Money makes the world go round

The international capital market is the world’s largest source of new financing. Stephen Hester, of Credit Suisse First Boston, examines how housing finance institutions can use the market

The international capital market, or Euro-capital market, now represents the world’s largest source of new financing. The market originated in the early 1960s following the imposition by the US government of controls on outflows of capital from the US. The restrictions led to a transfer of dollar financing activity and expertise offshore, principally to London. Subsequently, the activity spread across borders and across currencies worldwide.

The success of the international capital market is based on its ability to meet the needs of investors, borrowers and financial intermediaries alike in more attractive and effective ways than existing domestic capital markets. The increasing level of cross-border investment and, in the 1980s, a global trend towards deregulation of financial markets have provided powerful new stimuli to growth of the international capital market.

The scale of the market can be illustrated by the annual volume of new issues of Euro-securities. This has risen from $US148 million in 1963 to $US135.7 billion last year and a much larger volume expected for 1986, demonstrating the dramatic increase in use of this market by borrowers in preference to their own domestic capital markets. The graph provides further evidence of the market’s breadth, illustrating the growth in issuance of non-dollar securities through the Euro-market system and, more recently, the remarkable increase in distribution of equity through this same channel.

Investors

The international capital market has been able to offer investors a large supply of high quality investment securities — initially interest-bearing but increasingly also equity securities and a variety of more sophisticated hybrids. It also has a delivery system tailored to the characteristics and needs of individual investors through effective use of tried and tested local distribution systems such as the branch networks of major continental banks.

In addition there has developed, for the sophisticated institutional investor and financial intermediary, a global ‘over-the-counter’ distribution system (operating by telephone) that has emphasised low-cost, fast provision of investment opportunities.

Securities that are bearer rather than registered, and free of withholding taxes, eliminate many of the complex and costly impediments that investors worldwide have found investing directly into local capital markets abroad.

The international capital market, despite the lack of formal regulation and investor protection mechanisms, has enjoyed enviable credit characteristics. The principal reason is undoubted investor conservatism that has restricted the great bulk of issues to high quality corporate, bank or sovereign investments. This contrasts with the poor experience of international commercial bank lending during recent years. Investors also enjoy a full range of instruments in each major currency. Since the advent of floating exchange rates, the critical decision in international investment has been that of currency.

Investors have therefore remained conservative judges of credit risk since investment performance is seldom determined by lowering investment quality in search of a small yield improvement.

Borrowers

High quality borrowers of all types and nationality have used this market which offers them: the greatest quantity of funds available on, generally, the most advantageous terms; an absence of costly and restrictive regulation enabling instant access to funds; in general, absence of the extensive financial covenants frequently demanded in domestic markets; great flexibility to tailor the structural characteristics of debt to fit particular financial needs; a highly innovative and responsive product delivery system.

The seeming complexity of new financing techniques which receive widespread publicity is largely illusory. Most ‘new’ structures simply represent different combinations of existing instruments and techniques previously applied in other situations and other capital markets. Clearly, at
a price, most financial combinations are possible. Nevertheless generally the optimum securities financing offers an investor a simple, easily understood credit, currency, and interest rate decision. Simultaneously, a 'private' financial structuring, frequently using currency and interest rate swaps and different forms of options, may transform the securities obligation into a form preferred by the investor.

The international capital market has traditionally been dominated by fixed and floating rate debt securities of short to medium term maturity. Lately we have seen the successful development of markets for longer-term debt instruments of 20 years to periods (US$16.1 billion in new issues in 1984 and 1985).

The full range of equity and equity-linked securities has increasingly been issued encompassing pure equity, preference shares, convertible debt and equity warrants (options). New issues in these categories have aggregated US$16.7 billion in 1986 to date up from US$5 billion in 1983. Clearly for many lesser known borrowers, these issuing opportunities are restricted. Nevertheless within the last two years the international capital markets have provided equity, convertible bonds, perpetual debt and long term debt to many financial institutions ranging from Barclays Bank, Citicorp and Nationwide Building Society to Caled, H. F. Ahmanson and the Prudential Corporation plc.

Currencies

The key benefits which a range of currency markets present are:

The ability for many borrowers to finance on terms hitherto unavailable in their own domestic currency. An excellent illustration is the £3,285 million raised by British building societies in the last 12 months through Euro-sterling bonds and floating rate notes. Finance has been raised at rates well within the cost of retail sav-

ings deposits and yet for maturities ranging from seven to 15 years. During the same period domestic corporate bond issues totalled well under £1,000 million.

The ability to exploit comparative advantages in different currency markets arising from variations in investor credit perceptions or rarity value. An example of a currency swap funds may often be raised on superior terms through foreign currency issue which is fully hedged into the domestic liability required.

Ultimately the availability of finance in other currencies will assist international expansion by housing finance institutions by effectively counteracting the entry barriers that entrenched retail deposit gathering networks have represented hitherto.

The principal interest rate alternatives are fixed interest rates or variable rates usually linked to interbank deposit rates — the so-called floating rate note. In addition, more complex structures such as deep-discount securities and instruments where capital appreciation is linked to other indices or prices (eg, oil) have been possible for select borrowers in order to exploit particular investor preferences.

The floating rate note (FRN) market in particular has opened substantial new opportunities to financial institutions. In 1986 US$55.75 billion equivalent of FRNs were issued up from US$6.7 billion in 1981. The FRN offers financial institutions for the first time the ability to manage their balance sheet assets through the acquisition of a tradable security. In turn the liquidity of the market has encouraged many other risk averse investors ranging from central banks to large corporations and managers of liquid assets who hitherto held this liquidity with the banking system. Most housing finance institutions rely for the bulk of their funding on retail deposits on which interest rates will vary and maturities are generally shorter than the assets financed. For many such institutions the FRN market now offers large quantities of low cost medium to long term funds that allow much greater stability to be built into the balance sheet.

Security

In general, as previously mentioned, the international capital market has been highly credit and name sensitive and has offered only restricted opportunities to many housing finance entities. This still remains the case. Nevertheless the larger and more liquid segments of the market have developed the sophistication to accept both high quality direct credits (such as the UK building societies) and credit substitutes, most notably secured debt obligations.

The FRN market which typically comprises the most financially sophisticated investor has been the first to accept collateralised debt. Substantial new opportunities have therefore arisen for housing finance originators whose assets are generally among the most creditworthy available to the financial system, yet who are, for reasons of size or financial strength, unable to borrow unsecured funds in this market.

In 1984-86 US$5 billion equivalent has been raised in the form of international securities secured by mortgage assets. The international capital market has not yet developed much demand for the type of mortgage-backed securities issued in the US domestic markets. Nevertheless, investors in fixed rate bond markets are likely to become more receptive to this type of offering over time.

Swaps

More than any other technique, the growth of the market in currency and interest rate swaps has revolutionised use of the international capital market.

A swap is simply the agreement of two counterparties to cover each other's payment obligations at
agreed rates for an agreed period of time. This allows a borrower great freedom to use the type of borrowing that, relative to others, will obtain his maximum comparative cost advantage. Through the use of swaps the borrower can find a counterparty to cover his liability under the borrowing in exchange for an equivalent liability conforming to his desired borrowing structure (ie, a different currency or interest rate configuration). The comparative advantage of the first borrowing provides the margin necessary to entice a counterparty offering attractive borrowing costs in exchange for a matching liability in the desired form.

The swap market has grown from $US20 billion equivalent in 1983 to $US150 billion last year. It has been estimated that 60% of all new fixed rate bond issues are now linked to swaps. Many housing finance entities make heavy use of their own domestic bond markets and the swap allows a diversification of funds to complement these traditional sources of finance. However, it is important to recognise that most housing finance entities are not well known outside their own markets, not least because their business is seldom multinational. For such borrowers international markets may be slow to offer comparative advantage and currency swaps will offer only limited sources of new funds. In particular, the swap market outside dollars is frequently imperfect and illiquid, offering only restricted supply of funds.

**Options**

As the international capital market has developed a whole range of more sophisticated financial tools have been used, frequently adapted from the US domestic market. These tools essentially represent a range of options over currency, interest rates, maturities, equity, etc. In many cases, investors are willing to pay more for an option than a borrower perceives to be his 'risk' in writing the option. The swap markets have also been able successfully to insure issuers against the exercise of such options sometimes at a low enough price to produce an attractive funding opportunity.

The simplest forms of options are investor 'put' options and borrowers' 'call' options, both regular features of many capital markets issues. The former offer investors effectively a future interest rate option for which they are prepared to pay a premium. Such premium may be attractive to a borrower who can contemplate some uncertainty on debt maturity. Options have also been successfully securitised and sold as warrants.

Equally, the US savings and loan industry has been a heavy buyer of interest rate ceilings. The demand for these allowed $US6 billion of new floating rate note issues with interest rate ceilings last year. Issuers sold the 'ceiling' privately as the proceeds more than compensated for higher rates demanded by investors in these instruments. The borrower thereby achieved a cheaper funding cost, and the ceiling buyer acquired an important new tool for managing business risk.

The international capital market has become a vital alternative and complement to traditional domestic fund raising. The importance of this alternative lies both in the additional sources and structures of finance offered and in the market practices and techniques that are fast changing domestic capital markets. No major user of capital can ignore these markets as a source of competitive finance.

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Stephen A. M. Hester is responsible for capital market coverage in the UK for Credit Suisse First Boston with particular focus on the building society sector. CSFB has been the pre-eminent lead manager in the international capital market for the past six years and has been prominent in introducing US savings associations and British building societies to different sectors of the market.