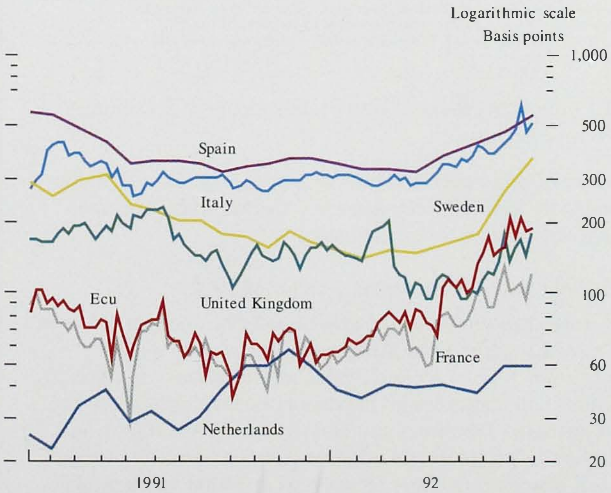
Financial market developments

Economic uncertainties unsettled many financial markets

Growing uncertainties over European economic and monetary union and the divergence of interest rates among the major economies were reflected in widespread instability in international financial markets during the third quarter. The overall level of activity in the international bond markets nevertheless remained high. Many investors switched into the 'safe haven' of assets denominated in deutschmarks, dollars, yen and Swiss francs.

The disturbance in European markets was reflected in several financial indicators. Bond prices in some European currency sectors were particularly volatile. As Chart 1 shows, spreads on government bond yields relative to German bunds rose steeply in some countries. The price of Ecu bonds fell further below their theoretical level (constructed from the basket of underlying currency sectors). In the eurobond market, corporate bond yields generally rose relative to government benchmark bonds, as risk premia were marked up in some sectors. Historic and implied volatilities for most European bond futures also rose significantly during September.

Chart 1
Government bond yield differentials[(a)]

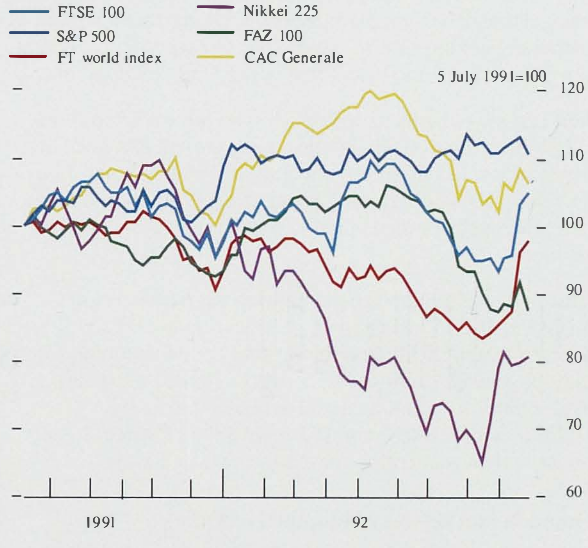


Note: Weekly data except for the Netherlands, Spain and Sweden.
Source: Bloomberg and Datastream.

(a) Ten-year government bond yield differential over German bonds.

Equity prices in a number of smaller European and Scandinavian countries fell by up to 20% during the third quarter. The UK equity market was subdued during July and August, mainly reflecting concerns over the outlook for the UK economy. But, as can be seen in Chart 2, share prices rose markedly following sterling's suspension from the ERM as investors anticipated interest rate cuts. The French stockmarket rose slightly at the end of the quarter, although the intense pressure on the franc helped to keep turnover low. By contrast, turnover in German equities rose towards the end of the quarter, but prices fell, reflecting investors' views that a substantial interest rate cut in the near future was unlikely. The US equity market traded in a fairly narrow range, with concerns over corporate earnings and uncertainty over the outcome of the presidential election only partially offset by lower interest rates. In Japan, the announcement of financial system and fiscal support packages during August helped boost equity prices from their six-year low.

Chart 2
Equity indices (a)



(a) End-week prices.

Pressures eased slightly on Japanese banks

The financial system support package, the relative strength of the Nikkei and lower yen interest rates have contributed towards a slight easing of pressure on Japanese banks over recent months. The main elements of the support package (including measures still to be implemented) which will affect the banks were:

- measures to discourage banks from liquidating part of their equity portfolios ahead of their end-September reporting date;
- a proposed new corporation to ease the burden on the banking system of property-backed loans;
- proposals for tax relief to help banks meet the increasing costs of bailing out troubled financial institutions and further tax relief on provisions; and
- an increase in public funds available for stock market investment.

International activity of banks in the BIS reporting area

The international activity of banks in the BIS reporting area declined further in the second quarter (see table), wholly due to the interbank market, reflecting the continuing retrenchment by Japanese banks. Interbank claims between Japan and other centres fell by $99 billion (giving a cumulative fall of $316 billion or 20% since the end of 1990), as Japanese banks unwound business between their domestic and foreign offices. Most of the $42 billion fall in reporting banks' local foreign currency claims also took place in Japan, taking Japan's share of international banking assets (comprising cross-border plus local foreign currency claims) below that of the United Kingdom.

Foreign currency claims in dollars and yen fell by $30 billion and $24 billion respectively, while strong growth was seen in the French franc ($5.5 billion) and guilder ($4.4 billion). Ecu claims fell by $3.3 billion, after a rise of $8.2 billion in the first quarter, with banks in the United Kingdom recording a fall of $7.9 billion.

Countries outside the reporting area were net borrowers of funds, taking up $15 billion, with new lending to OPEC countries and non-OPEC developing countries accounting for $7.5 billion and $3.1 billion respectively. Banks' outstanding assets and liabilities with Eastern Europe both rose by $1.9 billion, with further interest arrears by the Former Soviet Union more than accounting for the increase in claims.

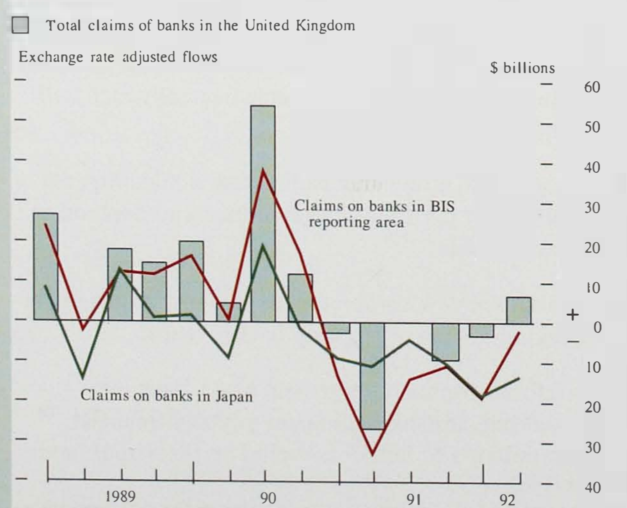
The London market—second quarter 1992

Total cross-border business of banks in the United Kingdom was fairly flat in the second quarter. A large fall in claims on banks in Japan ($14.6 billion), continuing the decline since the fourth quarter of 1990, was largely offset by increased interbank claims on other countries (see chart), notably the offshore banking centres and the United States, which rose by $7.2 billion and $4.3 billion respectively.

Shifts in the interbank market also dominated movements in liabilities. Interbank liabilities to the offshore banking centres and the United States rose by $6.1 billion and $8.1 billion respectively, offsetting declines elsewhere, relating mainly to liabilities to banks in Switzerland ($4.4 billion), Germany ($4.1 billion), Japan ($3.9 billion) and Italy ($3.4 billion).

Outside the BIS reporting area, liabilities increased by $3.7 billion, with liabilities to non-oil developing countries up

External lending of banks in the United Kingdom



Cross-border business of banks in the BIS reporting area

$ billions: changes exclude estimated exchange rate effects

	1991 Q2	1991 Q3	1991 Q4	1992 Q1	1992 Q2	Levels at end Q2	Changes Q3 (b)
Liabilities to countries:							
BIS area	-135	-36	40	-48	-52	5,102	
of which, interbank	*-120*	*-36*	*50*	*-63*	*-53*	*4,128*	
Outside BIS area	-7	10	3	-8	2	722	
Unallocated	8	-5	18	27	13	463	
Total	**-135**	**-32**	**61**	**-29**	**-37**	**6,287**	
Claims on countries:							
BIS area	-101	-8	104	-55	-35	5,240	
of which, interbank	*-121*	*-28*	*85*	*-79*	*-67*	*3,994*	
Outside BIS area	-8	6	17	10	15	790	
Unallocated	1	-2	-8	8	3	130	
Total	**-108**	**-4**	**114**	**-38**	**-17**	**6,160**	
Of which transacted by banks in the United Kingdom (a)							
Liabilities to countries:							
BIS area	-35.3	5.5	-9.0	-19.8	-10.5	809.8	
of which, interbank	*-28.0*	*-0.6*	*-2.0*	*-16.4*	*-3.5*	*597.9*	
Outside BIS area	6.6	2.1	-3.3	-1.5	3.7	173.0	
Unallocated	-3.3	-7.9	7.6	7.0	6.9	119.7	
Total	**-32.0**	**-0.3**	**-4.7**	**-14.3**	**0.1**	**1,102.5**	**38**
Claims on countries:							
BIS area	-30.2	-3.9	-8.6	-11.2	-0.3	846.3	
of which, interbank	*-33.9*	*-15.3*	*-11.4*	*-20.0*	*-2.7*	*638.8*	
Outside BIS area	-0.2	-0.6	-0.5	2.4	0.9	112.7	
Unallocated	2.5	3.4	-1.3	4.5	6.6	24.9	
Total	**-27.9**	**-1.1**	**-10.4**	**-4.3**	**7.2**	**983.9**	**54**
Claims by currency							
US dollar	-23.2	-3.9	-8.9	-10.5	7.4	467.2	12
Deutschmark	0.5	0.4	-10.9	-0.6	-2.6	145.0	8
Sterling	-6.2	-2.6	-2.5	1.1	6.2	93.6	17
Japanese yen	-6.1	-0.6	-11.8	-3.6	-11.6	82.4	-1
Claims by nationality of banks (b)							
Japanese	-4.7	-15.1	-7.8	-26.4	-12.[illegible]	265.1	-13
American	1.5	1.0	-1.9	0.7	-2.4	108.0	-3
British	-6.0	3.5	0.9	2.9	3.0	149.7	16
German	-2.7	5.8	2.1	4.1	3.7	111.2	22
French	-3.1	0.4	0.0	3.5	-2.5	36.2	11
Italian	-7.7	0.4	2.9	-0.6	1.7	81.0	5

(a) Also includes some other financial institutions. More details by country and currency are given in a press release issued on 16 September 1992.
(b) Q3 changes are provisional. Nationality and Q3 changes only relate to monthly reporting banks.

by $3.1 billion and those to Eastern Europe by $1.2 billion. Claims rose slightly.

The share of cross-border claims of Japanese banks in London continued to decline. German banks' market share rose and now exceeds that of American banks.

Provisional data for the third quarter of 1992

Provisional data show that the cross-border business of banks in the United Kingdom grew sharply during the third quarter (mainly at the time of the turbulence in the currency markets in September), in contrast with the depressed level of activity in recent quarters. Liabilities and claims rose by $38 billion and $54 billion respectively. In addition, foreign currency business with UK residents also rose sharply, so that total international liabilities rose by $55 billion and claims rose by $67 billion. The net rise in international claims reflected net sterling lending to overseas of $7 billion and a sizable but not unprecedentedly large switch of $5 billion out of sterling by UK banks.

British banks accounted for a considerable share of the international business, with claims and liabilities both up sharply (by $20 billion and $25 billion respectively). The strongest growth, however, was generated by other EC banks, with liabilities up by $42 billion and claims up by $45 billion—German and French banks were particularly active. Japanese banks' international business continued to decline.

The capital ratios of all of the large Japanese banks at the end of September seemed to be back above the minimum target for March 1993 under the Basle agreement. The banks' capital positions benefited from several factors: the relative strength of the Japanese stockmarket, which increased the value of their unrealised portfolio holdings (45% of which qualifies as Tier 2 capital); the strength of the yen against the dollar (which reduced the yen value of banks' dollar-denominated assets); and banks' active measures to raise capital and control assets. The need for further provisions on bad loans, however, may be a continuing drag on profitability.

Banks' performance remained mixed . . .

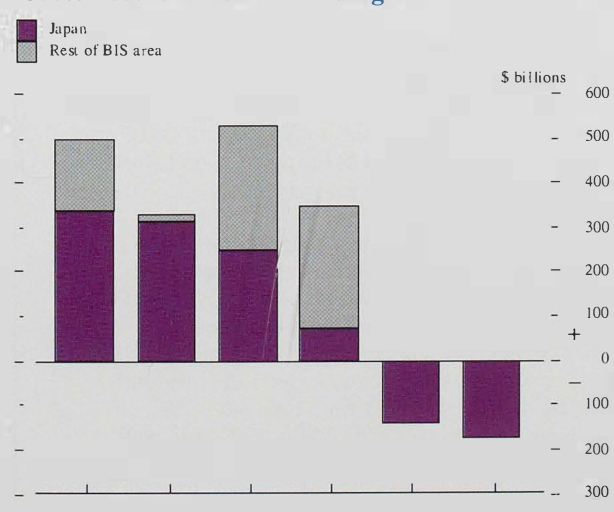
The first half-year results of major British banks were mixed. Some reported improved pre-tax profits, but bad debts and provisions were still high. There are also signs that large banks in several countries (such as France, Germany, Spain and Switzerland) which so far have been less affected by asset quality problems are facing growing pressure on some parts of their loan books. In the Nordic region, bad debts still weigh heavily on the banking sector. By contrast, US banks' earnings continued to recover against a background of lower interest rates, widening margins, stabilising—and in some cases, improving—asset quality, buoyant securities trading revenues and some cost cutting. As a result, the share prices of US banks further improved relative to the rest of the market.

. . . and bank lending was mainly subdued . . .

In the United Kingdom and the United States, outstanding domestic bank lending to industrial and commercial companies has contracted this year, as the tough economic environment and efforts by companies to reduce their gearing have combined with banks' increased focus on asset quality and risk pricing.

As Chart 3 shows, the international interbank market also continued to contract during the second quarter. Banks have continued to reassess the credit quality of some of their counterparties and, in a few cases, have reduced exposure limits. Credit concerns, and the growth and increasing sophistication of risk management instruments such as derivative products, have also led to a shortening of interbank maturities.

Chart 3
Cross-border interbank lending (a)



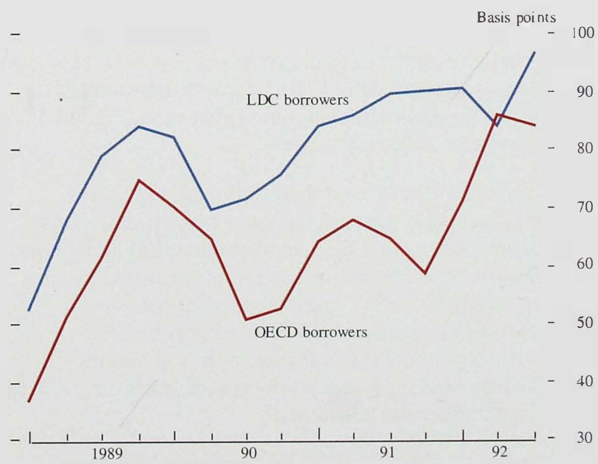
Source: BIS.

(a) Within BIS region only.

. . . with the exception of the syndicated loan market

While net international bank lending has remained subdued, announced international syndicated loans have seen a revival, with the quarterly average for the second and third quarters (some $70 billion) around twice the average for the previous two years. Low dollar interest rates have encouraged company restructuring and refinancing, particularly among US borrowers keen to lock in to low-cost funds. A few top quality companies and supranational and sovereign borrowers (including the United Kingdom, Sweden and the EC) were also attracted to the syndicated loan market during the third quarter. Some of the loans were provided on fine terms but were well oversubscribed, illustrating that banks are still willing to lend to well-regarded borrowers (Chart 4).

Chart 4
Spreads paid on international syndicated credits



Note: Spreads are three-quarter, backward-looking averages weighted by loan size.
Source: Bank of England ICMS database.

The UK loan was a multi-currency revolving credit facility equivalent to ECU 5 billion, with a three-year maturity, and was the first part of foreign currency borrowing of ECU 10 billion announced by HMG on 3 September. The facility can be drawn in deutschmarks, US dollars, yen, Swiss francs or Ecu.

International capital markets

Investors preferred non-European currencies

The level of gross bond issues in the international markets, at $75 billion in the third quarter, was little changed from the same period of last year (Table A), but the proportion accounted for by floating-rate issues rose. The currency composition of fixed-rate bond issues during the third quarter shifted towards the US dollar, yen and Swiss franc

Recent developments in derivatives and international interbank markets

International interbank markets have seen major changes in recent years. In particular, the use of derivative financial instruments to manage risk has grown rapidly, raising questions about the possible impact on financial markets and how regulators and firms should respond. Last year, the Governors of the central banks of the G10 countries set up a working group to study recent developments in international interbank relations, including the use of derivatives. The BIS has recently published the group's report (the Promisel Report).(1)

The report, which drew upon interviews with market participants, identified significant changes in the wholesale markets:

- Distinctions between markets, such as domestic and international, have become blurred. Links among markets and institutions have also been greatly strengthened, partly through the faster spread of information and the greater use of complex instruments and strategies covering several market segments.

- Derivatives activity now spans many wholesale markets (see the table), while some traditional markets (such as interbank deposits) have become relatively less significant. By the end of 1991, the identified outstanding notional value of derivative contracts on interest rates and currencies exceeded the level of BIS reporting banks' international assets. The exposures involved, however, are much smaller than the notional principal: the amount at risk through counterparty default, for example, represented on average on conventional assumptions between 2% and 4% of the contracts' notional value.

- Many banks have restricted their interbank exposures, reflecting increased concern to manage credit risk. This reflects perceptions that the risk of counterparty default has increased, and greater difficulties in assessing and pricing counterparty risks because of the use of entities and complex off-balance-sheet products subject to few disclosure requirements (in, for example, companies' published accounts). These products can, however, be used to manage market risk efficiently.

- Partly because of credit concerns, interbank business seems to have become increasingly concentrated in a relatively small group of institutions. So have more complex transactions, also reflecting the need for advanced systems and expertise to handle OTC derivatives. However, the report also identifies intensified competition resulting from deregulation, which has eroded barriers between segments of the financial industry and between domestic and foreign markets.

Markets for selected derivative instruments

Notional principal amounts outstanding at end-year, in billions of US dollars equivalent

	1986		1987	1988	1989	1990	1991
Exchange-traded instruments (a)	583		725	1.300	1,762	2,284	3,518
Interest rate futures	370		488	895	1,201	1.454	2.159
Interest rate options (b)	146		122	279	387	600	1,072
Currency futures.	10		14	12	16	16	18
Currency options (b)	39		60	48	50	56	59
Stock market index futures.	15		18	28	42	70	77
Options on stock market indices	3		23	38	66	88	132
Over-the-counter instruments (c)	500	(d)	867	1,330	2,402	3,451	4,449
Interest rate swaps (e)	400	(d)	683	1,010	1,503	2,312	3,065
Currency and cross-currency interest rate swaps (e) (f)	100	(d)	184	320	449	578	807
Other derivative instruments (e) (g)	—		—	—	450	561	577
Memorandum item:							
Cross-border plus local foreign currency claims of BIS reporting banks	4.031		5,187	5,540	6,498	7.578	7,497

Sources: Futures Industry Association (FIA), various futures and options exchanges worldwide; International Swap Dealers Association (ISDA); BIS calculations.

(a) Excludes options on individual shares and derivatives involving commodity contracts.
(b) Calls plus puts.
(c) Only data collected by ISDA. Excludes information on contracts such as forward rate agreements, over-the-counter currency options, forward foreign exchange position, equity swaps and warrants on equity.
(d) Estimate.
(e) Contracts between ISDA members reported only once.
(f) Adjusted for reporting of both currencies.
(g) Caps, collars, floors and swaptions.

Market participants identified several further factors which have contributed to changes in interbank relations in recent years. These included: the Basle capital accord and market pressures for higher capitalisation, which have encouraged banks to switch into off-balance-sheet business and in some cases led them to restrain their interbank activity; the continuing institutionalisation of savings and the more active management of portfolios internationally, which has greatly increased the volume and size of domestic and cross-border financial transactions; and continued advances in computer technology, which have enhanced banks' risk assessment and ability to meet more diverse customer demands.

The report welcomes the sensitivity and responsiveness of market participants to the risks they face as helpful in reducing the likelihood of serious disruptions. Some factors, however, could exacerbate any problems: increased links across markets could help to spread problems; the reduced transparency of firms' balance sheets may increase banks' reluctance to support troubled counterparties; the liquidity of markets may prove illusory under stress; and faster price movements and information flows could reduce reaction times.

The report emphasises that to keep pace with the rapidly changing financial environment, market participants should continue to develop management awareness of the risks involved, along with procedures and infrastructures to monitor and control risks. It argues for further efforts to address complex structural issues facing the wholesale markets: enhanced netting schemes (together with resolution of technical and legal issues, currently being pursued in other fora); efforts to improve, and where possible move towards some harmonisation of, accounting and reporting practices for off-balance-sheet instruments; and continuing efforts to resolve legal uncertainties, such as the application of domestic laws to international activities.

The report also points out that the changes present new challenges to central banks and other supervisors which oversee firms active in derivatives markets. It stresses the importance of capital adequacy and appropriate risk management systems within banks and suggests that, to help ensure this, central banks and other supervisers need full understanding of the risks being run. It recommends, for example, improved statistics and continuing liaison with market participants.

(1) The report follows on from two previous studies: 'The international interbank market: a descriptive study', published by the BIS in 1983, and 'Recent innovations in international banking', published by the BIS in 1986.

Table A
Total financing activity:[a] international markets by sector

$ billions, by announcement date

	1990 Year	1991 Year	1991 Q3	1991 Q4	1992 Q1	1992 Q2	1992 Q3
International bond issues							
Straights	172.1	263.5	60.5	59.7	88.8	67.5	51.4
Equity-related	33.0	43.8	11.8	4.7	7.1	3.4	4.7
of which:							
Warrants	*22.6*	*31.8*	*9.6*	*3.6*	*5.3*	*2.4*	*4.2*
Convertibles	*10.4*	*12.0*	*2.2*	*1.1*	*1.8*	*1.0*	*0.5*
Floating-rate notes	57.9	21.4	4.4	4.2	6.1	12.7	18.2
Bonds with non-equity warrants (currency, gold, debt)	0.1	1.0	0.2	0.6	0.4	0.3	0.2
Total	**263.1**	**329.7**	**76.9**	**69.2**	**102.4**	**83.9**	**74.5**
Credit facilities (announcements)							
Euronote facilities	70.6	95.9	17.5	26.5	19.6	24.2	28.9
of which:							
CP	*47.6*	*38.3*	*10.5*	*10.2*	*4.0*	*2.9*	*2.8*
MTNs	*20.2*	*56.0*	*6.8*	*16.2*	*15.5*	*20.7*	*25.9*
NIFs/RUFs	*2.8*	*1.6*	*0.2*	*0.1*	*0.1*	*0.6*	*0.2*
Syndicated credits	164.0	136.7	28.1	37.4	28.2	79.3	62.9
Total	**234.6**	**232.6**	**45.6**	**63.9**	**47.8**	**103.5**	**91.8**
Memo: amounts outstanding							
All international							
Bonds (b)	1,435.3	1,648.3	1,457.3	1,648.3	1,607.1	1,707.9	1,767.0
Euronotes (c)	111.2	144.9	136.9	144.9	156.2	166.5	174.9
of which, EMTNs	*21.9*	*38.5*	*31.4*	*38.5*	*41.0*	*47.5*	*53.7*

(a) Maturities of one year and over. The table includes euro and foreign issues and publicised placements. Issues which repackage existing bond issues are not included. Figures may not add to totals because of rounding. Bond total includes issues from MTN programmes.
(b) BIS adjusted figures, including currency adjustment. Includes issues of fixed-rate bonds and floating-rate notes.
(c) Euroclear figures.

and away from some higher-yielding ERM and Scandinavian currencies (Table B). Those international investors who had anticipated the convergence of interest and inflation rates (and resultant increases in bond prices in the high-yielding currency sectors) saw weakening currencies and falling bond prices reduce the value of their foreign currency bond portfolios.

Table B
Currency composition of fixed-rate bond issues[a]

Percentages of total issues announced

Currency denomination	1990 Year	1991 Year	1992 Q1	1992 Q2	1992 Q3
US dollar	35	33	29	34	43
Ecu	9	11	16	8	—
Deutschmark	5	6	9	8	7
Swiss franc	12	7	4	3	8
Sterling	6	7	4	7	6
Canadian dollar	3	8	5	10	6
Yen	15	13	13	10	13
French franc	4	6	5	12	8
Australian dollar	4	2	2	1	3
Other	7	7	13	7	6
Total	**100**	**100**	**100**	**100**	**100**

(a) Including equity-related issues.

Ecu trading was subdued . . .

Ecu markets suffered in the currency pressures of August and September, reflecting the uncertainty in European markets. Trading volumes in both bond and money markets fell very considerably, partly offset by a rise in turnover on futures exchanges. Securities market activity dried up for several days, as market-makers and investors re-evaluated the prospects for currency union. More recently, however, activity has picked up and Ecu products have outperformed those in Ecu component currencies.

The Bank modified its tender procedures for Ecu Treasury bills, by setting maximum yields at which bids would be accepted in the regular auction held on 13 October. These maximum yields were set at a margin of ten to fifteen basis points below LIBID (tighter than those seen in light and sporadic secondary trading over previous weeks), to encourage market participants to trade bills on terms consistent with the United Kingdom's strong credit standing. The tender sold just over a quarter of the ECU 1 billion on offer and by the end of October the Bank had sold a further ECU 300 million, at similar spreads below LIBID, as the bill market continued to recover. There were also encouraging signs of a recovery in bond market activity and liquidity, as the revival of confidence spread to longer-dated securities.

The authorities decided not to proceed with the fourth tender for Ecu Treasury notes to mature on 24 January 1995. (The Information Memorandum issued in January had scheduled this tender for 20 October.) Such a tender would have added further amounts to a note which is already, at ECU 2 billion, one of the handful of very large issues in the Ecu market. In view of the depressed state of the bond market the authorities judged that it would be most helpful for the market if they did not on this occasion proceed with a tender. The next regular date for a Treasury note tender would be in January 1993.

. . . and sterling debt issues fell

After a spate of new sterling issues early in July, the value of new issues announced fell sharply in August and September. Bond yields became increasingly volatile during the quarter, reflecting uncertainty about the outcome of the French referendum and therefore over the future path of the exchange rate and interest rates.

The uncertain UK economic outlook also reduced demand for UK company debt. The possibility of higher interest rates kept down the level of FRN announcements, while continuing limited interest rate swap opportunities may also have deterred issuers of fixed-rate debt.

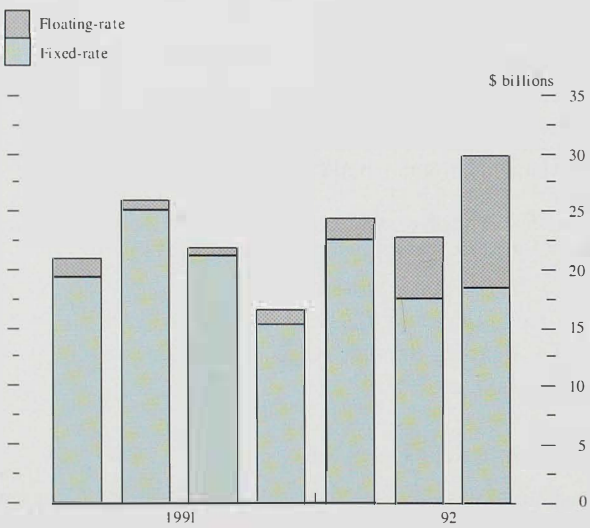
By contrast, the US bond market saw a high level of issues, partly benefiting from the uncertainty in European markets. Utilities and banks were the largest borrowers. Foreign issuers, which are generally less well known in the US domestic market and so often offer higher returns to investors, were also active and met strong demand from US institutions.

Non-financial companies made fewer issues of fixed-rate international bonds during the third quarter, following extensive supply earlier in the year, and reductions in corporate debt ratings contributed to a widening of spreads relative to government benchmarks. However, several OECD governments and state agencies tapped the international markets to strengthen their international reserves. The credit ratings of foreign currency debt of Italy and Canada were recently reduced; the credit rating of Sweden is under review.

The FRN sector saw a revival . . .

The floating-rate note (FRN) sector of the international bond market, which has seen little liquidity in recent years, has witnessed a revival in 1992 (see Chart 5). Much of the recent activity has related to 'collared' FRNs, which offer investors a coupon between predetermined minimum and maximum levels. At times, the minimum coupon has been some two percentage points above dollar LIBOR, providing an attractive investment for those investors who do not expect dollar interest rates to rise significantly.

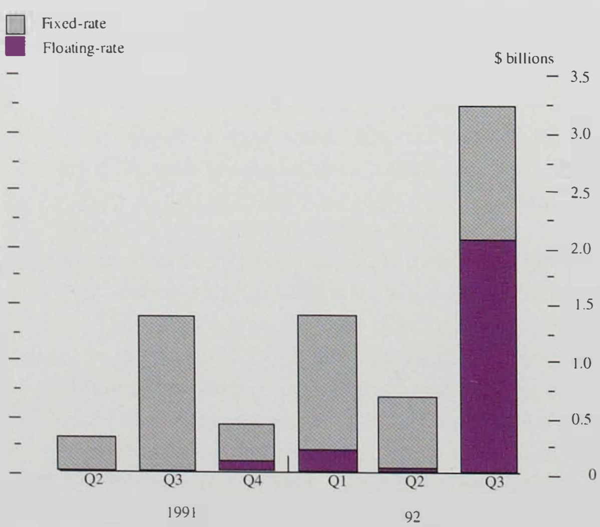
Chart 5
Eurodollar fixed-rate bond and floating-rate note issues



Source: Bank of England ICMS database.

Issuers may have been encouraged to use the FRN sector because there has been a deterioration in the terms on which fixed-rate debt may be swapped into floating rates. The higher earnings of US banks and the perception that their creditworthiness has improved may also have contributed to the revival of FRNs, since banks are significant issuers and investors in the FRN market. Banks' FRN issues, at $6.7 billion, accounted for around one third of all issues in the latest quarter. As Chart 6 shows, Japanese banks have been large issuers of subordinated FRNs, as part of their efforts to improve their capital adequacy.

Chart 6
Japanese banks' issuance in international bond markets

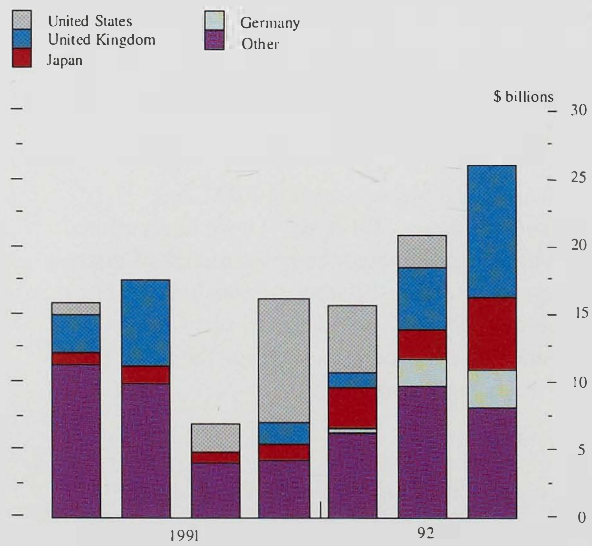


Source: Bank of England ICMS database.

. . . and EMTNs continued to grow

The euro-medium-term note (EMTN) market has continued to grow in recent months, with UK and Japanese borrowers prominent (Chart 7). UK mortgage lenders took advantage of the flexibility of MTN documentation to make further issues, while Japanese companies are showing signs of widening their funding bases away from their reliance on domestic banks. Steps to liberalise the DM debt markets have also allowed issues of DM EMTNs. During the second and third quarters, a number of borrowers established EMTN programmes which included the option to issue in deutschmarks.

Chart 7
EMTN programmes announced by country



Source: Bank of England ICMS database.

In the derivatives markets, the level of currency warrant issues rose sharply during the third quarter as volatility in the foreign exchange markets increased. The total value of announced OTC warrant issues more than doubled (to $4.7 billion) in the third quarter.

Two changes may affect the currency composition of debt issues

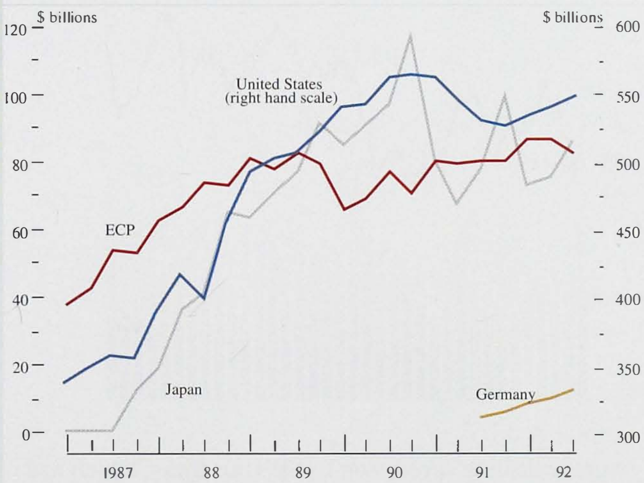
In August, the German authorities took steps to deregulate the DM debt markets and make them more competitive. Several restrictions were lifted:

- for DM debt issued by foreign non-bank issuers to have a minimum maturity of two years;
- for all DM bonds to be cleared domestically;
- for the principal paying agent to be a German bank; and
- for DM commercial paper to be issued through a German-incorporated subsidiary.

Recent developments in overseas commercial paper markets

Commercial paper (CP) is a short-term debt instrument issued by industrial companies and financial institutions for a range of purposes, including working capital and arbitrage. Issues are usually for one to six months, but are often 'rolled over' on maturity. CP is a very flexible funding instrument: once a programme is established, issues can be made almost immediately and often in a range of currencies. In the 1980s, there was rapid growth of CP markets, with many companies able to obtain funds more cheaply by issuing CP than by borrowing from banks. The CP markets remain an important source of finance. In the United States, for example, outstanding CP borrowing reached $530 billion at the end of last year (compared with a total of $620 billion for banks' total commercial and industrial lending).

Selected commercial paper markets



Note: Outstanding issues are converted at end-quarter exchange rates. Latest available data may not be end-quarter.

Source: Central banks, Euroclear.

US CP

The US CP market is the oldest and largest of the CP markets. After strong growth in the market during the 1980s, 1990–91 was flat and 1992 saw only modest growth. Three main factors have contributed to the slowdown: subdued industrial activity has reduced companies' short-term financing needs; low interest rates and a steep yield curve have increased the relative attractiveness of longer-term fixed-rate debt; and from June 1991, the Securities and Exchange Commission reduced the limit on investment in lower-rated (A2/P2) CP by US money funds from 25% to 5% of their total money market assets.

The pick-up in issues of CP this year partly reflects increased issuance of asset-backed CP, particularly by US and Japanese banks, with special vehicles often being set up for this purpose. This increases banks' balance sheet flexibility and helps to cope with capital pressures by moving assets off balance sheet.

Yen CP

The yen market was established in November 1987 and expanded rapidly to become the world's second largest domestic CP market. Important factors behind the early expansion of the market were the low fees charged by the banks and interest-rate arbitrage by large companies issuing CP to fund purchases of higher-yielding CDs and time deposits. These opportunities in part reflected restrictions on CD holdings by investment funds and regional banks, which have now been lifted.

During 1991 and 1992, however, an increased proportion of CP has been issued to raise working capital, with perhaps 30%–40% of outstanding issues now for this purpose. Since early 1991, companies' recourse to the CP market as an alternative to bank borrowing has been encouraged by CP interest rates at lower levels than the banks' short-term prime lending rate.

This trend has been bolstered by the banks' reluctance to undertake additional corporate lending because of capital and asset quality pressures. A few companies (for example, those faced with the need to refinance large expiring equity-warrant bonds) have turned to CP for bridging finance, rather than using domestic banks or the relatively underdeveloped corporate bond market.

The yen CP market may also benefit from the establishment in Japan of money-market funds for the first time in May 1992. Such funds have been active purchasers of CP in other domestic markets (for example, in the United States) and could help to generate further liquidity.

Eurocommercial paper (ECP)

The ECP market grew rapidly through the 1980s, as a successor to the underwritten euronote market. Over the last two years, the growth of the ECP market has slowed, reflecting the maturity of the market, slower economic growth and the increased attractiveness of domestic CP markets. Lower quality and unrated issuers in particular may be able to obtain funds more easily in domestic markets, where name recognition is more important than in the ratings-conscious ECP market. It may also have become cheaper to borrow directly in some domestic CP markets than to swap US dollar proceeds from ECP issues into other currencies, as some 40% of ECP issuers are estimated to have done previously, because of a decline in currency swap opportunities. The liberalisation of several domestic markets this year has also increased their attractiveness. This year, several Japanese companies have established ECP programmes carrying parent rather than bank guarantees, as Japanese banks are reported to have increased the cost of these guarantees as much as fourfold in recent years.

Deutschmark CP

The DM CP market, established in February 1991, is the newest of the major markets. Its early rapid growth continued this year, with more foreign issuers establishing programmes through domestic subsidiaries. (Since August, foreign institutions have also been allowed to issue DM CP directly.)

Nevertheless, some borrowers are not obtaining such fine terms as in 1991. This may indicate some oversupply of paper. The investor base has also remained narrowly domestic, which some market participants have ascribed to a lack of credit ratings. This contributes, together with the strong links between banks and companies, towards the continuing domination by major German banks of DM CP arranging and dealing.

DM debt still, however, has to be lead managed by a German-based credit institution.

The liberalisation measures contributed (together with uncertainty in some other European currency sectors) to a rise in euro-deutschmark issues during September and October. The United Kingdom announced a five-year DM bond issue on 20 October as part of the programme of foreign currency borrowing announced on 3 September. At DM 5.5 billion, it is by far the largest international DM bond in the market and will provide a highly liquid investment medium for international and German domestic institutions. DM 1/2 billion has been subscribed by the Bank for possible use in repo operations with market-makers to reinforce the liquidity of the bond. The bond was very well received and has traded actively since launch.

As part of a package to standardise withholding tax rates, the Italian authorities removed the exemption from withholding tax for Italian investors' holdings of new international bonds issued by state borrowers and certain supranational organisations. Supranational borrowers, who have in the past issued very aggressively priced bonds, often in smaller currency sectors such as pesetas and escudos, aimed at Italian investors, are now likely to look elsewhere for their funding.

UK markets

Sterling equity issues remained subdued

The value of new equity issues announced by UK issuers remained relatively low during the third quarter, reflecting increasingly uncertain market conditions during the already quiet summer period and the failure of a number of new issues in June and July. Two large issues in July, amounting to £760 million, accounted for nearly half of the total for the whole quarter.

Within the total, the number of rights issues was significantly lower than in the same period in 1991 (see Table C), reflecting perceptions that prospects of economic recovery had receded and the underperformance relative to the market of many companies which had made rights issues in 1991. There are also indications that institutional shareholders have been concerned at the use of funds from rights issues for balance sheet restructuring (as was often the case last year) rather than for investment.

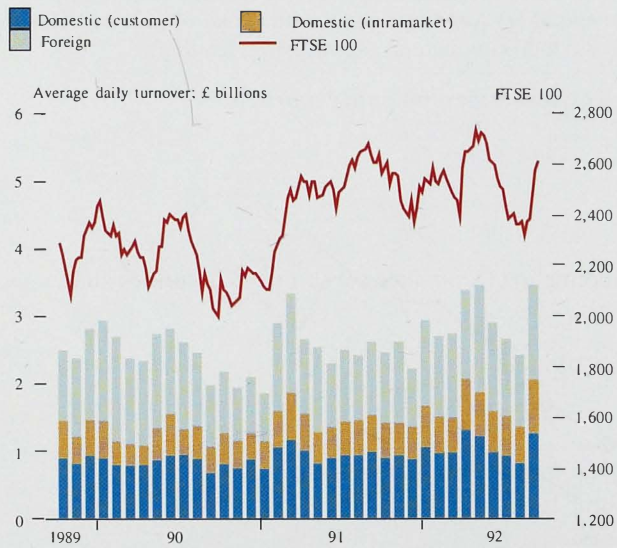
Table C
Announcement of rights issues

	Number of issues	Value £ millions
1991		
Q1	25	2,045
Q2	87	4,130
Q3	43	2,720
Q4	37	1,410
Total	**192**	**10,305**
1992		
Q1	31	1,555
Q2	33	935
Q3	17	375
of which:		
July	*10*	*300*
Aug.	*4*	*30*
Sept.	*3*	*45*

Turnover rose sharply during the ERM crisis

Daily turnover in domestic equities averaged £1.6 billion in the third quarter (Chart 8), compared with £1.8 billion in the second quarter, but reached a peak of over £4 billion on 16 September and over the following two days after sterling's suspension from the ERM. Turnover on SEAQ International averaged £1.2 billion, also lower than in the previous quarter, with a peak of £2.9 billion on 16 September.

Chart 8
Equity turnover and prices on the London Stock Exchange



Average dealing spreads on FTSE 100 stocks, which had narrowed with the increased turnover in the second quarter, widened slightly from 1.58% to 1.76%. Average spreads on less liquid stocks rose to 14.1%, compared with 12.6% in the second quarter.

Two firms withdrew from market making in a number of smaller companies, leaving many of these companies with only a single market-maker. This prompted a review of the Stock Exchange's Company Bulletin Board (an order-exposure system designed for trading of illiquid stocks for which less than two market-makers were prepared to quote prices). Renamed the Stock Exchange Alternative Trading Service (SEATS), changes are now being introduced whereby single market-makers may take on the obligation to quote continuous prices alongside the existing display of orders, in return for market-maker privileges in these stocks.

For much of the third quarter, the FTSE 100 index continued on the downward trend which began in May, reaching a low of 2,281 on 25 August. The index rose sharply after the fall in sterling on 16 September and closed the third quarter at 2,553, after a peak of 2,621 on 24 September.

Two new indices were launched on 9 October: the FTSE Mid 250, covering those 250 companies which rank in size immediately below the FTSE 100; and the FTSE Actuaries 350, which combines the FTSE 100 and the FTSE Mid 250.

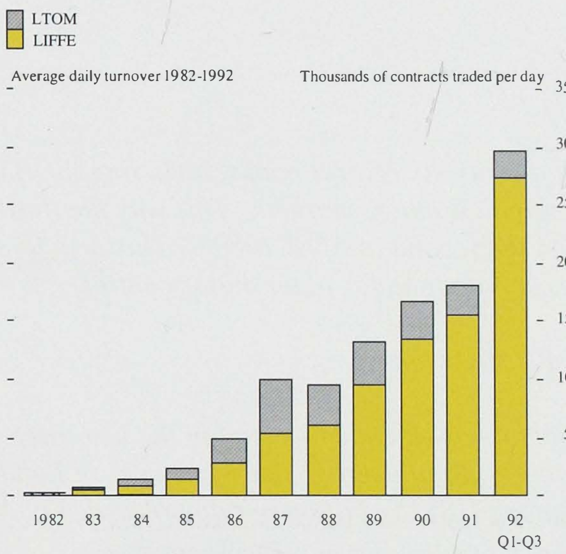
From January 1993, two versions of the FTSE Small Cap Index will also be introduced. One of these will include investment trusts, covering some 450 companies.

Daily turnover in the gilt-edged market averaged £2.8 billion in the third quarter, compared with £4.3 billion in the second quarter. The average number of bargains fell from 2,990 per day in the second quarter to 2,225.

Futures and options trading in London reached record levels

Turnover on London's futures and options exchanges reached record levels during the third quarter, 19% higher than in the previous quarter and 76% higher than a year earlier (see Chart 9). Activity was boosted by exceptional volatility in the European financial markets. On 16 September, turnover on LIFFE exceeded trading levels on the Chicago exchanges.

Chart 9
LIFFE (a)



Source: LCH.

(a) LIFFE merged with LTOM on 23 March 1992.

Regulatory and settlement developments

The Formation Committee set up by the Securities and Investments Board (SIB) to work towards the establishment of a new self-regulating organisation (SRO) for retail business published its proposals on 24 September. The new SRO will be known as the Personal Investment Authority (PIA).

The proposals were subject to consultation until 6 November. Once finalised, they will form the basis of a prospectus made available to all prospective members of the new SRO. If sufficient members endorse it, the PIA will apply formally to the SIB for recognition as an SRO. After a transitional period, the two existing SROs mainly responsible for regulation of retail investment business (LAUTRO and FIMBRA) will be wound up.

The Cadbury Committee on the financial aspects of corporate governance published its draft report on 27 May. The draft report has already prompted many companies to review their procedures and initial reactions have now been received from major institutional shareholders. The recommendations for audit and remuneration committees have been welcomed, together with the main proposals designed to strengthen the role of non-executive directors. There is also broad support for the incorporation of key features of the report into a code of best practice. The final report is expected to be published before the end of the year.

The Pension Law Review Committee under Professor Goode has issued a consultation document inviting views on a wide range of questions, including the security of pension fund assets and whether a compensation scheme to protect pension benefits should be introduced. Comments are also invited on whether the current complex regulatory regime for pensions should be simplified. The consultation period runs until 15 December.

Entry testing for TAURUS, the Stock Exchange's planned electronic equity system, began early in September for a small number of participants and the communications server which will support the TAURUS messaging network was introduced later in the month. All three releases of rules and the supporting TAURUS procedures manual, which will establish the day-to-day operating procedures of the system, have now been issued for public consultation by the Stock Exchange.