

Developments in international banking and capital markets in 1989

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 international equities.

- *The growth of international banking business accelerated slightly in 1989 with evidence of increased activity within Europe. Non-bank business grew more rapidly than interbank business.*
- *Japan maintained its position as the largest international banking centre in terms of assets.*
- *Primary activity in international capital markets remained buoyant, owing to the strong issuance of equity-related bonds by Japanese borrowers. In other sectors of the eurobond market, profitability remained low, reflecting the intensity of competition.*
- *Other important developments during the year included the introduction of US-style syndication procedures to the eurobond markets; the launch of a 'global' bond by the IBRD; and the extension of credit ratings in the eurocommercial paper market following a number of defaults.*

Overview

International banking activity recovered a little during 1989 following the previous year's rather slower rate of growth (see Table A); however, growth remained substantially below the very strong annual rate recorded in the boom years of 1986 and 1987. Banks' concern to reduce exposures to specific debtor countries and the more rigorous capital adequacy standards set by the Basle Supervisors' Committee were probably the major restrictive influences on international lending. These developments have contributed to a growing

preference for securitised financing on the part of both lending banks and borrowers. This has resulted in a range of new off-balance-sheet products which may have been a further contributory factor to the reduction in traditional on-balance-sheet lending. Deregulation in a number of domestic markets may also have stimulated the repatriation of some international business. Although these underlying influences have not changed greatly over the last two years, developments in 1989 can be distinguished from those of 1988 by a number of more expansionary factors which have offset the contractionary factors described above. These expansionary influences include the prospect of the European single market, the continuing dismantling of statutory restrictions on capital movements in Europe and drawdowns of the rapidly growing number of syndicated credits that have been arranged over the last two years.

In contrast, gross borrowing on international capital markets remained buoyant in 1989, although the equity-related sector accounted for all of the increase in the issue of fixed-rate bonds. Issues of bonds with equity warrants attached to finance investment by Japanese industrial companies were strong, especially in the first half of the year, a reflection of the strength of the Tokyo Stock Exchange (TSE) and the low cost of funding (swapped from dollars into yen). Activity in the remainder of the international bond market was subdued. Issues of straight fixed-rate bonds declined. The main exception was the dollar sector where a combination of lower interest rates and dollar appreciation resulted in a more positive sentiment among investors.

Table A
Estimated net lending in international markets
1984-89

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

	1984	1985	1986	1987	1988	1989 ^(a)
1 Gross international bank lending	152	297	654	760	501	532
2 Net international bank lending	90	105	195	300	225	235
3 Gross new bond issues ^(b)	109	165	222	181	219	197
4 less redemptions and repurchases	25	39	59	71	82	64
5 Net new bond issues	84	126	162	110	138	134
6 Net new euronote placements	6 (c)	10 (c)	13	23	20	10
7 Total international financing (2+5+6)	180	241	370	433	383	379
8 less double counting	28	55	83	53	67	45
9 Total net international financing	152	186	287	380	316	334

Source: BIS, Bank of England and Euroclear.

- (a) January to September.
(b) On a completions basis.
(c) Bank estimates.

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

As a result of these trends, equity-related issues accounted for over a third of all fixed-rate bond issues; the major Japanese securities houses were the main underwriters of eurobonds; and the equity-related sector provided one of the main sources of profits in the eurobond market as a whole. Elsewhere profitability remained low, apart from other specific market niches such as swaps and private placements.

The strength of competition and the erosion of underwriting commissions led to a number of changes in syndication procedures, including the introduction of US-style fixed-price re-offering procedures. By the year-end the new procedures had been used in a number of issues and in a variety of different currency sectors, suggesting they would co-exist with the more conventional syndication procedures. However, the new procedures have not resolved the fundamental problem of overcapacity in eurobond underwriting, and the success of an issue still depends crucially on realistic pricing. Low profitability was also evident in the eurocommercial paper (ECP) market, causing some dealers to withdraw. The defaults and difficulties faced by a number of companies in meeting their obligations on their ECP programmes accelerated the use of credit ratings in this sector.

Further deregulation occurred in several markets during the year. Some measures, for example the liberalisation of foreign exchange controls in Scandinavia, provided a boost to external borrowing. Others, such as those in Japan, were designed to improve the competitiveness of domestic markets. The net effect of these developments has been to widen the choice of markets for potential borrowers and, although many domestic markets remain more regulated than the euromarkets, to place increased pressures on the latter to remain competitive. Innovations continued in 1989, as underwriting houses sought lower funding costs for borrowers. The IBRD's \$1.5 billion global bond issue showed that it was possible successfully to issue a (registered) bond simultaneously in both the US domestic bond market and the euromarkets. Securitisation continued to widen, from mortgage-backed securities to issues backed by credit card and other receivables, and LBO loans. In addition, more use is thought to have been made of hedging instruments, such as caps and collars, reflecting the volatility of interest rates during the year.

International banking developments

International bank lending⁽¹⁾ grew by \$532 billion (9.7%) in the first three quarters of 1989, compared with \$501 billion (9.7%) for the whole of 1988. This compares with an annual growth rate of some 20% in 1986 and 1987. Growth in 1989 was characterised by an actual fall of \$5 billion (-0.6%) in recorded lending to countries outside the BIS reporting area and a concentration of activity

Table B
Growth of international lending

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

	1985	1986	1987	1988	1989(a)	Percentage change in 1989
Gross lending	297	654	760	501	532	9.7
of which:						
To inside area	269	627	738	497	532	11.5
of which:						
Banks	231	519	559	369	387	10.7
Non-banks	38	108	179	128	145	13.6
To outside area	24	14	11	8	-5	-0.6
Unallocated	4	13	12	2	5	8.6
Net lending (b)	105	195	300	225	235	9.8
of which:						
To inside area	77	168	277	215	235	21.9
To outside area	24	14	11	8	-5	-0.6

(a) January to September.

(b) 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.

within the reporting area, where lending to non-banks (+14%) increased more than interbank business (+11%). The BIS's calculation of lending to end-users, which incorporates all outside-area lending and all lending to inside-area non-banks (together with an adjustment for on-lending of inside-area interbank funds to end-users), was therefore subject to the strongly expansionary impact of the latter and the modestly contractionary impact of the former. The net result was a resurgence in final lending to \$235 billion in the first three quarters of 1989, the second highest level ever recorded.

On the funding side, the growth rate of international liabilities edged up slightly, with the majority of new deposits emanating from countries inside the BIS reporting area.

The interbank market within the BIS reporting area

Interbank business accounted for 79% of BIS-area banks' total cross-border business conducted in the first three quarters of 1989, down from around 83% in each of the two previous years. This fall is likely to have been largely due to the introduction of the Basle capital adequacy guidelines, which have reduced the attraction of high volume, low margin, wholesale lending.

However, the facility with which some major international banks have been able to raise new capital has allowed total international interbank business to grow by 11% in the first three quarters of 1989. There was an unexpected doubling of business between banks in Europe from \$39 billion in 1988 to \$81 billion in the first three quarters of 1989 which was almost certainly stimulated by the plans for a single European market by the end of 1992. In particular, the further dismantling of exchange controls in France, Italy and Denmark and the growing presence of Japanese banks in Europe are likely to have been significant factors. A \$55 billion increase in local foreign currency business between banks in Japan was another stimulus.

(1) This analysis is based on statistics collected from banks in the BIS reporting area. International business refers to all banking transactions in foreign currency—both cross-border and with local residents—plus cross-border transactions in domestic currency.

A possible explanation for this could lie in developments in the equity-warrant dollar bond market. Japanese companies have been raising dollars cheaply in Europe through this market and swapping them for yen with banks in Japan. This may have accounted for the growth in the foreign currency interbank market in Japan; the

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-Sept. 1989
	1987	1988	1989(a)	
Cross-border interbank lending	496	355	324	3,302
<i>of which:</i>				
Between banks in Japan and in other reporting countries	334	321	204	1,422
Between banks in the United States and other reporting countries				
except Japan	74	14	18	647
Between banks in Europe	60	39	81	793
Other	28	19	21	440
<i>Interbank lending as a percentage of all cross-border lending</i>	83	83	79	69
Memorandum items				
Lending to resident banks in foreign currency(b)	62	7	63	594
International interbank lending	558	362	387	3,896
<i>Interbank lending as a percentage of all international lending</i>	73	72	73	66

Source: BIS.

(a) January to September.

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

consequent reduced need to raise dollars elsewhere would also be consistent with the sharp fall in cross-border interbank business involving banks in Japan. A further contributory factor in the latter development may have been the new procedures introduced in the Tokyo money market at the end of 1988 which encouraged the repatriation of business previously undertaken via foreign branches.

Non-bank business within the BIS reporting area

Lending to non-banks within the reporting area rebounded from the rather subdued level of 1988 to grow by some 14% in the first three quarters of 1989. While the sustained buoyancy of economic activity throughout the year may have contributed something to this outturn, drawdowns of syndicated lending⁽¹⁾ are also likely to have been a major factor. The observed relationship between the announcement of syndicated credits and actual international bank lending is not strong, since in many cases credits are precautionary and never drawn down. However studies in the Bank have identified a statistical link, albeit rather weak, between announcements and drawdowns after three months. Announcements of international syndicated credits rose strongly in 1988 and 1989 (\$99 billion and \$152 billion respectively) with industrial entities within the reporting area being by far the most important borrowers. This compares with actual international bank lending to non-banks of \$128 billion in 1988 and \$145 billion in the first three quarters of 1989.

The sharp rise in local foreign currency lending to UK non-banks from \$12 billion in 1988 to \$25 billion in 1989, for example, is consistent with drawdowns of US dollar credits related to the recent strong mergers and acquisitions activity.

Cross-border borrowing by Japanese non-banks grew very strongly to \$25 billion in the first three quarters of 1989 from \$15 billion in 1988, but most of this took place in the third quarter when a tightening of window guidance may have encouraged borrowers to look offshore for funds. At the same time, local foreign currency borrowing by Japanese non-banks fell sharply. American non-banks continued to be substantial takers of funds.

Non-banks also provided a growing source of international funds in the first three quarters of 1989, with deposits reaching \$72 billion. Non-banks in Europe were the major suppliers. German non-banks made cross-border deposits of \$20 billion, mostly in deutschemarks, prompted, at least in the first part of the year, by rising euro-deutschemark interest rates which led domestic rates. The temporary imposition of withholding tax on domestic interest income may also have been a factor. UK non-banks provided \$11½ billion, over half of which were local foreign currency deposits. American non-banks, on the other hand, withdrew \$13 billion of cross-border deposits.

Business outside the reporting area

An absolute exchange rate adjusted fall of some \$5 billion (-½%) was recorded in bank claims on countries outside the reporting area in the first three quarters of 1989. This brought the level of claims outstanding down to \$705 billion at end-September 1989 from \$720 billion at end-December 1988. The fall was wholly due to a further reduction of exposures to Latin America (-\$10.6 billion). Argentina, Brazil and Mexico represented 80% of the fall in Latin American claims. Sales of debt in the secondary market are likely to have been a large element of this fall. The average price of claims on the major debtor countries fell to under 35% of face value in 1989. In addition, debt conversion arrangements register as a reduction in exposure to the extent that they involve a discount in the value of a claim or if they involve the transfer of a claim to a non-reporting institution.

In addition to Latin America, a number of other reductions in outside area claims were recorded *vis-à-vis* some OPEC, African and Asian countries. In fact the only growth area was Eastern Europe, where the Soviet Union received over \$6 billion in the first three quarters of 1989.

The inflow of funds from outside the reporting area fell by over a half in the first nine months of 1989 (\$26 billion). This reflects a sharp fall in the rate of increase of deposits from OPEC countries which may largely reflect the lower oil prices pertaining for much of the year.

(1) An article on developments in the international syndicated loan market in the 1980s appeared in the February 1990 *Bulletin*, pages 71-7.

Currency analysis

Business denominated in US dollars continued to dominate international activity in 1989, accounting for over half of total external assets outstanding at end-September 1989 (Table D). The yen and the deutschmark were the next most important currencies, accounting in roughly equal shares for a further quarter of outstanding external business, while the Swiss franc and sterling accounted for around 4% each.

In terms of the flow of external lending during the first three quarters of 1989, the dollar remained the most traded currency, accounting for well over a third of total eurocurrency business. The yen was the second most traded currency with a share of just under a quarter.

Eurosterling lending slowed sharply after the surge in 1988—probably owing to the level of sterling interest rates. Swiss franc business continued to contract and the deutschmark's share slipped slightly. The private ECU also lost some of the share it had gained in 1988. The United Kingdom consolidated its position as the major

Table D
Currency breakdown of external lending by BIS area banks ^(a)

Percentages: flows exclude estimated exchange rate effects

	Flows			Outstanding at end-Sept. 1989
	1987	1988	1989(b)	
US dollar	47.9	38.2	35.2	52.5
Deutschmark	8.6	13.6	12.8	12.5
Yen	29.6	23.1	23.4	14.4
Swiss franc	0.5	-1.7	-0.1	4.2
Sterling	3.2	9.2	4.3	3.8
ECU	2.0	4.9	3.9	2.6
Other (c)	8.1	9.8	8.6	4.2

Source: BIS.

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

(b) January to September.

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

ECU banking market, accounting for 31% of ECU claims at end-September, with France in second place accounting for 21%. However, data for London show that some three quarters of ECU business is interbank, suggesting that use of the ECU as a means of settlement for commercial transactions remains limited.

There are differences in the nature of business in the different eurocurrency sectors, possibly reflecting the extent to which particular currencies have become truly internationalised. Some two thirds of identified cross-border yen lending, for example, is carried out by banks in Japan, though these figures exclude yen business in the Far Eastern offshore centres; on the other hand, in the case of the eurodollar and the eurodeutschmark the majority of the business (three quarters for the dollar and two thirds for the deutschmark) is carried out by banks outside the issuing country. Cross-border sterling lending is fairly evenly split between lending by banks in the United Kingdom and lending by banks in other reporting centres. However, with the dismantling of national

barriers it is becoming increasingly difficult to distinguish between 'pure' domestic and international banking business and it is likely, particularly in London, that a proportion of local, domestic currency, business is in fact related to international financial transactions.

Analysis by centre

Japan maintained its position as the largest international banking centre in 1989, increasing its share of total international lending to 21½% at end-September 1989, compared with the United Kingdom's 19½%. According to the Banker's annual survey, the seven largest banks in the world ranked by assets are Japanese. In addition, the activities of overseas branches of Japanese banks have continued to grow strongly, particularly in the United States, the United Kingdom and some other European centres. In the past a tightly regulated domestic market has encouraged Japanese banks into the international banking market. There are signs that the easing of regulations in the domestic market at the end of 1988 may have encouraged some repatriation of cross-border business by Japanese banks. Nevertheless, international business by banks in Japan continued to expand quite strongly in the first three quarters of the year, probably boosted, at least to a degree, by the easing in April 1989 of regulations governing transactions with the Japanese offshore market; indeed a substantial proportion of the growth of international lending over the year was in the offshore market. Unusually, Japanese banks were net exporters of funds in the first nine months of 1989, but there were continuing substantial net inflows to non-banks.

International transactions of Japanese banks have been influenced in the past by seasonal activities related to the publication of their financial accounts. Findings from statistical analysis within the Bank suggest that this seasonal pattern has been weakening in recent periods. Increased activity by Japanese banks observed particularly in the third quarter of recent years may have been influenced as much by conditions in the domestic market as by window-dressing activity.

The shares of total international banking business of banks in the *United States* and *Canada* slipped to 9.4% (10.1% in 1988) and 1.2% (1.3% in 1988) respectively at end-September 1989. US non-banks, however, increased their international borrowing by 11% and withdrew international deposits (-6%). Overall, the United States continued to be a substantial net importer of international banking funds.

The share of total international lending of banks in the *reporting offshore centres* fell by one percentage point to 17½% at end-September 1989. Cross-border business on both sides of the balance sheet grew by about 7% compared with 11% the previous year. Deregulation in a number of domestic markets may have reduced the need to use the offshore centres to some extent but the business of banks in some offshore centres, particularly Hongkong

and Singapore, with banks in other reporting centres continued to grow strongly. Over 60% of the claims of Hongkong banks were *vis-à-vis* Japan at end-1989, with business between the centres having grown noticeably in recent years since the establishment of the Japanese offshore market.

The international activities of reporting banks in *Europe* increased more rapidly in the first nine months of 1989 (9%) than in the previous year (6%) but their share of total international lending remained more or less unchanged at just under half. As mentioned above, the single market,

Table E
International banking analysed by centre

\$ billions

	End-September 1989			Total(a)	Percentage share of total		
	Foreign currency lending to:		Domestic currency lending to non-residents		End-Dec.		
	Residents	Non-residents		1987	1988	1989(b)	
Gross lending	1,123	3,518	1,252	6,100			
<i>of which:</i>							
Belgium	45	143	9	197	3.8	3.4	3.2
Luxembourg	38	205	3	246	4.2	4.1	4.0
France	73	267	47	387	6.6	6.3	6.4
Germany, Federal Republic	5	69	151	225	4.0	3.8	3.7
Italy	40	58	3	101	1.9	1.9	1.7
Netherlands	21	116	29	166	2.5	2.5	2.7
Switzerland	18	59	48	126	2.8	2.4	2.1
Swiss trustee accounts	207	3.4	3.1	3.4
United Kingdom	282	822	72	1,176	22.1	20.9	19.3
Other European countries	95	127	24	246	3.9	3.8	4.0
Canada	25	44	4	72	1.5	1.3	1.2
Japan:							
'Offshore' market	68	244	168	480	4.0	6.8	7.9
Other	413	227	191	831	14.6	14.2	13.6
United States:							
International banking facilities	..	60	273	333	5.4	5.6	5.5
Other	..	11	226	237	4.4	4.5	3.9
'Offshore' banking centres	..	1,066	4	1,070	18.0	18.5	17.6

.. not available.

Source: BIS.

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

(b) End-September 1989.

capital liberalisation and the growing presence of Japanese banks in Europe have all contributed to the faster rate of growth. For some time now Japanese banks have been the major players in international banking business conducted in the United Kingdom and during 1989 they increased their presence in Germany and France.

While the United Kingdom remained by far the most important international banking centre in Europe, its share of total international banking business fell nearly 2 percentage points in the first nine months of 1989 to just under 19½%. This was largely owing to an absolute fall in local foreign currency interbank lending. The Netherlands and France recorded the highest growth of international banking activity with lending rising by 23% and 14% respectively. Strong growth was also recorded in Belgium and Luxembourg (12%), Germany (11%) and Austria (10%).

It is difficult to pinpoint the reasons for the very strong growth of international business in the Netherlands in the first nine months of the year. Most of the new lending was cross-border with the focus apparently on business with EC partner countries. In France the strongest growth occurred in the first quarter of the year under the combined influences of the opening of a new Japanese branch there and a further easing of exchange control. In Germany, lending was mostly cross-border and much of it was in deutschemarks. A balancing outflow of funds through the banking system is likely to have been stimulated by the continuing accumulation of large financial surpluses, as a reflux of long-term capital following the announcement of the repeal of the withholding tax on domestic interest income in April added to the inflows on current account. The avoidance of domestic reserve requirements may also have played a part. In the latter part of the year, developments in Eastern Europe may also have had an influence, although lending by West German banks to East Germany is recorded as domestic business and therefore does not affect international banking data. BIS figures show an absolute fall of some 10% in international claims of banks in Switzerland, but this excludes the placement of funds held on trust which grew steadily though the year to stand at \$207 billion in September 1989.

In the United Kingdom, cross-border business continued to grow strongly during the year, most of the lending being in foreign currency. Japan and continental Europe were the major recipients of funds. Japanese banks continued to use London as a funding centre for the operations of connected offices elsewhere in the world. Interbank lending accounted for over two thirds of new external business but lending to non-banks increased nearly twice as fast as it had in the previous year. Local foreign currency lending accelerated a little in 1989 owing entirely

Table F
Net cross-border banking flows

\$ billions; flows exclude estimated exchange rate effects

	Flows			Outstanding at end-Sept. 1989
	1987	1988	1989(a)	
Net borrowing/lending(-)				
By residents of				
United States				
Banks	47.9	13.5	3.7	38.2
Non-banks (b)	4.5	5.8	31.1	-42.3
Total	52.4	19.3	34.8	-4.1
Germany, Federal Republic				
Banks	-4.1	-8.7	-4.1	-77.0
Non-banks (b)	1.9	0.2	-16.1	-0.5
Total	-2.2	-8.5	-20.3	-77.5
Japan				
Banks	24.6	23.3	-30.9	15.8
Non-banks (b)	26.2	13.6	21.3	69.6
Total	50.7	36.9	-9.6	85.4
United Kingdom				
Banks	6.2	27.6	28.8	106.3
Non-banks (b)	-2.9	3.6	1.1	3.1
Total	3.3	31.2	29.9	109.4

Source: BIS.

(a) January to September.

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

to lending to non-banks which increased by 26%. The largest increase was to the non-bank financial sector (+£12½ billion), with Japanese banks accounting for a fifth of outstanding lending to this sector at end-November 1989. Foreign currency lending to manufacturing industry grew by £6½ billion, with EC banks accounting for a quarter of outstanding lending at end-November 1989. Local foreign currency interbank lending fell by 10%.

Japanese banks remained the largest nationality group in London but their share of international lending fell from 36½% at end-1988 to 35% at end-1989. With the British banks' share also falling slightly and the US banks' share broadly stable, it was the continental European banks which made ground in 1989, bringing their share of international assets up to 22% from 20% at end-1988.

International capital markets

The international bond market

Issues of fixed-rate bonds, at \$235 billion in 1989, reflected a doubling of equity-related bonds and a decline in the volume of straight issues; floating-rate issues were little changed. After repayments, total net issues amounted to almost \$170 billion.

Table G
Announced^(a) international bond issues

	1987	1988	1989
\$ billions			
Fixed-rate bonds			
Straights	117.0	160.0	149.3
Equity-related bonds	43.3	41.8	85.1
of which:			
Warrants	25.7	29.7	69.6
Convertibles	17.6	12.1	15.6
Bonds with non-equity warrants (currency, gold, debt)	3.3	1.2	0.5
Total fixed-rate bonds	163.6	203.0	234.9
Floating-rate notes	12.0	23.5	24.2
Total gross new issues	175.6	226.5	259.1
Repayments	71.1	78.8	89.6
Total net new issues	104.5	147.7	169.5

Source: Bank of England ICMS database, BIS.

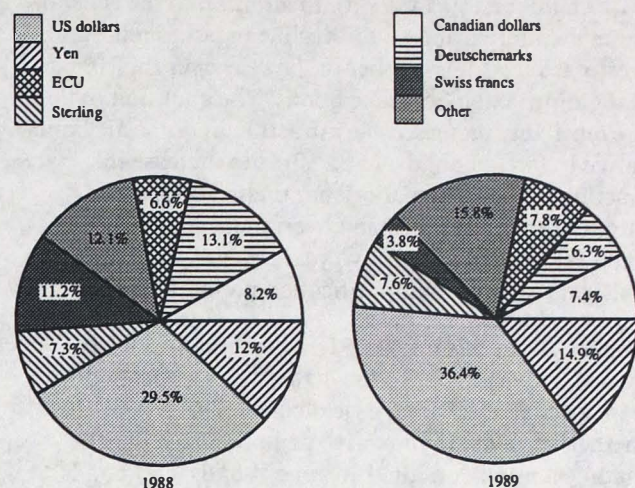
(a) The differences in totals between this table and Table A reflect the difference between announcements and completions.

Straight fixed-rate bonds

The decline in straight fixed-rate bonds was concentrated in the non-dollar currencies as investors required a risk premium for the greater currency volatility and because of rising interest rates resulting from some tightening of monetary policies. A reduction in the external financing requirements of a number of sovereign borrowers following improved budgetary positions also contributed to the decline. There was a small increase in secondary market activity, reflecting an increase in the turnover of dollar-denominated eurobonds.

Primary issues denominated in dollars rose to \$54.2 billion in 1989—36% of the total of straight fixed-rate bonds. Earlier in the year, the appreciation of the dollar and the decline in US interest rates created a positive sentiment towards dollar eurobonds. However,

Chart 1
Currency composition of straight fixed-rate international bonds

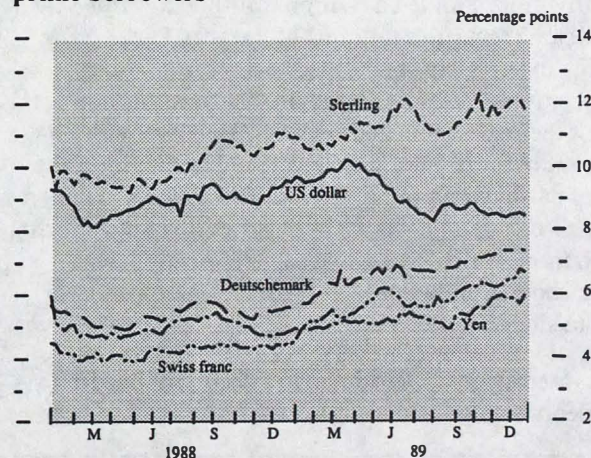


Source: Bank of England ICMS Database.

sentiment was affected later in the year by the re-emergence of concerns over event risk and fears over the implications for the eurobond market of the US junk bond crisis. This led to some substitution by investors away from eurodollar corporate issues towards higher quality bonds such as US Treasuries and other sovereign or supranational issues causing spreads on eurodollar corporate issues to widen.

A number of large deals on behalf of sovereign and supranational borrowers supported the eurodollar bond market over this period. Among these was the IBRD's \$1.5 billion global bond issue, the first fully fungible issue launched simultaneously in both the US domestic and the eurodollar market. The potential for greater liquidity enhanced the attraction of the deal, enabling the IBRD to launch the issue at a lower spread than would have been attained had it issued separate tranches in the two markets. However, the ability of other borrowers to take advantage of the global bond technique is thought to be limited to those with very large funding programmes.

Chart 2
International bond yields: 5-year bonds;
prime borrowers



Source: Salomon Brothers.

There was a substantial decline in activity in the foreign deutschemark sector in 1989, with total issues falling to DM 17.6 billion (\$9.4 billion). In addition to the general factors mentioned above, the decline in issues reflected investors' uncertainty earlier in the year over the 10% withholding tax on domestic bonds. The abolition of the tax from 1 July increased the attraction of domestic bonds relative to foreign bonds. In an effort to increase the attraction of deutschemark-denominated bonds as a source of funds, the German government reduced the minimum maturity, from five years to two years, and abolished the minimum notification period for issues.

However, issues of short-dated bonds remained fairly subdued, in part owing to the higher costs associated with the inverted deutschemark yield curve. There were, nonetheless, several innovative deutschemark issues, including a number of dual currency bonds, and bonds with redemption formulae linked to the performance of stock indices. Higher inflation and a weaker currency were the reasons for the decline in Swiss franc bond issues to Sw.Fc. 8.9 billion (\$5.6 billion).

In spite of rising inflation and tight monetary policies in many of the countries whose currencies comprise the ECU, issues amounted to a record ECU 10.6 billion (\$11.7 billion), almost 8% of all straight fixed-rate issues. Despite the higher cost of funds, there was a marked increase in issues by corporate borrowers, partly reflecting attractive swaps created by tax arbitrages resulting from several ECU Treasury Certificate issues by the Italian government. In addition, the market was supported by institutional investors, although earlier in the year uncertainty over the recomposition of the ECU had led to some selling of ECU bonds as investors anticipated that the higher yielding new currencies (the Spanish peseta and the Portuguese escudo) would put upward pressure on ECU yields, and lead to capital losses. In the event, the recomposition of the ECU led to only a modest rise in yields.

The volume of euroyen issues increased to ¥3,092 billion (\$22.3 billion) partly reflecting a sharp rise in issues of maturity below four years, following the relaxation of the minimum maturity limit from four years to one year and a day. Investors adopted a cautious attitude towards yen fixed-income securities for most of the year. However, a widening in yen swap spreads led to a surge of issues in December (worth almost \$6 billion). Throughout the year, many of the issues launched were private placements, a significant proportion of which were tailored to meet the needs of particular investor groups. These issues included several zero-coupon deals, step-up issues (ie issues which have coupons which are increased periodically), dual currency bonds, and issues with redemption formulae linked to stock-market indices.

Higher interest rates contributed to a decline in fixed-rate issues denominated in sterling to £6.6 billion (\$11.4 billion).

The sector was also affected by the re-emergence of concerns over event risk following Hoylake's hostile bid for BAT Industries. As a result, it became more difficult for UK corporate borrowers to issue sterling eurobonds without providing substantial premia and/or strict event risk covenants, and by year-end spreads over gilts had widened appreciably. The market was, however, boosted by the liberalisation measures which were introduced in the 1989 UK Budget allowing eurosterling issues with maturities of less than five years and sterling medium-term notes.

In the United Kingdom, banks reassessed their ability to engage in swaps with non-corporate counterparties following the uncertainty surrounding the legality of local authority swap deals with banks and the High Court's ruling in October that Hammersmith and Fulham's swap activities were *ultra vires*.⁽¹⁾

Among the other high-yielding currencies, primary activity in both the Australian and Canadian dollar sectors declined in 1989. The total volume of issues in a number of smaller currency markets rose sharply during 1989. The growth reflected deregulation, which enhanced the ability of borrowers to issue bonds in currencies such

Table H
Eurobond issues in emerging markets

\$ millions			
Currency	1987	1988	1989
Danish krone	1,440.7	1,119.6	276.6
Portuguese escudo	—	34.7	44.9
Italian lira	794.7	1,754.4	3,750.2
Irish punt	—	—	131.8
Spanish peseta	240.6	731.1	2,159.3
Austrian schilling	911.4	1,156.2	1,280.3
Swedish krona	45.1	80.2	1,383.2
Total	3,432.5	4,876.2	9,026.3

Source: Bank of England ICMS database.

as Swedish kroner, and also strong demand for high-yielding liabilities of some ERM member currencies.

Equity-related bonds

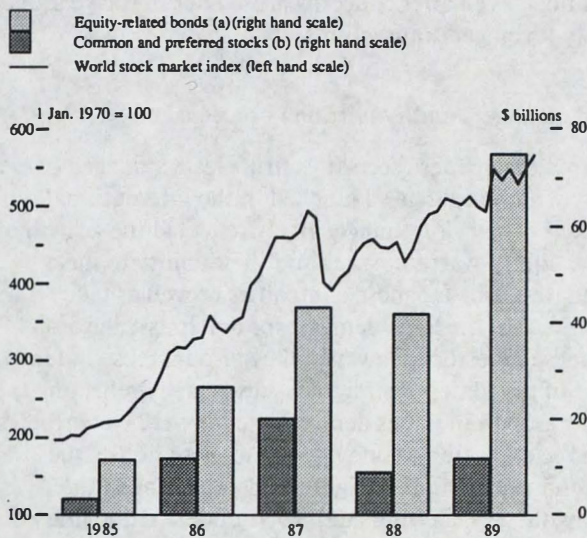
The sharp increase in equity-related bonds resulted from a higher volume of bonds with equity warrants attached, most of which were denominated in US dollars. The main factor responsible for the growth in this sector was the buoyancy of Japanese equity markets, especially in the first half of the year. Other factors included the expansion of the retail investor base in Japan, as well as earlier fiscal and accounting changes which increased the attraction to Japanese banks and life insurance companies of capital gains relative to coupon and dividend income. These factors also encouraged the development of secondary market trading in Tokyo. Later in the year some weakening in equity markets, bouts of over-supply and less attractive post-swap yen funding costs contributed to the moderation in the pace of issues.

(1) In February 1990, the Appeal Court concluded that those interest rate swaps which Hammersmith and Fulham entered into in order to manage interest rate risk were lawful, but those which were entered into for the purpose of trading were illegal.

International equities

The primary international equity market encompasses the underwriting and distribution of equity to investors in markets outside the issuer's domestic market by international syndicates of securities firms and banks. It includes equity offerings of common or preferred stocks; targeted foreign offerings (equity issued in a particular foreign market); and the issue of registered stocks which can be transformed to enable them to be traded on overseas markets as domestic instruments, such as American Depository Receipts.

Value of international equity and equity-related bond offerings



Source: Morgan Stanley, Euromoney Bondware and Bank of England ICMS Databases.

- (a) All euro-equity offerings, targeted foreign offerings, and American Depository Receipts.
 (b) Convertible bonds and bonds with equity warrants.

The international equity market grew particularly rapidly from 1982 to 1987, owing to rising world stock markets and international portfolio diversification. Then the worldwide stock market crash of October 1987 brought the growth of international issues to a halt, as investors tended to want to reduce their international exposures. In the post-crash environment new issues of international equities fell sharply, from \$8.8 billion in the third quarter of 1987 to \$1.3 billion in the fourth. The value of international equity offerings remained low in 1988 at \$9 billion (although issues of equity-related bonds were less affected, because the main issuers were Japanese, and the Tokyo stock market recovered rapidly in 1988). The primary market for international equities recovered to \$14.9 billion in 1989 (although this was still below the 1987 level), indicating that the October 1987 crash may not have reversed what is a long-term trend towards international portfolio diversification and increased issues of international equity. As was the case for domestic new issues, the most important reason for the increase in international equity offerings in 1989 was that stock markets around the world rose for most of the year.

Continental European companies in particular have been able to take advantage of rapidly rising equity

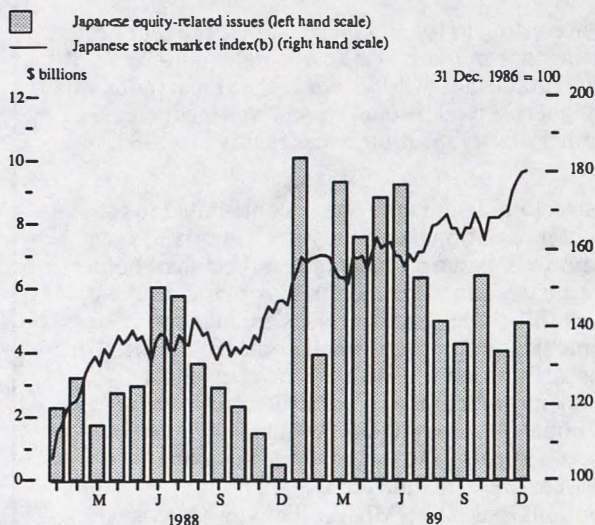
prices (according to the Financial Times, the index of European stock markets was 26.9% higher at the end of 1989 than at the end of 1988, while the global index was 21.2% higher). An additional reason was the increase in the number of privatisation issues relative to 1988.

Other structural factors may have contributed to the growth in international equity issues. Companies may want to broaden and strengthen their shareholder base, and to seek the finest available pricing for their equity. In this context, many issues are made to overcome the constraint of small domestic markets, or markets already satiated with a firm's paper. An increasing number of issues are structured with international investors in mind, though still often undertaken as part of standard domestic issues. Examples of these include the Dfl 1.2 billion (\$0.6 billion) issue for NMB-Postbank, which was deemed too large to be issued solely on the Amsterdam Stock Exchange; the \$900 million issue for Euro-Disney, in which half the shares were issued outside France; the \$1.1 billion privatisation of Repsol, the Spanish state and oil company, in which \$430 million of equity were offered abroad; and a number of issues by international banks.

The management of an international equity issue can be highly profitable for investment banks although greater competition to win mandates may eventually cut margins. Two approaches to the placement of international equities have developed. In the past most were syndicated along what is termed a 'flexible' approach, in which syndicate members were able to sell their allocations anywhere they wished, thus allowing the supply of shares to flow to where demand was greatest. This tended to result in shares being placed with large institutional investors in London. Increasingly, however, placements are based on the 'ring fence' method of syndication, whereby the lead manager organises syndicates for each region or market in which the shares are to be sold. The syndicate members are then not allowed to sell their allocation of shares outside the country or area allocated to them. In this way, the lead manager tries to exert more control over placement.

The settlement of international equity transactions takes place either in the issuer's country of residence, or through domestic depositories that maintain a pool of foreign stocks and settle according to local procedures, or through international depositories, such as Euroclear and Cedel which are themselves linked to the national systems. The important differences which exist in the settlement procedures of the leading exchanges, such as different timetables and costs, may represent a barrier to the expansion of cross-border equity trading. The failure of some transactions to settle is partly due to the nature of telex-based trade-matching mechanisms, which can result in delays, errors and disputes over the terms of transactions. In recent years there has been greater attention to the need to reduce the various risks arising from delays and failures in international settlement by improving the efficiency of settlement systems.

Chart 3
Japanese equity-related issues^(a) and equity prices



(a) Source: Bank of England ICMS Database.
 (b) FT-Actuaries world index.

There was also an expansion of equity warrant issues in currency sectors which had hitherto witnessed only modest levels of activity, including a near tripling of issues denominated in deutschemarks (to \$3.2 billion), while issues made in Swiss francs were almost double their previous year's level (\$2.5 billion).

Issues of convertible bonds also increased, mainly the result of a higher volume of issues denominated in Swiss francs. The first issue since 1987 of a yen domestic bond issue with equity warrants occurred in the third quarter, following regulatory changes in April which were intended to facilitate the issue of such bonds and lower the cost of yen financing. By the end of the year ten domestic yen issues worth ¥435 billion (\$3.1 billion) had been introduced in Tokyo.

In December, the market was unsettled by proposals from Japan's Ministry of Finance (MoF) that all Japanese equity warrant issues should be listed on the TSE and that primary issues of Japanese equity warrant eurobonds should be registered locally. The main aim of the proposal was to improve price transparency in Japan's secondary market for warrants. It led to discussions at the end of the year between market practitioners and the MoF to determine ways in which the MoF's aims could be met without impairing liquidity in the market.⁽¹⁾

Floating-rate notes

Issues of FRNs in 1989 amounted to \$24.2 billion, much the same as in 1988. Higher interest rates in most of the major non-dollar currency sectors sustained demand for floating-rate instruments among investors. The volume of issues denominated in sterling fell, reflecting a slowdown in the pace of mortgage-related financing by UK specialist

mortgage lenders and UK building societies. The mortgage-backed securities (MBS) market nevertheless continued to dominate the sterling sector. Following the liberalisation of sterling bond maturities announced in the 1989 Budget, one of the specialist mortgage lenders launched the market's first issue to be based on the US 'collateralised mortgage obligation' structure, where mortgage redemptions are used to repay sequentially tranches with different maturities. The variable-rate note (VRN) structure introduced in 1988 continued to be used principally by UK banks to strengthen their capital bases. In a further development, several issues (worth almost \$2 billion) were introduced which were collateralised by portfolios of LBO loans or high yield bonds. These issues continued even after concerns arose later in the year over highly-leveraged transactions.

Lead managers and syndication procedures

The major Japanese securities firms lead-managed over a third of all bond issues launched in the international markets. Their dominance largely reflected the growth of dollar equity-warrant issues and their ability to meet mandates from Japanese companies as well as take advantage of the large demand for dollar assets from Japanese investors. However, they also increased their share of mandates of straight issues—partly reflecting the strong growth in issues denominated in yen. Nevertheless, with the exception of one major Japanese house, the lead-management of straight bonds was concentrated among the US, German and Swiss underwriting houses.

The equity-related sector provided one of the major sources of profits in the eurobond market during 1989, helping to offset low margins and losses in other sectors. Concerns over low profitability resulted in the introduction of a number of measures to improve syndication procedures and encourage more realistic pricing of bonds. In April new guidelines regarding stabilisation fees and allotments to co-managers were published. In the third quarter a major US house introduced US style underwriting procedures with the aim of ensuring a more orderly market and arresting the decline in underwriting commissions. (Under this method the syndicate underwriting the bond issue agrees to sell the bonds at a fixed price to primary market investors. This may be compared with the traditional methods where in practice syndicate members sell bonds at different prices, often at a discount, to attract investors.) By the end of 1989, over 30 new issues had been syndicated employing fixed-price re-offerings, in both the dollar and a variety of other currencies. These amounted to an equivalent of \$9.6 billion, or 18% of straight eurobonds launched since July. However, it is recognised that the method does have certain limitations, especially where the issue involves swap arrangements or where there is a high proportion of retail investors.

(1) By March 1990 the registration requirement had been introduced, while following discussions with both domestic and foreign houses the MoF had agreed to the introduction of an interdealer broker system to improve price transparency. For a discussion of other developments in this sector during the first quarter of 1990, see page 193.

Table J
Announced euronote facilities

	1987	1988	1989
ECP/ECDs	46.3	52.7	47.9
NIFs/RUFs	15.2	10.5	6.6
MTNs(a)	12.0	16.1	11.8
Total	73.5	79.3	66.3

Source: Bank of England ICMS database.

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

Euronotes

The volume of announcements of new euronote facilities declined to \$66 billion in 1989, reflecting the fact that many of the large and creditworthy borrowers already had programmes in place. The reduced level of primary market activity in the ECP market may also in part be explained by the inversion of the yield curves in the major OECD countries for part of the year. However, the estimated stock of outstanding euronotes increased (to \$79.2 billion at the end of 1989), reflecting an expansion in eurocommercial paper (ECP) and euro-medium term notes (EMTN), which more than offset the decline in notes issued under committed facilities.

In the second half of the year the ECP market was affected by defaults among a number of ECP issuers. Traditionally, investors in the euromarkets have attached less importance to credit ratings on short-term obligations than have US investors. But the cumulative effect of the defaults was a reassessment by euromarket participants of the risks involved in purchasing short-term corporate securities. Dealers reported that the placement of unrated paper became much more difficult, and that the spreads on unrated and lower-rated paper had widened. The renewed focus on credit ratings may also have made it more difficult for lower-rated borrowers to establish facilities, thereby contributing to the reduction in the level of announcements. It is likely, however, that the defaults will nevertheless accelerate the trend towards a fully rated market. It has been estimated that 45% of outstanding programmes at the end of the year were rated, and that some 70% of the paper issued came from highly-rated programmes. The ECP market was also affected by the decision by a number of dealers to phase out their ECP operations.

The volume of new EMTN programmes announced declined to \$11.8 billion in 1989. The decline was in part a result of the tendency for borrowers to establish programmes in the US MTN market owing to its larger size and greater liquidity, although the competition from eurobonds in the form of small tranches of fungible tap issues may also have contributed to the fall in announcements. Institutions that have announced EMTN programmes have tended to be banks, financial institutions active in the financing of consumer durables, and sovereign entities. However, in 1989, industrial and service corporations were the predominant arrangers of such programmes. EMTN programmes are generally regarded as providing a useful complement to more

established types of securities, since they can be tailored to meet the requirements of both issuers and investors in terms of size, maturity, currency denomination and coupon structure. The growth of the EMTN market is expected to be further stimulated by various liberalisation measures which have both opened up new sectors of the market, for example in the United Kingdom, Germany, and Japan, and provided further encouragement to the introduction of multicurrency programmes.

International syndicated credits

The international syndicated credits market continued to recover from its low point of the mid-1980s. The value of announced credits increased to \$152 billion, mainly reflecting a growth in funding for borrowers from the major OECD countries, although there was also a rise in credits for borrowers from developing countries. The value of merger and acquisition related credits increased from 25% of credits announced in 1988 to 37% in 1989. Much of this increase was related to the largest ever syndicated loan, a \$13.6 billion credit on behalf of Kohlberg Kravis Roberts for the leveraged takeover of RJR Nabisco. Participation in such deals was particularly attractive to the banks as they could earn high margins and fee income through the provision of related services and products, such as interest rate hedging instruments. The strong demand for mergers and acquisition finance partly explains the rise in spreads seen over the year in the credit market.

Table K
Announced eurocurrency syndicated credits

	1987	1988	1989
Country of borrower:			
Major OECD	61.4	70.5	99.1
Minor OECD	15.0	18.3	25.7
Developing countries	9.6	9.3	25.1
Eastern bloc	1.9	1.2	2.2
Other	0.8	0.2	0.2
Total	88.8	99.4	152.2

Source: Bank of England ICMS database.

The Basle capital adequacy rules have reportedly led to increased activity in the secondary market for loan syndications. Banks are less interested in keeping drawn facilities on their books, since the spread often does not meet the cost of capital required to cover them under the Basle rules. The result has been an increase in the volume of credit transfers to smaller banks and to corporations outside the banking sector (such as insurance companies), by for example sub-participation, which earns the originating banks fee income, and which enables them to reduce the assets on their balance sheets.

Borrowing activity by country group

Aggregate borrowing through the international banking and capital markets by major OECD countries as a group rose by over \$55 billion in 1989. Most of the increase was, however, concentrated in two countries—Japan and the United States. Issues of fixed-rate bonds by Japanese borrowers virtually doubled, most of which reflected

Table L
Total borrowing activity by country grouping

\$ billions, at quarterly rates

	1987	1988	1989
OECD	75.3	90.6	104.1
<i>of which:</i>			
United States	13.7	9.9	19.0
Japan	13.2	14.8	26.5
United Kingdom	13.1	18.3	12.6
Developing countries	2.2	2.6	5.6
Oil producers	0.6	0.8	1.5
USSR, China and Eastern Europe	1.6	0.8	1.1
International institutions	4.8	5.8	6.5
Total	84.5	100.5	118.8

Source: Bank of England ICMS database.

equity-related issues by Japanese corporations. An increase in syndicated credits by US companies, much of which was related to merger and acquisition activity, accounted for all the growth in borrowing by entities in the United States. The increase in borrowing in these two countries was more than sufficient to offset the fall which occurred in several other major OECD economies, including the United Kingdom.

The OECD countries as a whole continued to dominate the markets, accounting for over 87% of total activity.

Analysis of borrowing by sector reveals a decline in sovereign bond issues (from \$30 billion in 1988 to \$24 billion last year), mainly a reflection of the tight fiscal policies and continued declines in budget deficits in several countries. Concerns over credit risks, and the corresponding increase in funding costs, adversely affected issues of corporate bonds, especially in the United States and the United Kingdom. The smaller OECD countries as a group recorded an overall decline in euromarket activity. Borrowing by developing countries rose, most of which was via the credits market. The increase in borrowing by oil producing countries was mainly the result of a surge in borrowing by Indonesian state entities as a result of an intensive capital investment programme. An increase in syndicated credits accounted for much of the rise in international financing activity by Eastern European borrowers: the principal borrowers remained the traditional state-owned entities such as the USSR's Vnesheconombank and the National Bank of Hungary, although the relaxation in foreign borrowing laws in the USSR, the first stage in a long term process of liberalisation, allowed the introduction of other Soviet borrowers to the euromarkets.