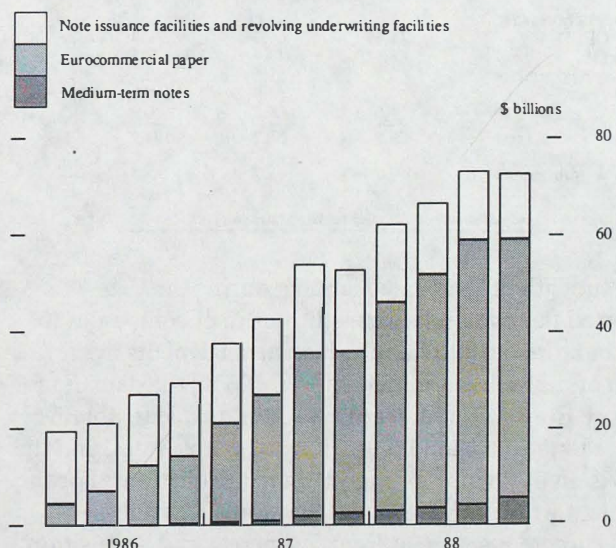
Table J
Announced euronote facilities

\$ billions	1986	1987	1988
ECP/ECDs	17.8	45.7	51.4
NIFs/RUFs	47.6	15.1	10.5
MTNs(a)	5.5	12.1	15.2
Total	70.9	72.9	77.1

(a) Includes ECP with MTN option and global MTNs.

recorded in 1987, probably a reflection of the fact that many major borrowers already have programmes in place. The stock of outstanding euronotes drawn rose from just under \$53 billion at the beginning of 1988 to \$73 billion by the end. Much of the growth was a result of the increase of eurocommercial paper (ECP)/eurocertificates of deposit (ECDs), reflecting the continuing shift away from note issuance facilities (NIFs) and revolving underwriting facilities (RUFs).⁽²⁾ The market for medium-term notes (MTNs) also developed during 1988, both in terms of the value of outstanding notes—up from \$2.8 billion to \$5.6 billion—and from the wider range of borrowers who are prepared to utilise the market.

Chart 5
Outstanding euronotes



Source: Euroclear.

Corporations in the United States and the United Kingdom were the major arrangers of new ECP programmes, with many utilising both the US commercial paper and the ECP markets, depending on which offered the most favourable terms. The investor base for ECP is now quite broad, and includes corporations and institutional investors as well as banks, but effectively excludes retail investors given the large minimum size of notes. With investors showing more concern over credit quality, there is a trend towards companies acquiring ratings for their ECP programmes (a well-established feature of the US commercial paper market).

(1) A detailed discussion is given in E P Davis, 'Industrial structure and dynamics of financial markets—the primary eurobond market', Bank of England *Discussion paper*, No 35.

(2) The development of the ECP market is analysed in detail in J G S Jeanneau, 'Structural changes in world capital markets and eurocommercial paper', Bank of England *Discussion paper*, No 37.

The ECP sector also experienced a number of innovations and examples of product development in 1988, many of which were designed to expand the investor base. These included the introduction of mortgage-backed ECP (already a feature of the US domestic market) which overcomes uncertainty over maturity if mortgage loans are repaid early (one of the financing problems associated with mortgage-backed bonds). In addition, some Japanese houses announced ECP programmes where the return on paper issued is linked to Japanese government bond futures contracts.

The total value of announcements of *eurocurrency syndicated credits* amounted to almost \$102 billion in 1988 compared with \$89 billion in 1987 and only \$30 billion in 1986.⁽¹⁾ Most of the arrangements were for companies in the OECD countries, which accounted for some 82% of the total. Arrangements for developing countries and Eastern European borrowers accounted for only 9% and 1% respectively.

Table K
Announced eurocurrency syndicated credits
\$ billions

	1986	1987	1988
Country of borrower:			
Major OECD	11.6	61.4	72.8
Minor OECD	6.6	14.9	18.3
Developing countries	8.7	9.6	9.3
Eastern bloc	2.0	1.9	1.2
Other	1.0	0.8	0.2
Total	29.9	88.7	101.7
<i>of which, transferable (a)</i>	3.3	2.7	2.3

(a) Loans that can be passed on by the lending bank to a third party.

The strength of syndicated lending during the year reflected three main factors—the desire of companies to obtain more flexible standby loan arrangements in the form of multiple-option facilities (MOFs); the demand for finance from second-tier corporations unable to obtain access to the eurobond market at acceptable rates, and the provision of finance for mergers and acquisitions. For the year as a whole it is estimated that some \$30 billion of total eurocredits were utilised for merger and acquisition activity, much of it by UK companies, especially for acquisitions in the United States.

The syndicated loan market continued to be characterised by strong competition for mandates. For example, margins on multiple-option facilities remained very low, often only a few basis points above Libor for prime corporate borrowers. The fees and margins earned on merger and acquisition activity proved to be more profitable for banks. Those borrowers who have accumulated debt for these purposes are vulnerable to increases in interest rates,⁽²⁾ and as a consequence the margins charged by some banks were related to the borrower's gearing or interest cover ratio. In general, banks in the credits market appear to have been prepared to

assume a higher risk/return profile on lending, especially through merger finance, in order to raise rates of return.

Borrowing activity by country grouping

The overall pattern of borrowing by country was again dominated by borrowers from major OECD countries, who accounted for 66% of activity in 1988, similar to the proportion for 1987. Gross activity by major OECD borrowers increased by 17% over the year, reflecting increases in issuance of eurobonds and announcements of syndicated credits. UK institutions, which recorded a 38% increase in total borrowing, were the largest borrowers. By

Table L
Total borrowing activity by country grouping
\$ billions at quarterly rates

	1986	1987	1988
OECD	71.2	75.1	90.6
<i>of which:</i>			
United States	16.1	13.7	9.9
Japan	10.6	13.2	14.7
United Kingdom	5.8	13.1	18.2
International institutions	5.2	4.9	5.8
Developing countries	2.6	3.2	3.4
Eastern Europe	0.7	0.6	0.8
Oil producers	0.9	0.6	0.7
Total	80.6	84.3	101.3

Source: Bank of England ICMS database.

contrast, the volume of activity by US borrowers fell by 27%, leaving Japan in second place. The decline in US borrowing occurred in all sectors, while the growth of Japanese borrowing largely reflected the strength of equity-related issuance. Borrowing by minor OECD countries increased sharply; institutions in Austria, Australia and Sweden were particularly active. Borrowing by non-oil developing countries showed little change, while there was a modest increase in activity by oil producers and Eastern bloc borrowers.

Innovation

After the subdued pace of financial innovation following the stockmarket crash, the larger securities houses began again to devote resources to innovation, partly to meet the special needs of borrowers, but also to distinguish themselves from other firms in a very competitive market. The innovations included the development of specialised instruments for private placements, the introduction of VRNs in the floating-rate sector, and perpetual subordinated capital notes. A further innovation was the inauguration by the UK government in October of a Treasury bill programme denominated and payable in ECUs. The effect has been to widen the range of short-term assets available in ECUs. It should also contribute to the emergence of a benchmark at the shorter end of the ECU market. The creation of a liquid short-term ECU market should also help to promote development of the ECU eurobond sector. There were three tenders of ECU Treasury bills in the final quarter of 1988, all of which were oversubscribed. The programme has continued in 1989.

(1) It should be noted that these figures exclude wholly domestic activity, which, especially in the United States—was sizable.

(2) Although many companies are believed to have hedged by swapping into fixed-rate funds or through the purchase of interest rate caps.

Regulatory developments

During 1988 there were a number of significant regulatory developments. The most important of these affecting banks was the BIS agreement on capital convergence. Although the agreement is not due to take full effect until 1992, it has already had an impact in requiring some banks to raise new capital on equity markets or through the issuance of subordinated bonds. There was some evidence of a further tendency for banks to seek to maximise fee income and greater interest in loan securitisation in response to tighter capital standards.

Compliance with the requirements of the Financial Services Act (FSA)—which took effect at the end of April 1988—is reported to have raised costs for participants in the London eurobond market, although provision was made under SIB rules to allow the practice of stabilisation of new issues in specific circumstances to continue. In order to meet the requirements of the FSA, the Association of International Bond Dealers (AIBD) assumed the role of independent regulator for the eurobond market. To meet the reporting requirements of the FSA, the AIBD inaugurated a new trade matching and confirmation system—TRAX—which, because of the speed with which deals can be confirmed, should improve the market's transparency.

The Japanese authorities continued with their programme of financial liberalisation. The Ministry of Finance (MoF) announced plans to ease restrictions on borrowing in the euroyen loan market by resident Japanese companies. The MoF also issued guidelines for shelf registration of corporate bonds which took effect from 1 October 1988. Shelf registration will give both Japanese and foreign companies greater freedom to issue domestic yen bonds and allow them to take advantage of favourable market conditions. In the commercial paper market, the MoF increased the range of permitted maturities on domestic yen CP and broadened the market by allowing foreign subsidiaries of Japanese companies, supranational institutions and foreign government-backed issuers to utilise the market.

There were a number of important developments in other centres. These included:

- A gradual loosening of the rules governing issue of Swiss franc foreign bonds. Developments included a rule change of the main bank underwriting syndicate which allows a member to turn down a co-management role if it considered that the pricing of a new issue was unattractive. As foreign banks have built up a presence in Switzerland in recent years, they have put further pressure on the syndicate to allow them to play a greater role in underwriting. The main syndicate also agreed to allow Swiss subsidiaries of foreign financial institutions to join, subject to certain conditions.
- In September the French Ministry of Finance announced they would list French government bonds as American Depositary Receipts (ADRs) on the New York Stock Exchange, a move seen as a further step to liberalise the French bond market by actively encouraging foreign investors. The move represented the first time ADRs had been used for bonds and the NYSE said that it expected more foreign governments and corporations to list debt as ADRs.
- In the European Community, discussions on the harmonisation of rules for the conduct of financial services continued during 1988 and are likely to have implications for the location of international capital market activity. The basic framework relating to international capital markets is set by directives such as the draft Second Banking Co-ordination Directive and the draft Investment Services Directive. The latter will allow investment firms located in one member state to provide a variety of investment services to clients in other member states. Other developments included a decision to exempt eurobonds from the EC Directive on Prospectuses. The Community is also considering a Commission proposal to introduce a withholding tax on interest income of EC residents, although it has been decided not to apply the tax to eurobonds.